JULY/AUG 2017

Today's CPA

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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PCAOB Oversight of Broker-Dealer Auditors

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CONTENTS

VOLUME 45, NUMBER 1 **JULY/AUGUST 2017**

cover story

society features

technical articles

columns

departments

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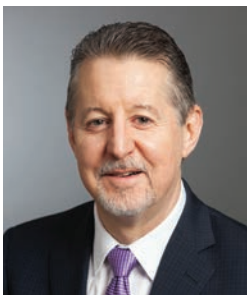
Steady As We Go

Editor's Note: In this first *Today's CPA* issue of the Society's new fiscal year, incoming TSCPA Chairman **Jim Oliver**, CPA-San Antonio, CGMA, will discuss the upcoming year.

By Jim Oliver, CPA, CGMA, 2017-2018 TSCPA Chairman

The traditional nautical command "steady as she goes" tells the helmsman to maintain a ship's current course. That's my philosophy starting as the 2017-2018 TSCPA chairman.



Outgoing Chairman **Kathy Kapka**, CPA-East Texas, CGMA, feels strongly about Society efforts to convince students to major in accounting and sit for the CPA exam. I also see this as a critical priority and plan to preserve the valuable insight that Kathy, as an educator, brought to this issue. The relative decline in new CPAs entering the profession is a trend that we must work to reverse. We need plenty of CPAs in the pipeline as baby boomers in accounting continue to retire.

In addition to expanding outreach to Texas high schools, we're considering how best to market accounting to even younger students – middle school and even elementary school. Our AICPA Chairman **Kimberly Ellison Taylor** decided in the third grade to become a CPA.

Although students majoring in accounting have been increasing, a declining percentage of graduates are sitting for the exam. I can understand how someone with an accounting degree in hand and a decent job offer may not immediately see the allure of completing the 150-hour requirement, taking another exam and becoming certified. But I also know that these new professionals are limiting their future options significantly if they don't go ahead and become CPAs early in their careers when doing so is usually so much easier. How do we make them see that while an accounting degree probably guarantees them a job, becoming a CPA pretty much guarantees them a career? We have to keep working on this.

Chairman-elect **Stephen Parker**, CPA-Houston, to whom I'll pass the torch next year, sees a link between the issues Kathy raised and the somewhat reduced support for TSCPA in recent years from some of the larger public accounting firms. As a recruiter for PricewaterhouseCoopers, he's uniquely positioned to observe how early and continued involvement with the Society is a multi-win scenario: accounting majors and graduates become more knowledgeable and allied with the profession; TSCPA grows and thrives; and firms benefit from a higher quality staff and other intangibles. As the first Big Four partner in over 15 years to serve as TSCPA chairman, Stephen can help us determine how we might mirror other states that benefit from more involvement by big firms.

To this end, during my tenure, I intend to kick off fresh efforts to reach out to these firms, to remind them that there is value in a coalition with TSCPA. The largest firms may not need us for CPE – they have their own in-house programs. But they might be overlooking other opportunities, like networking at our conferences – it's not uncommon for large national firms to sponsor association conferences for that very reason. And, by forging a stronger alliance with us, they support TSCPA lobbying efforts with the Texas Legislature and our efforts to keep the CPA pipeline flowing. Long-term objectives beyond billable hours and client development should be important to all CPAs in leadership roles concerned about the future of the profession.

> "WE NEED TO BUILD ON PAST EFFORTS AND CHART OUR FUTURE DIRECTION IN A STEADY, CONSISTENT MANNER GUIDED BY OUR STRATEGIC PLAN."

So, Kathy started a lot during her year as chairman that will proceed through my year and carry forward into Stephen's year. TSCPA needs continuity. We need to build on past efforts and chart our future direction in a steady, consistent manner guided by our strategic plan. If not, the ship risks veering off course, going in circles, even running aground. As the future brings choppy or uncharted waters, our strategic planning process will help us wisely adjust our course to navigate through them.

Meanwhile, I'm going to keep driving home the message of the value and values of our profession. TSCPA has value. The CPA certificate has value. Even how our unity and diversity work together has value. I plan to keep talking about those subjects until perhaps people tire of hearing it. I don't tire of it. I am delighted to be part of this community, a community committed to upholding the value our certificate represents. ■

Jim Oliver, CPA, CGMA is a partner with Houston-based CPA firm Calvetti Ferguson and resides in San Antonio. He can be contacted at joliver@calvettiferguson.com.

Representing Taxpayers in Sensitive Audits

A Look at the Fundamental Challenges of an Eggshell Audit

By Jason B. Freeman, JD, CPA | Column Editor

Sensitive audits present the tax practitioner with unique challenges. They require the exercise of judgment and discretion, as well as an understanding of administrative procedure and even a command of constitutional and evidentiary rules. At times, they may also require that the practitioner carefully balance duties to a client with their own ethical and legal obligations.

Sensitive audits come in several forms. An "eggshell" audit, for instance, is a civil audit that has the potential to turn criminal. There are lurking issues – potential tax fraud or evidence of other legal violations, such as money laundering or structuring – that the auditor may discover. A "reverse eggshell audit" involves a civil tax audit that is being conducted alongside a parallel criminal investigation. Sensitive audits may also involve undisclosed parallel investigations by other state or federal agencies.

Such audits often raise a host of issues. For instance, should the taxpayer file an amended return to correct prior mistakes? What about the obligation to file a current year return while the audit is ongoing? When does the taxpayer have a valid privilege against providing certain information or documents, and what steps or events might inadvertently waive that privilege? What are the signs that a taxpayer may have been referred criminally? Eggshell audits often bring these questions and others to the forefront.

Amended Returns, Current Returns and Admissions

The question of whether to file an amended return is one that frequently surfaces in the context of sensitive audits. The decision is one that should be analyzed carefully. An amended return filed after an audit or investigation has begun will not remove tax fraud that exists with respect to an original return, although in certain circumstances an amended return may be a factor that potentially militates against a criminal prosecution or helps show a lack of willfulness. An amended tax return, or any tax return for that matter, is a sworn statement filed by a taxpayer under penalty of perjury. It can therefore be used as an evidentiary admission against the taxpayer, perhaps even relieving the government of the burden to produce other (more difficult to obtain) evidence that may be necessary to successfully bring a criminal case.

What about returns that come due during an audit? A pending audit or even a criminal investigation does not excuse a failure to file a current return, even where that return would require disclosures that make it clear that a prior return that is under audit was not filed correctly. It is a crime to willfully fail to file a tax return and tax representatives have an ethical obligation under Circular 230 to advise a client of this requirement and the potential penalties for failing to do so. As a practical matter, it will often be advisable to obtain an extension of the deadline in order to buy time and to learn more about the focus of the audit.

In some circumstances, a taxpayer may need to file a so-called Fifth Amendment return, a tactic that must be approached carefully. In doing so, taxpayers cannot, for example, make a blanket Fifth Amendment claim over their entire return, but instead must assert the privilege on an item-by-item basis. A failure to properly file such a return may compound existing problems, potentially subjecting the taxpayer to "frivolous return" penalties or even criminal prosecution for willfully failing to file a return.

Parallel Proceedings and *Tweel* Violations

Sensitive audits inevitably involve the potential for parallel proceedings, which raise unique concerns. Courts have developed guidelines to police the IRS in this context, particularly when it conducts parallel civil and criminal tax investigations. Perhaps the seminal case in this arena is *United States v. Tweel*. Under that case and its progeny, simultaneous civil and criminal audits are not prohibited. Nor does the government have any outright duty to inform a taxpayer that matters arising in a civil audit could be used in a criminal investigation.

At the same time, however, the IRS may not use its civil arm to conduct or further a criminal investigation and employ "deceit, trickery or misrepresentation." That means, for instance, that an auditor cannot lie when asked if he/she has made a criminal referral or whether a parallel criminal investigation is ongoing. Violations of this rule – so-called *Tweel* violations – can lead to the suppression of evidence on Fourth Amendment grounds.

The Privilege

One of the first steps in properly handling a sensitive audit is to assess and ensure the preservation of the privilege. Does the client, for example, have information or possession of documents that could expose the client to criminal sanctions? If so, that information needs to be assessed and steps should be taken to avoid a waiver of the privilege. Taxpayers faced with an audit interview may need to consider invoking the privilege with respect to questions that would elicit incriminating responses. Where the IRS seeks documents that contain incriminating information (or where their very existence may prove incriminating), the act-of-production privilege may protect a taxpayer from being compelled to produce the documents.

At the same time, the applicability of countervailing doctrines, such as the required records doctrine or the "collective entity" doctrine, should also be analyzed. Practitioners and their clients should carefully vet the risks and benefits of asserting a privilege, as well as the proper manner for doing so.

In the process of vetting sensitive issues, such as the very existence of a privilege, practitioners should be careful to ensure that those

continued on next page

discussions themselves are privileged, lest the practitioner inadvertently convert himself/herself into a key witness against the client that can be compelled to disclose the content of those discussions. Many an accountant has been compelled to provide documents and testimony against their client because communications that they believed to be privileged were, in fact, not. For example, *United States v. Spencer*, 700 F.3d 317 (8th Cir. 2012) presents a case where the accountant-CPA was required to testify against his client at the client's criminal trial. As a matter of risk management, practitioners handling sensitive audits should have a firm grasp of the limits of the accountant-client privilege.

There are many misconceptions about the scope of the federal accountant-client privilege under Section 7525 of the Internal Revenue Code. In fact, many are not aware that the accountant-client privilege is not available where it is needed most: It does not apply in criminal proceedings. Nor, for that matter, does it apply in other proceedings outside the federal tax context – for example, divorce, SEC or even state tax proceedings. In fact, courts have held that it does not even apply to communications engaged in for the purpose of preparing a tax return, raising the question of what exactly it does protect. Against this background, care must be taken to protect communications about sensitive matters.

Despite the extremely limited scope of the federal accountant-client privilege, an accountant can often be cloaked with an actual common law attorney-client privilege through the use of a *Kovel* arrangement. Under *United States v. Kovel*, the federal case that lends its name to the arrangement, an attorney may engage an accountant to assist with the audit and thereby extend the more robust attorney-client privilege to the accountant. Where properly employed, this tool brings an accountant under the umbrella of the attorney-client privilege and protects accountant communications, helping to ensure that the accountant cannot later be compelled to testify against the client.

Beware of Potential Pitfalls

Sensitive audits often create potential pitfalls for the representative themselves. The practitioner must always take steps to ensure that they abide by both governing ethical rules and statutes. For instance, a practitioner cannot make a false representation to an IRS agent, but at the same time may be prohibited from disclosing privileged information without the client's consent. Practitioners who violate these rules (and others) risk disbarment from practice before the IRS or, worse yet, committing a federal crime themselves.

Among the more commonly encountered criminal statutes that have been turned against practitioners in this context, Section 7206(2) of the Internal Revenue Code makes it a crime to aid or assist in the presentation of a false or fraudulent document. Similarly, Section 7212, a broadly worded statute, makes it a crime to attempt to obstruct or impede the administration of the Internal Revenue laws. The government will use these provisions and others to bring criminal charges against practitioners where it believes a violation exists. Practitioners must therefore take all necessary steps to ensure that they abide by any governing rules throughout the proceedings. This requires a more concerted and proactive effort than may generally be necessary outside of the sensitive-audit context.

The Fraud Development Process Generally

When a field auditor uncovers indicators of fraud, IRS procedures require the auditor to meet with his/her group manager and, where the manager concurs, to initiate contact with a Fraud Technical Advisor (FTA). The FTA plays a central role in the development of potential fraud cases and is involved in all cases with potential criminal fraud or civil fraud penalties. If the auditor, group manager and FTA agree that there is a potential for fraud, the auditor prepares Form 11661, *Fraud Development Recommendation – Examination*, the case is placed in fraud development status and a fraud development plan is formulated.

If an auditor subsequently identifies affirmative acts of fraud, the auditor is required to suspend examination activity without disclosing the reason for the suspension. Radio silence (or an auditor's abrupt cancellation of a scheduled meeting or extended failure to respond) can thus imply a potential criminal referral.

If criminal criteria are met, the FTA will ultimately recommend a referral to the IRS Criminal Investigation Division (CI) and the auditor will refer the case through the FTA to CI via Form 2797, *Referral Report of Potential Criminal Fraud Cases*. Shortly thereafter, the CI special agent assigned to the case will initiate a conference with the auditor, his/her group manager, the supervisory special agent, and the FTA to review the evidence gathered to support the charges.

The conference will cover a number of issues that bear on CI's decision whether to accept the referral, including the amount of the additional tax due, the flagrancy of the alleged violation, any public interest in the matter and the deterrent effect that would be achieved from proceeding. Generally, within 30 days of this conference, the same group will confer again to discuss CI's decision to accept or decline the referral.

'Badges' of Fraud

In developing fraud cases, auditors look for indicators of fraud – known as "badges" of fraud – to establish fraudulent behavior. Most fraud cases involve individuals and business taxpayers with poor or nonexistent internal controls or a lack of separation of duties, but tax fraud can occur in many contexts. While by no means an exhaustive list, some of the common "badges" or indicators of fraud that the IRS looks for include the following: Omitting specific items where similar items are included; omitting entire sources of income; an inability to explain substantial increases in net worth; inadequately explaining dealings in large sums of currency; dealings in cash; failing to file a tax return, especially for a period of several years, despite evidence of substantial amounts of taxable income; claiming fictitious or substantially overstated deductions; claiming substantial business expense deductions for personal expenditures; providing false or altered documents; keeping multiple sets of books; failing to keep adequate records; the existence of false book entries or alterations, back-dated documents or false invoices; variances between the tax return and books; inclusion of income or deductions in the tax return of a related taxpayer when tax rate differences are a factor; the use of secret bank accounts; conducting business transactions in false names; making false statements; attempting to obstruct the examination; failing to make full disclosure; holding assets in the name of others; and a pattern of consistent failures to report income over multiple years. Again, this is only a partial list of the potential indicators of fraud that the IRS looks to, but where any such indicators exist, a taxpayer's risk of criminal referral may increase.

Signs of a Criminal Referral

At all times during the audit, a practitioner should remain alert to signs that the civil audit may have "gone" criminal. The signs will vary depending on the context and the nature of the case. However, there are several indicators that have traditionally been signs that a potential referral may have taken place or may be imminent. For instance, where a revenue officer copies extensive documents or requests original documents rather than copies, these may be signs that the auditor is building the basis for a referral. If the agent focuses on "intent"-based questions, such as what the taxpayer knew or why certain items were deducted, this may also be a sign.

Other signs include excessive interest or focus on sensitive transactions, efforts to obtain information from third parties that could have easily been obtained from taxpayer records, seeking to meet with the taxpayer more than once, requesting sworn affidavits from the taxpayer or third parties, conducting a large number of third-party interviews, and questions about the taxpayer's lifestyle and financial status. Of course, a visit from a CI special agent is the ultimate sign that a civil audit has turned criminal.

Navigating the Process

Sensitive audits require a unique skillset and knowledge base. To navigate the process and maximize a client's prospect for success, the practitioner must be able to identify trouble spots ahead of time and assess any applicable procedural rights, as well as formulate an adaptive strategy.

Throughout the process, the practitioner must be attuned to a host of subtle signs and clues, and be able to identify the opportunities to help steer the audit in the right direction. And, of course, along with a firm grasp of the background principles and administrative processes, the practitioner must fully understand, and always remain mindful of, their own ethical and legal obligations. ■

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The Digital Threat

By Mano Mahadeva, CPA, MBA | Column Editor

Read recent news headlines and one is easily reminded how vulnerable even the most cautious of organizations can be to cyberattacks. Even when companies invest in technologies and implement safety policies, cyberattacks can happen and they have lasting impacts on organizational security and the bottom line.

"The attack hobbled hospital customers within the British National Health System turning away ambulances and canceling surgeries." … "The internet company, being bought by Verizon, says a state-sponsored actor stole email addresses, passwords and birth dates." … "The data breach was significantly broader than originally reported – the company reported that 70 million customers had information such as name, address, phone numbers and email addresses hacked." … "Millions of health insurance customers woke up Thursday morning to an email from the company telling them hackers had gained access to its computers and that demographic information might have been stolen" … "This malicious code is capable of directly controlling electricity substation switches."

Attacks such as these are increasing in numbers even as companies invest in technologies, improve their capabilities and tighten their policies. Why? It's because more companies are stashing their valuables, such as intellectual property, customer data, financial data and other critical assets, online. And we are more open and connected now on the internet in transacting business than we have been compared to years past. These valuables have become a treasure trove for many bad actors – cybercriminals engaging in fraudulent transactions, politically charged hacktivists trying to change political outcomes and even state-sponsored hackers looking to steal critical information.

Not all of these attacks are external in type – internal attacks do occur, where some are intentional and some unintentional. I have been "spear phished" a few times – once I received a very innocent email from our CEO to wire funds to a specific company, not a large amount, where the contents looked legitimate. I called my CEO and asked him about the wire and he was quite surprised. The sender email was perfect, but when I hit "reply," I was looking at a strange looking return address! Another example is that of the Target hack, which was external in that a vendor employee fell for a malicious email where the hacker sent malware-laced emails to take over the victim's computers, and upon gaining control of a laptop via remote access, stole the retailer's payment card data.

Now think about one of your employees looking up a website of a sandwich shop that delivers food. Most likely, this sandwich shop does not have the resources to fortify its web practices and as a result, gets easily infected by malware. Your employee, who is not educated or trained about cyber issues, looks for a lunch option using the office network and gets infected. Or another employee receives an email that looks very legitimate or enticing, but contains malware and opens the email. A frequent problem is that of sharing, or using, another person's password (think Snowden) or keeping one's laptop logged on with the owner nowhere to be seen. These are examples of internal attacks, none of which were malicious, but occurred due to a lack of training and/or non-compliant behavior.

Building a fortified defense to protect a business against such attacks is not cost efficient. Complying with a security framework is nice, but not enough to fend off sophisticated hacks. Having employees merely sign off paperwork annually to say they "read and will comply" is not being compliant! Being in denial by saying that "nothing will happen" is playing the odds. And playing it "safe," is NOT a goal!

So here are some proactive measures to think about:

- comprehensive education for all on cybersecurity;
- frequent training for all employees, with a focus on office tools being used for personal use such as Facebook and Twitter;
- educating the board on the risks – some may not be aware of the dangers;
- using an outside company to complete a formal assessment of cybersecurity efforts;
- conducting periodic audits on IT security;
- assessing the security of outside vendors and customers – ask them for a pertinent date to confirm that their risk culture is similar to yours;
- very careful hiring practices that maintain robust ethics and compliance policies;
- within legal bounds, possibly monitor employee activity in specific cases;
- raising awareness; and
- making EVERYONE accountable for sound, safe and compliant practices.

No cyber system will ever be impenetrable. But one must do what should be done as the costs to remediate can crush a company. The loss of proprietary data, blackmail, regulatory costs, public relations fallout, company reputation, ransom demands, the timing of audit disclosures and associated lawsuits – all of these costs can easily outstrip what was paid in Bitcoins on the WannaCry attack. So spend the time and invest wisely by defining and deploying the right technology along with the appropriate policies and operations, which become a strategic asset of your company.

Mano Mahadeva, CPA serves on the Editorial Board for TSCPA. He can be reached at manomahadeva@gmail.com.

New AICPA Standards Aim to Take a Bite Out of Cybercrime

By C. William (Bill) Thomas, CPA, Ph.D.

Adapting to business in cyber space has been both terrific and terrifying. From automobiles to air conditioner thermostats, things are going digital. Horror stories of foreign and domestic hackers stealing identities, account numbers, information and even elections have awakened us to a whole new world of potential threats, as well as the need for taking new actions for data protection. Given the reputation of CPAs as trusted business professionals, it is logical for business to turn to us for help.

SOC for Cybersecurity

To help businesses meet the growing challenges of cyber risk, the Assurance Services Executive Committee (the Committee) of the American Institute of CPAs (AICPA) has introduced a market-driven, flexible and voluntary cybersecurity risk management reporting framework. The framework is a key component of a new System and Organization Controls (SOC) for Cybersecurity engagement, through which a CPA reports on an organization's enterprise-wide cybersecurity risk management program. This framework will enable all organizations in a wide variety of industries to take a proactive and agile approach to cybersecurity risk management and to communicate with stakeholders regarding those activities.

The framework contains roles for both financial management of the entity and the CPA practitioner. Management is responsible for preparing information about the entity's cybersecurity risk management program. This information includes a narrative description of the program that describes how the entity identifies its most sensitive information, ways in which the entity manages its cybersecurity threats and the key security policies designed to protect the entity's information assets against those threats. It also includes management's assertion about whether the description is presented in accordance with the description criteria and whether the controls within the program were effective to achieve the entity's cybersecurity objectives. The CPA practitioner is responsible for performing an attestation examination and providing a report that expresses an opinion on management's description and on the effectiveness of controls within the program.

Criteria for Describing and Evaluating Controls

The Committee has developed two distinct, but complimentary sets of criteria for use in the description and examination of the cybersecurity risk management program. Use of common criteria enhances comparability between reporting entities with regard to cybersecurity matters. The two sets of criteria include: (1) description criteria for use in management's narrative description of its program and (2) control criteria for the CPA practitioner's use in a consulting or attestation engagement.

Description criteria are a set of benchmarks for use when preparing the entity's description of its cybersecurity risk management program. The entity's program consists of the policies, processes and controls designed to protect information and systems from security events that could compromise the achievement of the entity's cybersecurity objectives, as well as how it detects, responds to, mitigates and recovers from such events. Description criteria include (1) nature of the business and operations; (2) nature of the information at risk; (3) objectives of the entity's cybersecurity risk management program; (4) factors that affect the entity's cybersecurity risk; (5) the entity's cybersecurity risk governance structure; (6) the entity's risk assessment process; (7) processes by which risks are communicated; (8) ways the entity monitors risk; and (9) the entity's cybersecurity control processes.

Control criteria are used in either consulting or attestation engagements to evaluate and report on controls over the security, availability, processing integrity, confidentiality or privacy of information and systems. AICPA has revised a set of Trust Services Criteria for this purpose that may be used by the CPA practitioner. These criteria align with the Committee of Sponsoring Organizations of the Treadway Commission's (COSO's) 2013 *Internal Control – Integrated Framework*, to better address cybersecurity risks and increase flexibility in application across an entire entity, including at a subsidiary, division or operating unit level within a function relevant to an entity's operational, reporting or compliance objectives. Organizations may also use other criteria, as long as they are appropriate for the engagement.

Attestation Guide Coming Soon

The Committee is developing an attestation guide, *Reporting on an Entity's Cybersecurity Risk Management Program and Controls*, expected later this year. In addition to providing guidance in performing attestation engagements, this guide may be helpful to CPAs engaged to provide cybersecurity advisory services to an organization that may help them improve their cybersecurity risk management programs. In addition, use of the description criteria and control criteria may assist management of various entities in establishing a common approach and language to use when communicating with their boards and other stakeholders about the entity's cybersecurity risk management efforts. To read further, consult https://www.aicpa.org/InterestAreas/FRC/AssuranceAdvisoryServices/Pages/AICPACybersecurityInitiative.aspx. ■

C. William Thomas, CPA, Ph.D. is the J.E. Bush professor of accounting in the Hankamer School of Business at Baylor University in Waco. Thomas can be reached at Bill_Thomas@baylor.edu.

Top Five Technology Mistakes

By Val Steed, CPA, MA, CITP

I've been using accounting technology and other forms of technology for more than 30 years, both in my business and personal life. I've taught countless classes on the business benefits of using technology, but I've also seen all kinds of mistakes that users make. I've compiled a list of the top five technology mistakes I see on a regular basis and how you can protect yourself from making them.

Out-of-Date Antivirus and Antispyware

I can't tell you how many times people tell me they're unsure or have no idea which antivirus or antispyware they're currently using – if any at all. Many users run out-of-date software or let their licenses expire because they forget to update. Some even say they are too busy working on a project to allow the update to happen. This is extremely dangerous.

Every computer should run antivirus and antispyware software at all times. You should check and update your software daily and allow it to scan for malware at least as often, to ensure that you're protecting your system and your information. Many top products will have multiple updates per day, so you need to make sure to adjust your settings and allow your software to update and scan daily.

Identifying if You're at Risk

Daily scans can also help identify whether your system has been compromised. If your system does not allow an update for your anti-virus, it could be an indicator that there's a problem. The number one hint that you have a problem is when your antivirus software will not update. If you notice your antivirus will not update, you need to get help immediately and shut down that system.

Know Your Software

Get familiar with the software you're running. Learn what the update, scan and diagnostics screens look like and how to read them so you can pick off spyware scams before they install a virus on your machine. This includes Mac users not running antivirus software.

Ask any Mac user and you will probably hear some comment about how secure the Apple OS is compared to Windows. While I generally agree, there are a few things to keep in mind. Although Apple is not as big of a target as Windows, they still have vulnerabilities.

Almost all Mac users will begrudgingly tell you they are not running any anti-virus software. This is a big mistake. Many Mac users handle Windows files on a regular basis, without knowing – or caring – whether these files are infected, because a PC virus won't harm a Mac. Although the individual Mac isn't affected, they can become a carrier of Windows viruses in their environment.

I recommend fixing this issue by installing one of two, free antivirus solutions for Mac:

- www.sophos.com
- www.avast.com

Mac users reading this will find that these two products run very well and will not muck up their machine. Many Mac users actually report finding multiple Windows trojans and viruses during their first scan after installing these antivirus solutions. Dear Mac folks, please trust me on this one. I am an Apple person myself.

Allowing Unwanted Location Services to Track You

When you allow technology to track your location, you are proclaiming your location to the world. This is most common with social media, like Facebook or Instagram. Even text messages can be tracked to GPS origins if you do not turn that feature off on your mobile device.

You may think you're only sharing with your own contacts or friends, but many times when those friends "like" or "share" your original post, it broadcasts to a wider network of people. This means people you don't know suddenly know if you're on vacation or away from your home, opening yourself up to potential risk.

Be extremely careful with location services. Make sure you monitor and choose exactly which applications will be allowed to use location and which ones will not.

Table 1: Return on Investment

Return on Investment for	Results
One Year:	106%
Two Years:	212%
Three Years:	319%
Four Years:	425%
Five Years:	531%

Poor Password Management

Poor password management may be the most common account technology mistake that I see. And a lot of it stems from needing to remember so many passwords.

Here are a few examples of poor password management:

- Using the same password on multiple sites
- Using weak or common word passwords
- Using obvious passwords like family or pet names

Probably the best advice is to look to a password manager, such as Password Depot, RoboForm or the like. These will help you keep your passwords secure and allow you to differentiate your passwords across all your log-ins.

Ignoring Software Updates

Many software updates fix known vulnerabilities in the existing software. Simply updating your software can go a long way in keeping your information secure. This is most critical with Windows, but most applications become more vulnerable to attack when not updated on a regular basis.

I often hear "tech experts" claim that it is best to turn off Windows and Office updates. Unless you've been specifically instructed by your IT department, I don't recommend this. There are some cases where an update can cause problems with corporate applications and the IT department may have other protective measures in place for your company, but as a general rule, always check with your IT department before ignoring software updates.

For the rest of us, it's in our best interest to keep the updates flowing for Windows, Office and other applications. There are times when I will manually control QuickBooks, Adobe products and tax software updates, but I make sure to update QuickBooks and Adobe products at least once a month and tax software at least once a week.

Lack of Professional Training

Proper training on solutions and software that you use every day will make your job easier and more productive. Obviously, this may seem a little self-serving because we sell training, but I've seen the difference between a professionally trained user and someone who has used Google to "self-train." That's not a knock on Google. It is a fantastic resource for many things, but to ensure that you're not selling yourself short, I recommend seeking professional training for accounting technology. Following is an example of why I do.

Let's say you attend a full-day class on Excel. This class gives you skills to save you five minutes of work per day. With an annual salary of $70,000, working 208 days per year, the ROI for a $350 out-of-pocket class is shown in Table 1.

This is just a very small example of the power of professional training. Clearly, in the bigger picture it's worth the investment to ensure you have the knowledge and skills to help you succeed. This training can be anything from how to use Excel to the top five technology mistakes to avoid. ■

Val Steed, CPA, MA, CITP is the CEO of K2 Enterprises, a national technology training and consulting organization. He has 12 years experience in public practice and has been involved with the accounting technology industry for more than 30 years.

Now or Never

Texarkana CPA Determined to Do What it Takes

"The only people who achieve much are those who want knowledge so badly that they seek it while the conditions are still unfavorable. Favorable conditions never come." — C.S. Lewis

By Anne McDonald Davis

Nikki Laing, CPA-Texarkana, saw this quote by the Irish writer posted on professor Henry Wood's office door when she tackled college as a working mother. "I typed that up and framed it," she nods.

Lewis' long ago words sum up the kind of mindset it must have taken for Laing to travel each week, young son in tow, to Waco from Texarkana, returning on weekends to work in the family restaurant.


Nikki Laing, CPA-Texarkana

She chuckles: "I was in classes with these super-smart kids who would try and explain why oh why they weren't able to get their homework done. Really?! For me, staying up late finishing a homework assignment was less grueling than, say, staying up all night taking care of a sick child. I feel that once you've faced the challenges of parenting a small child, you can do practically anything."

Laing got her homework done. When she sat for the CPA exam, she not only passed first time around, her score was among the top 10 out of almost 900 candidates.

"I attribute that to the phenomenal Baylor accounting program," she credits modestly. "They make sure students are prepared for the exam. You don't even realize they're doing it because they don't teach to the exam. They're simply passionate about teaching everything."

Starting Out

Laing grew up in east Texas where she met her husband of two-plus decades, Keith. The couple married young. She says, laughing, "I don't necessarily recommend it ... but you never know."

The couple soon relocated to the border city of Texarkana to take advantage of the opportunity to buy into a restaurant franchise. "I was 22 years old," she recalls. "We'd been employed in the restaurant world; that planted the seed that we could work hard and do this. I've always been very interested in business, always had an entrepreneurial streak, always had my nose in some kind of book like Robert Kiyosaki's *Rich Dad Poor Dad*."

Though the couple was successful, they soon realized their bookkeeping system left much to be desired. Enter Mary Thomas Matthews, CPA, who had just wrapped up her term as the first female president of the Arkansas Society of CPAs. She taught Laing how to properly set up books and keep track of profits. Thus, another seed was planted.


Keith, Bryceson and Nikki Laing


Nikki, Bryceson and Keith Laing

"We were young and lacked much formal education," Laing admits. "So, with my husband's blessing, I took my young son with me to Waco to finish earning my business degree at Baylor University. I'd planned to major in economics and go on to law school. But then I took some basic accounting classes … and fell in love."

Advancements in computers and software made it much easier for Laing to study in central Texas while her husband continued to run the business in Texarkana. She settled on tax as her field of choice, which encouraged her to pursue at least part of the original plan: law school.

She counts back: "It took six years to do both. I would go to Baylor Law School for six months, come home to Texarkana during tax season and work at a law firm, and then be home during the summer. My son, Bryceson, is 18 now and headed to college himself. I've hammered into his head that mine was not the easiest route. He knows what it's like to be dragged around the state with his mom. One college he was considering has a top notch LL.M. (Master of Laws) program, and I horrified him by saying I was thinking of tagging along and earning my LL.M in taxation while he works on his engineering degree. I was kidding … but you should have seen his face."

Advice for Kindred Souls

Regardless of her maternal guidance, Laing has some encouraging words for older students about "doing it backwards." She reassures: "For nontraditional students thinking about going to college, I want you to know that life experience will give you an advantage. Whatever work you've been doing, it will help you grasp accounting concepts more easily. And be sure to get your certification. Why go through all that and not sit for the exam?"

Laing also advises CPAs of all ages to get involved in their professional community. Last year, she served as president of the Texarkana Chapter … although she unexpectedly had to curtail some of her planned activities and travel. The severe weather that hit the area in May 2016 destroyed their family home.

Laing is stoic: "We were in the bathroom in the center of the house; had our dogs in there with us. Thank goodness we were not hurt, but we were suddenly homeless! The day after the storm, Bryceson had to take his advanced placement tests; all of his final exams followed. It was also just a few days before my term as president of the CPA chapter began. Fortunately, there was a lot of advance preparation, with meetings set and so forth. I still served, but didn't get to do everything I wanted. But I did the best I could under the circumstances."

Among the advances that Laing cites for her chapter is becoming an approved CPE provider. Members, who include both Texas and Arkansas CPAs, now receive CPE credit for attending certain chapter meetings. "We offer all-day courses as well," she explains. "But this enables us to provide both fellowship and education at some regular meetings."

Currently on leave from her law firm while she puts her life back together and is once again able to give her clients proper focus, Laing expresses faith in the principles of Proverbs 31. She reflects: "The idea that youth and beauty are fleeting, that a woman's character and achievements matter more, that loving her family matters more, I hope I've been that kind of wife and mother." ■

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Crafting a Killer Value Proposition Statement

Being able to concisely explain the ingredients of a company's success – the customer, the problem, the product, the service – can lead to focused growth.

By Mark S. Brooks

Think of an organization that has a stellar reputation for elegantly solving customer problems. Now think of one that struggles to solve customer problems. The former tends to grow and satisfy markets. The latter usually doesn't survive long.

One major difference between the two is often the strength of their value propositions. A value proposition is a statement about the value that your product, service or innovation provides to a target customer. The concept has existed since the dawn of commerce, but the term value proposition really came into vogue in the late 1980s. Properly adopted, the value proposition can be a great catalyst for customer-focused innovation.

In concrete terms, a value proposition describes the problem your offering will solve, generally how it will solve it, why your target customer should use it and why it is distinct from alternative options. It should be constructed in a way that convinces a target audience to take action with your offering.

Operating with a strong value proposition can significantly enhance your ability to capture market share and growth while maintaining laser focus as a business. Conversely, the absence of a value proposition could increase the likelihood of a mismatch between your offering and your target audience, thus veering you off course.

Constructing a strong value proposition can be hard, especially when fast-moving market forces threaten to erode the efficacy and relevancy of your value proposition. Therefore, two fundamental questions arise: What components must be considered for a value proposition? And how might one create a strong value proposition?

Components of a Strong Value Proposition

A strong value proposition can be summed up in an acronym: TRUE. Your value proposition must be *true* for it to work.

Testable. The problem you are solving must be testable. First-hand observations, surveys, focus groups or personal experiences with the problem make it testable. These empirical data help you to better understand the nuances of the problem and the potential value of solving it.

Your offering must also be testable. For example, if your offering saves time or money, you must be able to demonstrate this to be true. Testing your solution does not stop with just proving it works. As customers use your offering, you must continuously test for its validity, relevancy, affordability and general satisfaction of the customer. Is it actually solving their problem? These data points give you important intelligence to help further refine your offering and tighten the value proposition.

Take Thumbtack, for example. Thumbtack is a company that connects consumers with local, qualified service providers. The founders of Thumbtack noticed a big problem: For busy working professionals and parents, the effort and time to find, vet and schedule professional service providers, such as plumbers, painters or even belly dancers can be frustrating and time-consuming. The problem is testable and observable by anyone who has ever scheduled those services. Moreover, Thumbtack conducted surveys and focus groups to better understand consumers' specific pain

points.

Thumbtack's solution is to be the intermediary between providers and consumers. It demonstrates this by facilitating price quotes, scheduling and communications between consumers in need of painting, repair work, etc., and local providers of the services. This is testable by measuring the response rates and general satisfaction of both consumers and providers.

Real. The problem that your offering addresses must be real. While it's nice to solve a problem for one customer, your business's growth is likely anchored to solving problems for many customers. Consider the size of the problem you seek to solve, the number of potential customers and whether the customer considers the problem significant enough to warrant a fix.

Your offering must also be real. It must actually do something to address the customer's problem. It must be accessible to them, solve an actual problem, make a particular task easier or more convenient, or generally make their lives better.

For example, modern-day firefighters deal with high-intensity heat for extended periods during fire and rescue calls. They need apparel that allows full mobility while providing exceptional thermal protection and durability. The problem is real as it is experienced by a large global market of firefighting professionals. It is also significant in that firefighters are trained to help those in need while also protecting themselves from danger.

In response, DuPont developed several pieces of wearable gear that protect firefighters from the dangers of high-intensity fires. DuPont's offering is demonstrably real as it actually helps make firefighters' jobs easier and safer.

Unique. Your offering should be distinct and unique from alternative solutions. It should provide a unique experience or be more accessible, cheaper, faster, better, etc., than alternatives. One or more unique characteristics of your offering will help establish and sustain a competitive advantage and potentially make your offering more attractive to potential customers.

For example, Tesla Inc. offers a portfolio of all-electric vehicles. Tesla cars provide a unique driving and ownership experience compared to other electric, hybrid or gasoline-powered cars. They generally have a long range by electric vehicle standards, are considered by some to be more stylish than competitors' offerings and have inspired legions of Tesla followers,

continued on next page

resulting in a unique culture among owners. Additionally, Tesla cars are equipped with sophisticated hardware whose performance characteristics are continuously modified through automatic software updates. Although the vehicles are not priced cheaper, each characteristic makes for a unique experience compared to Tesla's competition.

Essential. Finally, your offering must be essential in the eyes of a target customer. To be essential, your offering should be so clear and obvious that buying it is compelling, urgent, time-sensitive and generally the path of least resistance for the target customer.

Parents of newborn babies, for instance, are thrust into a frequent and continuous cycle of diaper changes. In the interest of cleanliness, hygiene and cuddliness, diapers are a simple necessity. For most parents, buying either cloth or disposable ones is compelling, time-sensitive and the path of least resistance for dealing with babies' surprises.

Editor's Note: This article first appeared in *CGMA Magazine*. For more articles, sign up for the weekly email update from *CGMA Magazine* at http://bit.ly/UZ07NC.

Mark S. Brooks is the senior manager of innovation at the Association of International Certified Professional Accountants, where he is focused on strategic innovation, thought leadership, growth of the profession and member value.

Renewing Your Membership

If you haven't already renewed your TSCPA membership, now is the time! TSCPA dues notices were sent out and paper statements were sent to members who had not yet renewed their dues by the end of May. You can access and update your records and pay your dues online at tscpa.org; don't forget to consider our affiliate contributions, if applicable.

If you have a question regarding your member dues, please contact Member Services at 800-428-0272, option 1. TSCPA looks forward to continuing to serve you in the 2017-2018 year.

TSCPA Recognizes 2017 Rising Stars

TSCPA congratulates the 2017 Rising Stars honorees. The 24 honorees were selected by a TSCPA task force based on their contributions to the accounting profession and their communities.

The 2017 Rising Stars will be featured in the September/October 2017 issue of *Today's CPA*. The CPAs include: Sara Averett, Fort Worth; Jacob Briggs, Fort Worth; Sarah Caldwell, Fort Worth; Steven Cannon, San Antonio; Rachel Day, East Texas; Sarah Elliott, Austin; Kristin Ferguson, Southeast Texas; Daniel Gomez, El Paso; Justin Lauderdale, Fort Worth; Elena Levario, Permian Basin; Misty Mata, Corpus Christi; Stephanie McCasland, Houston; Stephanie Morgan, East Texas; Jeremy Myers, Austin; Carrie Reese, Dallas; Edgar Rosillo, Dallas; Michael Shimanek, Dallas; Kellie Shipley, Corpus Christi; Travis Skinner, Central Texas; Tyler Smith, El Paso; Su Wah, Houston; Brandon Wenzel, San Antonio; Joshua Willson, Fort Worth; Karen Zhu, San Antonio.

Accountants Confidential Assistance Network

The Accountants Confidential Assistance Network (ACAN) is a peer assistance program that supports Texas CPAs, CPA candidates and/or accounting students who are addressing alcohol, chemical dependency and/or mental health issues. ACAN provides a confidential phone line at **1-866-766-ACAN** to help people who need assistance. You can also contact TSCPA's Craig Nauta at cnauta@tscpa.net.

To learn more about the program, please go to the Advocacy section of TSCPA's website at tscpa.org and click on Accountants Confidential Assistance Network (ACAN).

Disciplinary Actions

The following people have had their membership in TSCPA **suspended** by the Executive Board for a period of three years for non-compliance with TSCPA Bylaws Article III, Section (4A) for non-compliance with the Texas State Board of Public Accountancy's (TSBPA's) continuing professional education requirements.

- Marcus B. Gohlke, CPA, Pearland
- Michael Z. Rhyne, CPA, Houston
- Brian Rickmers, CPA, Cypress
- Charles D. Wright, CPA, Katy

The following people have had their membership in TSCPA **expelled** by the Executive Board under TSCPA Bylaws Article III, Section (4B). This action was a result of the revocation of their CPA certificate by TSBPA.

- Scott A. Blackston, Richardson
- Marshall K. Loftin, Crosby
- Martha E. Voigt, Dallas

Admonished – Michael R. Leathers, Baytown, entered into a settlement agreement effective May 23, 2017, under the Joint Ethics Enforcement Program in lieu of further investigation and proceedings of alleged violations of the codes of professional conduct of the Texas Society of CPAs and the American Institute of CPAs. Without admitting or denying any wrongdoing, Leathers is hereby admonished by TSCPA and AICPA.

Admonished – William M. Schuh Jr., San Antonio, entered into a settlement agreement effective March 17, 2017, under the Joint Ethics Enforcement Program in lieu of further investigation and proceedings of alleged violations of the codes of professional conduct of the Texas Society of CPAs and the American Institute of CPAs. Without admitting or denying any wrongdoing, Schuh is hereby admonished by TSCPA and AICPA.

After a brief visit, Rep. Mike Conaway (R-11) treated TSCPA members to the amazing view from his office balcony. Left to right: Jim Smith, CPA-Dallas; Ken Sibley, CPA-Dallas; Rep. Mike Conaway; Allyson Baumeister, CPA-Fort Worth; Lei Testa, CPA-Fort Worth; and Mark Lee, CPA-Houston.

TSCPA representatives attended the AICPA Council meeting of members. Left to right: Christi Mondrik, CPA-Austin; Lei Testa, CPA-Fort Worth; Allyson Baumeister, CPA-Fort Worth; Kathy Kapka, CPA-East Texas; and Lisa Ong, CPA-Dallas.

TSCPA's Successful Advocacy Efforts in Washington, D.C.

In May, TSCPA representatives participated in the AICPA Spring Council meeting of members in Washington, D.C., and then embarked on Capitol Hill visits to share the accounting profession's concerns with lawmakers.

During the visits, they enlisted support for Senate and House bills of the Mobile Workforce State Income Tax Simplification Act of 2017 (S. 540/H.R. 1393). This legislation would create a uniform national standard and limited state or local taxation of the compensation of employees who perform duties in more than one state or locality for more than 30 days during the calendar year. In June, the U.S. House of Representatives passed H.R. 1393, which had the active backing of several Texas U.S. House representatives.

The CPAs also asked for House members' support for H. Con. Res. 8. This bill calls for the comptroller general to give a presentation to a joint session of Congress on the Government Accountability Office's audited financial statement of the accounts and associated activities of the federal government, together with an analysis of its financial position and condition. Other topics they discussed included specific recommendations for improving IRS structure and service, as well as the accounting profession's contributions to the tax reform debate and how it can serve as a resource for future discussions.

While in Washington, D.C., **Jim Smith**, CPA-Dallas, TSCPA Chairman **Jim Oliver**, CPA-San Antonio, and TSCPA Federal Tax Policy Committee Chair **Christi Mondrik**, JD, CPA-Austin, met with **Rostylslav Shiller** and **Michael Baillif** with the IRS Taxpayer Advocate Service (TAS) to discuss issues raised in recent TSCPA Federal Tax Policy Committee letters to the IRS. Their focus was primarily on IRS appeals and the "Future State" initiative. They expressed to Shiller and Baillif that the committee shares National Taxpayer Advocate **Nina Olson's** concerns regarding IRS funding, the funding of the Taxpayer Advocate's Office and the focus of that funding on carrying out customer service objectives as set forth in the *Taxpayer Bill of Rights*. ■

Online Database Provides Free Access to Audit Research

The online Audit Research Summary (ARS) Database contains executive summaries of approximately 700 academic auditing research studies that have been published in leading peer-reviewed academic journals since 2005. The Auditing Section of the American Accounting Association developed and maintains the database. The summaries are written for quick and easy reading.

This free database is organized topically, keyword searchable and frequently updated with new summaries of academic auditing research. To access it, please go to the website at http://commons.aaahq.org/groups/e5075f0eec/summary. ■

Submit an Article to *Today's CPA* Magazine

Would you like to see your name in print? The editors of *Today's CPA* are seeking article submissions for the magazine. *Today's CPA* is a peer-reviewed publication with an editorial board consisting of highly respected CPA practitioners.

The publication features articles and columns that focus on issues, trends and developments affecting CPAs in all facets of business. If you would like to submit an article for consideration or to learn more, please contact managing editor DeLynn Deakins at ddeakins@tscpa.net or technical editor Brinn Serbanic at Brinn_Serbanic@baylor.edu. ■

Still Waiting for an Ending

By John Sharbaugh, CAE | TSCPA Managing Director, Governmental Affairs

Normally by this issue of Capitol Interest, we are able to give you a final account of what happened in the Texas Legislature. The regular legislative session ended on Memorial Day (May 29). But "normal" is not a word that defines the 2017 legislative session. And while the regular session is now over, Gov. Greg Abbott has called a special session to start on July 18. A special session runs for 30 days and the governor can always call additional special sessions if he so desires. So until the Legislature goes home for good, there is always an opportunity for additional laws to be passed. Until that happens, here is a review of some of the things that took place during the regular session and some insight into the call for a special session.

Some Nice Wins for CPAs and the Public

TSCPA-supported legislation that would require state and local governments to comply with GAAP, and would repeal Texas Code Section 2266, was approved by the Legislature in the final days of the session and was signed by the governor. It will become effective on Sept. 1, 2017. Our sincere thanks to Sen. Charles Perry, CPA, (R-Lubbock) and Rep. John Frullo, CPA, (R-Lubbock) who sponsored the legislation and helped shepherd it through the legislative process.

This is a nice win for TSCPA and our members, but more importantly this is a big win for the public. We now rejoin the rest of the country in requiring state and local governments in Texas to follow GAAP in all of their financial reporting. Having transparency in the financial reporting process is important for the public so they can understand the true cost of government and the size of future liabilities. GAAP compliance is critical to that goal.

Our other success this session was in seeing passage of a bill to provide a de Minimis exemption from the insurance services tax for licensed CPA firms. This legislation was also signed by the governor and will become effective on Jan. 1, 2018. Perry and Frullo were also the sponsors on this legislation and again deserve our thanks.

This issue was brought to our attention after a CPA firm was audited by the comptroller's office and advised that they had provided insurance services that were taxable. The firm involved thought they were providing traditional accounting services, which are not taxable. After many meetings with the Texas comptroller's office, we were able to work out a limited exemption for licensed CPA firms in Texas that realize less than 1 percent of their total firm revenue in a year from providing taxable insurance services as defined by the comptroller.

The comptroller was willing to support this type of proposal and issued a no significant revenue impact statement on the legislation. That was critical, as any bill that was classified as having a significant revenue impact was going to be DOA in the Legislature, especially this year when the state was facing severe fiscal challenges. So the legislation that was eventually passed will provide relief for those CPAs who do a very limited amount of this type of work or who unknowingly stray into providing insurance services thinking they were offering traditional accounting services.

The 2017 Session by the Numbers

The success that TSCPA enjoyed on our 2017 legislative agenda is looking even better in light of the final statistics for the regular session of the Legislature. According to the *Texas Legislature Online*, the 85th session saw 6,631 House and Senate bills filed and only 1211 passed. So that's an 18.2 percent pass rate. We are very happy that our two bills were among that 18 percent. This is actually a downward trend from the legislative session two years ago. In 2015, fewer House and Senate bills were introduced – 6,276, but more were passed – 1,323, for a pass rate of 21 percent.

The Budget Controversy That Wasn't

While many felt that the budget was going to be the big controversy in this legislative session and possibly lead to the need for a special session to get agreement, in the end it didn't happen. Instead, after several weeks of negotiations in a conference committee comprised of House and Senate members, they emerged with a compromise budget that encompassed ideas from both chambers.

Perhaps the biggest point of contention going into the conference committee negotiations was the differences between the two chambers on how to raise some of the needed revenue to support the budget. The House was in favor of tapping the state's Rainy Day Fund for $2.5 billion, which the Senate vehemently opposed. The Senate wanted to delay sales tax payments to the highway fund to pick up a similar amount ($2.5 billion), which the House called an "Enron" accounting gimmick.

In the end, what the conference committee proposed was a combination of the two. The final approved budget will tap the Rainy Day Fund for $990 million and pick up $1.9 billion by delaying sales tax payments to the highway fund.

Going into conference, the House was proposing a budget of $218.1 billion and the Senate $217.7, and what was approved was less than both of those offers. The final budget is slightly higher than the current budget ($216.7 billion versus $216.4) and is less in general revenue funding than the current budget ($106.7 billion versus $108.1).

The budget for 2018-19 spends slightly more than the current two-year budget, but after factoring in inflation and population growth, it translates to a 7.6 percent cut compared to current spending levels, according to the Legislative Budget Board (LBB). You can get all the details on the final budget by going to the LBB website here: http://www.lbb.state.tx.us/.

The Special Session and Sunset Shenanigans

If we ever needed a reminder of how important the sunset process is to regulated professionals like CPAs, we got a dramatic example in what happened this session to the Texas Medical Board and several other state agencies. This reinforces the seriousness of our mission for the 2019 legislative session, when the Texas Public Accountancy Act and Texas State Board of Public Accountancy (TSBPA) will be up for renewal under the sunset process.

When an agency (like TSBPA or the Texas Medical Board) goes through the sunset review process, they must get legislation passed that extends their "life." Otherwise, they will no longer exist. Each agency has its own authorizing statute. In the case of CPAs, it's the Texas Public Accountancy Act – Chapter 901 of the Texas Occupations Code. So this year, the agencies that were going through the sunset review process (including the Texas Medical Board) were all working to seek the passage of legislation that would "reauthorize" them and continue the existence of their "practice acts."

In addition to the individual bills applying to each agency going through sunset, the Legislature will traditionally sponsor and pass a "safety net" sunset bill to assure the continued life of the affected state agencies in the event their individual reauthorizing legislation does not get passed during the session. This year, the safety net sunset bill was sponsored in the House, by agreement with the Senate. The problem was the House did not pass the legislation by the deadline under the House rules. Speaker Joe Straus then made an appeal to Lt. Gov. Dan Patrick to have the Senate pass the bill, but Patrick countered with a request to have the House pass bills on bathroom privacy and property tax reform he wanted in return. That did not happen and the session ended without legislation being passed on any of these issues.

Without action by the Legislature, the agencies without regulations (including the Texas Medical Board) would enter a one-year "wind-down" period after Sept. 1, 2017, in which they would begin the process of shutting down completely. This would leave the state without an agency whose job it is to police doctors who practice in the state. Anybody, anywhere in Texas could call themselves a doctor. There would be no statute that says you have to do anything to be a doctor and there would be no process for handling complaints against doctors.

> "PASSING LEGISLATION IS NOT EASY, EVEN ON ISSUES THAT ARE NON-CONTROVERSIAL AND DO NOT HAVE MAJOR OPPOSITION. THERE IS NEVER A GUARANTEE THAT YOUR BILL WILL MAKE IT THROUGH THE LEGISLATIVE PROCESS."

This is what led to the need for Abbott to call a special session. When he issued the call, he said that the first issue of business is for the Legislature to pass a "sunset" bill. Once that is accomplished, he also provided a list of 19 other issues for the Legislature to consider during the special session. Among other things, that list includes the bathroom privacy and property tax reform matters Patrick would like to see passed. You can read the entire agenda for the special session by going to the governor's website here:

https://gov.texas.gov/news/post/governor-abbott-announces-special-session.

We will be back in a future issue of Capitol Interest with the final analysis of the 2017 Legislature when they finally stop meeting and go home for good.

Thanks to Our Advocacy Volunteers

Passing legislation is not easy, even on issues that are non-controversial and do not have major opposition. There is never a guarantee that your bill will make it through the legislative process. To have a chance, you need to be organized and have a good legislative team to support you.

I want to thank all the folks who were involved in our efforts this session who helped us reach success, especially all of our legislative key persons and PAC contributors. Their involvement made a big difference and we sincerely appreciate what they do to help advocate for the CPA profession and TSCPA. ■

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The Impending Death of Hospitals: How to Help Your Clients Survive

By Mark F. Weiss, JD

Major trends are changing the health care industry, trends that will shake the anticipated future of the government-health care complex to its core, trends that will impact your health care clients' businesses and, perhaps, your own.

As any Texas CPA with health care industry clients will attest, the business of health care has become increasingly "hospital-centric:" organized around hospitals and their associated health care systems. But at the same time, due to the convergence of the major trends that we'll address, those same hospitals, at least as we know them today, are dying or dead; they just don't know it yet.

Some will mourn their death. Some are afraid of a future without them. Others see tremendous opportunities and profit, both on the facility and provider sides: The services and patient care that hospitals and their aligned physicians once provided are being distributed to a wide range of outpatient facilities and provider practices. Others are being dematerialized as patients-as-consumers take, and demand, more control and involvement, thus opening lines to new ways for professionals to provide value.

Hospitals will shrink or close. Independent outpatient facilities will predominate.

How will your clients fare in this new world? How will you?

No Crystal Ball Needed

Although we sometimes like to feign that we have a crystal ball, this view of the future is open to all to see if you pay attention to the signs. For example, Mount Sinai Health System, based in New York City, has announced its plan to close its 865-bed Mount Sinai Beth Israel hospital and sell the property upon which it's located. Up to 700 employees will lose their jobs. The size of the replacement facility to be located elsewhere in the community? *70 beds.*

On the following pages, we're going to review some of the trends currently impacting, and soon to impact, hospitals that, I predict, will lead to their destruction, at least as we know them. There is absolutely no question that these trends are going to have an impact on your clients' facilities, medical practices and health care businesses. They must start preparing now.

Trend 1: Hospitals are Getting Bigger and That is a Weakness

Government induces physician labor. The Affordable Care Act favors the growth of hospitals with its incentives for aligning physicians. Think ACOs and other incentives to coordinate care, meaning coordination via hospitals.

Although reports lag by several years, at least 20 percent to 30 percent of all practicing physicians are currently employed by hospitals. There was a 34 percent increase in hospital employment of physicians between 2000 and 2010.

In addition, an uncertain number of physicians, very likely a significant number of them, are controlled by hospitals through alignment relationships such as accountable care organizations (ACOs) and foundation model medical groups.

Hospital merger mania. As hospitals gobbled up physician practices, hospitals began gobbling each other up as well. In 2013, there were 105 hospital mergers. In 2014, there were a few less, approximately 100. Overall, since 2010, there has been a 44 percent increase in the pace of hospital mergers.

Hospitals merge because they think that there's strength in a larger entity. In other words, they believe that it brings so-called economies of scale. If that means that two hospitals merge and become one, and then one facility closes down, perhaps that's the case. But that's not the general trend. Instead, mergers are often used to build bigger hospital systems in which there are little to no economies of scale. It's often the case that when large entities merge, administrative costs go up.

In the 1990s, there was a similar wave of hospital mergers. Most merged hospitals failed. The same argument about economies of scale was made then: that merging would cut costs, but it didn't turn out to be true.

Hospitals are losing the economic bet on employed physicians. A 2014 study by the Kentucky hospital industry revealed that the cost to hospitals of employing physicians is increasing. A majority of hospitals reported increasing losses per physician; on average, more than $100,000 per employee and, for some specialists, more than $200,000 per employee. The larger the hospital and the larger the hospital system, the larger the losses.

Hospitals are losing the bet on integrated delivery networks. And as to quality, a large study by the National Academy of Social Insurance "found little evidence that integrated delivery networks have reduced costs or improved the quality of care."

Fragility will lead to cascading failure. In the 1990s, if a hospital failed, chances were, it failed alone. In other words, the physician practices associated with that facility were independent. Certainly, office-based physicians found privileges at another facility. Hospital-based physicians were impacted disproportionately in comparison to their office-based colleagues, but at least there were other hospitals to which to expand their services.

Now, if a hospital or a merger-bloated hospital system with its employed or otherwise tightly affiliated physicians fails, all of those physicians are out of a job.

So we have merger for the cure of high costs. And we have a history from the 1990s of a similar trend that resulted in the failure to cut costs resulting in hospital failures. However, as opposed to the 1990s, many of these merged hospitals today not only have traditional hospital-side expenses, they have taken on the huge expenses of employing physicians. Note that's not just physician labor expense, but the complete expense of operating the practices, from space to equipment to supplies to staff and so on.

Trend 2: Physician-Owned Facilities

The growth of physician-owned facilities is a key disruptor of the traditional hospital business, shifting cases out of hospitals.

ASCs. Ambulatory surgery centers (ASCs) pull cases, generally the better reimbursed cases, out of hospital operating rooms. They offer a significantly cheaper alternative to Medicare, private payors and patients. They also make money for their physician owners.

Currently, there are more than 6,000 ASCs in the United States. There has been a slowdown in the net addition of ASCs during the last two years. In large part, this is due to the fact that hospitals are attempting to remove the competition by purchasing ASCs in the local market, closing some and converting others to hospital outpatient departments.

Notwithstanding that buying spree, it's unlikely that hospitals will be able to stop the shift of cases to the ASC setting. Procedures that only a few years ago were inpatient are now being performed on an outpatient basis. And, in some specialties, new surgical codes enable cases to be brought to ASCs, thus opening the specialty to fostering ASC development. A prime example is the explosion of interventional radiology procedures now being performed from outpatient facilities and the attendant birth of the irASC.

HOPD payment differential will backfire. Although recent federal budget legislation has reduced some of the benefit of operating an outpatient facility as a hospital outpatient department (HOPD), sooner or later the payment differential will play itself out to disrupt hospitals' futures. There's little justification for paying more to hospitals for the same procedure that can be performed in a hospital-free, that is, ASC, setting.

Even if the differential continues to be paid, physicians will continue to invest in and take cases to ASCs, and payors will continue to want access to their more cost-efficient services. It's unlikely that hospitals will be able to garner the political support to put the same roadblocks on ASCs that they've managed to place on physician-owned hospitals.

Physician-owned hospitals. To protect their near monopoly, the investor-owned and non-taxpaying hospitals (many of which are busy employing and otherwise aligning physicians) have claimed that if physicians own hospitals to create teamwork and provide coordinated care, it is "bad." But if hospitals own physicians to create teamwork and provide coordinated care, it is "good."

This nonsensical argument will eventually lose traction. Even if physicians are prevented from owning hospitals that qualify to treat federal health care program cases, they will continue to invest in smaller facilities focused on private payor cases. They will be able to avoid the low reimbursement that comes from governmental programs and the "no reimbursement" that comes from complete charity care.

Trend 3: New Classes of Competitors

New business models are disrupting the flow of patients, patients who were formerly destined to be referred into a hospital's "world."

Walk right in. These models include walk-in clinics of the type opening at retail stores, such as Walgreen's, Rite Aid and CVS. In fact, CVS, until recently known as CVS Pharmacy, is now known as CVS Health, which is a clear indication of where they believe health care is going. Other examples are the plethora of urgent care and even emergency care facilities built in strip centers, at heavily traveled intersections à la fast food franchises, and at other ease-of-access locations.

The point here is that these types of facilities signal a trend: Non-traditional ventures are disrupting the flow of patients to physicians' offices and to hospital emergency rooms. More importantly, because this trend has an exponential impact, patients don't have the same emotional barriers to obtaining medical care outside of the physician office or hospital setting that they had 20 years ago.

In other words, if care can be obtained in a less intense, less costly, more convenient setting, it's not just insurance carriers that are going to push for it; it's patients who are going to demand it.

Updated house calls. It's 7 a.m. on a Wednesday morning and you feel like death warmed over. When you call your doctor's office (not open until 9 a.m.), you know that you'll be told that they *might* be able to fit you in on Friday. You're lucky, because the average waiting time in the U.S. works out to more than 18 days.

But why bother, especially when a growing number of services will send a physician or nurse practitioner to see you now, at a cost that's probably one-third to one-half less than what your own physician would charge for an in-office appointment. And, if you don't have to see a physician or even a nurse, in person, why see one? Why not stay at home and simply transmit the same information about your condition to a physician or another provider via telemedicine?

It's not difficult to see that both house call services and telemedicine are disruptive to traditional medical practitioners. In fact, in some states, primary care physicians are exerting pressure on state regulators to make it more difficult for telemedicine and other telehealth companies to operate.

Eventually, those anticompetitive efforts will fail as patients demand those services. After all, pushing for regulation is the death gasp of any profession or industry; if they can't compete on their own, they turn to the government, and especially to bureaucrats, to protect them.

It requires only slightly more foresight to realize that, in the end, those and other new classes of competitors will not only disrupt traditional office practice, they'll disrupt hospitals, as well.

Patients will no longer be following the normal route of (1) go to a primary care doctor in an office building on or near a hospital campus; (2) be referred by that physician to a specialist on staff at the same hospital for

continued on next page

more detailed diagnosis and care; and (3) receive diagnostic services and treatment at the hospital.

Trend 4: The Role of Technology

We're at a technological tipping point and tech is the fuel for the fire of the demise of hospitals as we know them. For decades, the cost of technology in almost every industry *other than health care* resulted in lower costs to the consumer. In health care, however, all technology did was increase costs.

This history of technology also fed the growth of hospitals. Who could afford to buy the technology except large facilities? Wasn't it cheaper and more efficient to spread the cost of that technology by locating it in a central location, the hospital, for access by those in the community, both physicians and other providers, as well as by patients?

Thus came the centralizing of technology (read that as medical equipment) from imaging to monitoring to operating rooms themselves. Today, the cost of technology has shifted. Instead of being more expensive, it is less. In fact, in many cases it's become so much less that it is, or soon will be, affordable at the consumer level, bypassing completely the ASC and physician level. And, importantly, the size (sometimes there is, effectively, no size at all) of new equipment has shrunk.

Technology is quickly becoming the enabler for devices and for services that permit the disruption of the centuries-old doctor-patient relationship.

"Star Trek" in your home. Remember the "tricorder" from "Star Trek," the handheld medical diagnostic device? Now, it's time for the real one.

The Qualcomm Tricorder XPRIZE is a $10 million prize for a tool capable of capturing key health metrics and diagnosing a set of 15 diseases. In April 2017, two teams were declared winners. Both exceeded requirements for user experience and nearly met the benchmark of diagnosing 13 diseases. Final Frontier Medical Devices received $2.5 million as the highest performing team and Dynamical Biomarkers Group received $1 million for 2nd place.

Consider the OtoHOME device from Cellscope. It's an iPhone device that allows parents to examine their child's ears and record the result. It then connects them to a doctor for an immediate response. Dozens of other smartphone and wearable devices exist, each of which will reduce visits to traditional primary care doctors. Referrals to specialists (including all of those employed by hospitals) will be reduced, as will diagnostic procedures performed at hospitals.

Tech will lead to less invasive surgery and to implantable devices that allay more surgery. It's also bound to lead to more procedures that can be performed in either smaller, specialty hospitals or in outpatient settings. Hospitals will no longer need to provide everything to everyone. Procedures will move out of general hospitals into specialty ones and eventually will move out of hospitals altogether into ambulatory facilities.

The Bottom Line for Hospitals

Hospitals have expanded to become "full service" and have "bought" physicians to capture patients into the system. They claim that by closely aligning physicians, they can deliver better care at a lower cost. But they are losing money on employed physicians and there's no evidence that close alignment of physicians results in better care. At the same time, patients are increasingly taking more control of their own diagnosis (and in some cases care) via technology.

Both technology and new classes of health care businesses (e.g., CVS Health, Teladoc, etc.) are enabling patients to bypass traditional brick and mortar facilities (e.g., hospitals and physicians' offices).

Patients don't care as much as before whether they see a doctor, a nurse practitioner or some type of technician. And for hospitals, this is the big one: patients don't care as much if they obtain care from someone within the hospital's patient acquisition funnel or if they get surgery at an ASC or some other non-hospital site. As medicines improve (medicine as the future of surgery) and as miniaturization permits more procedures to be performed outside of the hospital, non-hospital facilities will syphon off a larger and larger percentage of hospital business.

Ultimate hospital bottom line: Hospitals will shrink. They will be for the sickest people only. They might become monitoring stations for patients receiving care at home. Many will fail.

The Bottom Line for Physicians and Other Providers

If your physician clients think that hospital employment or close alignment is safe, they should think again. Physicians, other providers and their groups can't ever be dependent upon a single hospital relationship. In the past, the concern was that a facility might terminate their contract. In the near future, the concern will be that the hospital might not survive.

Certainly, some hospitals will survive to provide services to the sickest patients and for the most complicated procedures. There will continue to be some reduced need for physician and other professional services at those facilities.

However, the majority of providers must plan for an out-of-hospital future for themselves and for perhaps all of their patients. That means work in, investment in and even the formation of freestanding ASCs and other facilities, which will be the future of facility-based care.

Your physician clients must adopt practices, both patient-centered and electronic, to empower patients who seek to monitor and manage their own health. Providers can no longer view those self-help actions as heretical to a hierarchical physician-patient relationship. Instead, they must view the relationship with their patients as collaborative in the same manner that any other expert consultant interfaces with the ultimate client.

Ultimate physician bottom line: Physicians will be impacted by two major thrusts. More and more patient care, including procedures, will move out of the hospital setting into freestanding and other locations, including patients' homes. Technology will enable patients to receive diagnostic information independent of traditional physicians' offices. Enterprising physicians will see the opportunities in these tectonic shifts. Others will fear them, with good reason. ■

Author's Note: This article is based in part on my book *The Impending Death of Hospitals: Why You Must Plan Your Medical Practice's Survival.*

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Managing Compliance with SSARS 21

By Michael S. Wilson, CPA, Ph.D.

CPAs serving the small- and medium-sized market must strike the right balance between complying with professional and regulatory standards, providing value-added client service, and mitigating litigation and other practice management risks. The purpose of this article is to identify best practices under Standards for Accounting and Review Services No. 21 (SSARS 21). Many CPAs will find ambiguous language removed from the standard, providing an opportunity to prepare financial statements without the burden of submitting a compilation report.

The significance of this SSARS may reveal itself as an unexpected surprise during the peer review process. Peer review helps to monitor a CPA firm's accounting and auditing practice. The goal of the program is to promote quality in the accounting and auditing services provided by American Institute of CPAs (AICPA) members and their CPA firms. This goal serves the public interest. There are two types of peer reviews: System Reviews and Engagement Reviews. System Reviews focus on a firm's system of quality control and Engagement Reviews focus on work performed on selected engagements. Whether subject to a system or an engagement review, a sample of SSARS 21 engagements is likely to be subject to review, and understanding and implementing the standard is essential when undergoing a peer review.

An important layer to the peer review complexity for CPAs is the increased focus on auditor independence. This issue has been especially challenging for accountants with clients who have trouble preparing financial statements in accordance with standards, creating a lingering question facing the profession: How does a CPA maintain independence when helping a client prepare financial statements?

In 2014, AICPA addressed the issue with its SSARS 21. The standards went into effect at the end of 2015. SSARS 21 provides a bright line between accounting services (preparation) and reporting services (compilation or review). The accountant no longer has to be concerned about whether a financial statement will be used only by management or by third parties. Its four sections allow a practitioner to evaluate the nature of the client relationship and select the best value-added service. CPAs are better positioned to focus on the unique needs of clients rather than deploying creative strategies to support the appearance of independence.

A Brief History of Compilation and Review Engagements

The 1971 landmark 1136 Tenants' Corporation case paved the way for compilation and review engagements. The case resulted in a sizeable judgment against a CPA firm sued by a cooperative apartment group for failing to uncover embezzlement.

The firm was hired to perform write-up services by the managing agent who committed the fraud. The financial statements clearly stated: "No independent verifications were undertaken," but the firm was found liable for failing to inquire about missing invoices. Without an audit engagement letter, the firm was unable to convince the court that the firm was not engaged to audit the financial statements.

Prior to 1978, accountants engaged to report on financial statements had two options: either perform an audit or issue a disclaimer of opinion on the financial statements. CPAs were required to evaluate financial statements from a perspective that the audit could be seen by third parties. With the issuance of SSARS No. 1, Compilation and Review of Financial Statements, in 1978, accountants were given another reporting option to address professional liability exposure associated with plain paper financial statements.

The basic standard for accountants who prepared and presented financial statements to their clients or to third parties was issued under Paragraph 7, stating "the accountant should not submit unaudited financial statements of a nonpublic entity to his/her client or others unless, as a minimum, he/she complies with the provisions of this statement applicable to a compilation engagement." The SSARS defined "submission" as "presenting to management financial statements that the accountant has prepared." As a result, accountants in public practice were required to perform a compilation engagement on those financial statements.

Submission was the equivalent of a compilation service when SSARS No.1 was issued, since paper statements were prepared and bound before presentation to clients. In today's electronic environment, financial data is often recorded in multiple computer platforms, including some in the "cloud." Computer software used by the client and the CPA makes it difficult to determine who prepared the statements.

Consider a situation where an accountant performs bookkeeping services. The CPA often has access to the client's cloud-computing system and may make a number of journal entries to record payroll

Table 1

SSARS Sections	Section 60 of SSARS 21	Section 70 of SSARS 21	Section 80 of SSARS 21	Section 90 of SSARS 21
When does the standard apply?	General principles for accounting and review services	Engagement to prepare financial statements	Engagement to perform a compilation	Engagement to perform a review
Purpose	Help CPAs understand professional responsibilities	Engagement to prepare financial statements without reporting on the statements	Engagement to perform a compilation engagement	Engagement to perform a review engagement
Major change?	No	Yes – Relevant for accountants who perform interim statements, use cloud computing and statements not expected to be used by third parties	No	No
Engagement letter required?	N/A	Yes	Yes	Yes
Independence required?	N/A	No	Yes	Yes
Report required	N/A	No	Yes	Yes

tax payments, sales tax payments, depreciation expense and revenue adjustments for a given period. The internal bookkeeper may account for recurring expenses and billing. The bookkeeper prints from the cloud accounting software for presentation to the owner. Who has prepared the financial statements – the accountant, the bookkeeper or the application?

Based on the original definition of submission, which focused on preparing and presenting, things worked well until technological advances muddied the waters. If the client sends a Quickbook file to a CPA and he/she makes adjustments to the financials, the work could impair independence.

The profession lived with the risk of potentially compromising independence. CPAs often discussed this issue during the peer review process and many firms were aware of the significant independence risk. Strategies included CPAs affiliating themselves with accounting service providers who would help clients prepare for an attest engagement. Many accountants were reluctant to relinquish services due to concerns about reduced billings and inserting another financial advisor into the equation. Clever CPA firms protected their independence by avoiding sending financial statements. They returned Quickbook files with recommended journal entries or created updated trial balance forms.

SSARS 21 eliminates the need for the CPA to answer the question of who prepared the financial statement. It eliminates the submission requirement. Table 1 includes key features that can help navigate the standards.

Section 60: General Principles for Engagements Performed in Accordance with Statements on Standards for Accounting and Review Services – This section provides general principles for engagements performed in accordance with SSARS. It identifies professional responsibilities when performing an engagement. An accountant used to perform a review, a compilation or an engagement to prepare financial statements is required to adhere to overall standards, as well as the appropriate engagement section. Section 60 provides guidance on:

- Ethical requirements
- Professional judgement
- Conduct of the engagement in accordance with SSARS
- Engagement-level quality control
- Acceptance and continuation of client relationships and engagements
- Conduct of the engagement in accordance with SSARS

Section 60 also requires accountants to agree upon the terms for all SSARS engagements with management or those charged with governance. The terms should be documented in an engagement letter with signatures of the accountant and those charged with governance to ensure management understands the arrangement.

Section 70: Preparation of Financial Statements – Section 70 is intended to be short and easy to apply for accountants engaged to prepare financial statements for clients without reporting on the statements. This section is especially helpful for those who prepare interim financial statements and perform cloud-based accounting services. This section can help accountants who prepare financial statements not expected to be used by a third party (management-use-only financial statements). Since this is a non-attest service, independence does not need to be determined.

Section 70 applies when an accountant in public practice is engaged to prepare financial statements. It does not apply when the accountant is engaged to perform an audit, review or compilation of those financial statements prepared by the accountant. If an accountant is engaged in an attestation service, it is important to recognize that assisting in the preparation of financial statements is a nonattest service (per ethics interpretation No. 101-3). The same applies when the accountant prepares financial statements as a byproduct of submission to taxing authorities, for personal financial plans, in conjunction with litigation or related to business valuation services.

In adopting the standard, SSARS 21 also embraces a principle-based approach, requiring accountants to apply professional judgment in determining if financial statements were actually prepared. Accountants should have conversations with clients to determine if the financial statements are part of the engagement for internal or external use. Because preparing financial statements is a nonattest service, there is no requirement to determine independence.

If the accountant prepares financial statements that omit substantially all disclosures required by the reporting framework, he/she is required to disclose the omission either in the statements or in a note to the statements. The accountant may also prepare financial statements that include limited disclosures and these disclosures should be labeled, "Selected Information – Substantially All Disclosures Required by the (reporting framework) Are Not Included." No accountant should omit disclosures if the intent is to mislead users of the statements. Finally, the accountant is required to include a statement on each page indicating, at a minimum, that "no assurance is provided" on the financial statements.

Section 80: Compilation Engagements – Section 80 applies when an accountant is used to perform a compilation engagement. This section differs from the prior compilations, which apply when the accountant

continued on next page

prepared and presented financial statements to clients or third parties.

The objective in a compilation engagement is to apply accounting and financial reporting expertise to assist management in the presentation of the financial statements without providing any assurance about material modifications. Section 80 retains the independence requirement. The accountant can omit substantially all disclosures on financial statements.

A major change is the literature related to reporting on financial statements. A report is required. The old non-reporting exception that the statements would not be used by third parties is replaced with Section 70. Section 80 also streamlines compilations to highlight that no assurance is provided. The standard report is simply one paragraph without headings. Additional paragraphs may be required based on the reporting framework when management elects to omit disclosures, when independence is impaired, when a departure from the reporting framework is known or if supplemental information accompanies the statements.

Section 80 is significant, because accountants are relieved from the responsibility to determine if they "prepared and presented" the financial statement to clients.

Section 90: Review Engagements – Section 90 of SSARS No. 21 redrafts the existing literature with a few changes. This section clarifies the requirements and guidance for review engagements and redrafts the review literature in SSARS 19, including providing a review report that includes headings. It also contains a requirement to list the city and state of the issuing office with letterhead references acceptable to meet the disclosure.

Specific Practice Considerations

SSARS 21 provides more options for CPAs who participate in creating financial statements. Accountants need to assess their level of service to ensure compliance with the SSARS sections and communicate with clients to avoid liability exposure. The navigation required can be summarized in the areas of practice: engagement letters, pitfalls related to Section 70, the need to educate clients and peer review considerations.

Engagement Letters

SSARS demands that CPAs focus on engagement letters. It makes clear that CPAs must have a written understanding when reporting on or preparing financial statements. But the standard doesn't require the documentation when only engaged to perform bookkeeping or assisting with the preparation of financial statements. The best defensive documentation in situations not subject to the SAS or SSARS is to specifically describe services that will not be performed with engagement letter statements including the language, "we will not audit, review or compile or prepare financial statements."

SSARS 21 distinguishes between accountants preparing financial statements or those merely assisting with statements. If engaged to prepare financial statements, the accountant is subject to SSARS 21. Merely assisting with the preparation of financial statements is a bookkeeping function not subject to the standard. With an engagement letter clearly indicating that the services do not include the audit, review, compilation or preparation of financial statements, clients can't allege that the accountant was to have reported or prepared statements.

Additional engagement letter considerations include the need for the accountant to agree upon the terms for all SSARSs engagements with management or those charged with governance. CPAs should sign engagement letters prior to any work being performed and engagement letters should be obtained annually. An important consideration is to clarify the specified reporting framework, such as accounting principles generally accepted in the United States.

Section Considerations

Section 70 preparation of financial statements is a nonattest service. When accountants perform such engagements, they are not usually considering audits or reviews for the same year. If audit or review services are on the horizon, Section 70 engagement letters should spell out the client's responsibility to designate who is responsible for bookkeeping or preparation of financial statements.

Section 70 may still be confusing to some CPAs and their clients. The guidance offered in SSARS 21 fails to implicitly state that the CPA is providing "no assurance," the not-so obvious intent of the standard. The examples suggest that the client provides "no assurance." CPAs engaged to perform a preparation engagement should make clear in their engagement letters and each page of the financial statements that "No CPA provides any assurance on these financial statements."

Section 70 also states that the CPA's name is not required on the statements. Some CPAs think adding their name has marketing benefits, but it may only create additional litigation exposure. Don't offer to associate your name with any Section 70 prepared financial statement unless there is a compelling reason to do so.

Section 70 lists four exceptions to compliance when preparing financial statements and not engaged to perform an audit, review or compilation of the financial statements. The exceptions occur when the financial statements are included in personal financial plans, in conjunction with litigation services, in conjunction with business valuation and solely for submission to taxing authorities. When preparing tax returns, CPAs should not think they are working outside the boundaries of Section 70. It simply means federal tax returns don't count as financial statements subject to Section 70.

Section 80 conditions are expected to result in fewer compilation engagements due to the introduction of preparation services. Compilation literature applies when the accountant is engaged to perform compilation services. Section 80 mandates that reports accompany all financial statements, so management-use-only (formally SSARS 8) financial statements are no longer permitted. Also, the compilation report is distinguished from audits and reviews by using a one-paragraph report with no headings. Additional paragraphs are required when:

- Financial statements are prepared in accordance with a special purpose framework.
- Management elects to omit substantially all required disclosures.
- The CPA's independence is impaired.
- The financial statements have a known departure from the applicable reporting framework.

Educate Clients and Users of Financial Statements

Accountants should have thorough discussions with clients to make sure they understand the service to be performed, whether it will include a report and whether there will be a statement regarding "no assurance" on each page.

CPAs should recognize that clients and their bankers may wish to have a report accompany the financial statements. CPAs and clients should discuss the Section 70 Preparation Engagement service and contrast it with a compilation. Education is the key to having users make informed decisions and to avoid CPAs performing services that don't meet expectations or needs.

Additional opportunities for education include the need to explain the client's responsibility for judgments in financial statements. Clients may request assistance with significant judgments regarding amounts or disclosures. CPAs can use their expertise in helping with those determinations.

CPAs should also follow up on unusual findings regardless of the level of service. The Tenants case is a good example. CPAs should recognize risk factors. They may find client records are unsatisfactory and should bring the matter to the attention of management and ask for more appropriate information, even without the requirement for inquiries as part of an engagement.

Peer Review Considerations

Peer review results plunge and deficiencies increase dramatically when any new SSARS is put into effect. The same may occur with SSARS 21. Those subject to peer review when their highest level of service is preparation engagement can opt out of peer review.

Accountants should plan and perform the engagement to be consistent with current standards, paying close attention to proper planning, independence considerations, risk assessment, fraud considerations, firm administration and quality control.

The SSARS standards offer opportunities for CPAs to maintain independence while helping clients prepare financial statements. As most CPAs know, independence has grown in significance from a peer review perspective. Becoming familiar with SSARS 21 is a worthwhile endeavor for CPAs who help clients prepare financial statements, but need to maintain their independence. ■

The author wishes to acknowledge the following resources:

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PCAOB Oversight of Broker-Dealer Auditors

By Billy Bob Messer, CPA, CGMA

Two years after the world learned Bernie Madoff had orchestrated the largest Ponzi scheme in history, the Dodd-Frank Act in 2010 gave the Public Company Accounting Oversight Board (PCAOB) oversight authority over auditors of broker-dealers (BDs). The purpose of this article is to help BD audit firms improve the quality of their audits and minimize PCAOB deficiencies in those audits. To do so, firms should understand the background of this regulation, analyze the differences between the PCAOB standards and the BD audit standards of the American Institute of CPAs (AICPA) and review the specific results of PCAOB's interim inspection progress reports.

Lastly, BDs and their auditors should understand PCAOB's plans for the future, so they can prepare for further changes as they arise. Although expansion of PCAOB oversight to include BD auditors may bring some painful changes in the beginning, these measures should ultimately result in higher-quality audits in the long run.

Background

Since its inception, PCAOB has transformed the auditing profession. Many of the changes within the last seven years can be at least partially attributed to the Madoff scandal. Understanding the audit quality breakdowns that contributed to this scandal can help auditors comply with these changes. First, Madoff's auditor was not adhering to professional standards, which could have been discovered by a thorough peer review. However, not only was Madoff's auditor not subject to PCAOB inspection, he was able to avoid peer review by telling AICPA that he did not conduct audits.[1] The large firms auditing investment funds holding Madoff investments were also guilty of performing insufficient procedures to assess the validity of the statements provided by Madoff,[2] and thus share some of the blame.

Two key lessons were gleaned from this scandal. First, a sufficient level of auditor oversight is necessary, as there are members of the profession who intentionally disregard the profession's standards. Second, auditors should thoroughly assess the reliability of third-party evidence, including evidence from other accounting firms. The government responded to the lack of auditor supervision by granting PCAOB oversight authority over the audits of BDs.[3] PCAOB addressed the second lesson by highlighting the reliability of third-party evidence in their inspection process.

In 2011, PCAOB implemented an interim inspection program designed to gather information for use in developing a permanent program. The first progress report was released in August 2012, noting deficiencies in each of the 23 BD audits inspected. The audits inspected within this report were performed under AICPA standards rather than those of PCAOB.[4] It is important to understand that PCAOB defines a deficiency as "the failure to perform, or perform sufficiently, certain required audit procedures." This does not mean that the Board concluded the firm lacked sufficient evidence to support its opinion, unless the Board specifically stated that fact.

However, it is particularly alarming to note that these inspection reports revealed that none of the audits, performed under existing standards, were performed satisfactorily.

Almost one year after the release of the first report, the SEC amended Rule 17a-5 to require that audits of BDs be conducted in accordance with PCAOB, rather than AICPA, standards.[5] Given the poor results in the first inspection, this expansion of control was practical and it would be difficult for the Board to continue to conduct inspections on audits performed in accordance with standards that it did not promulgate. Moreover, the deficiency rates noted in subsequent inspection reports showed little improvement,[678] making it difficult to argue against the need for stronger oversight.

Many of the findings in the reports relate to basic audit procedures, indicating a pervasive lack of audit quality. These reports collectively demonstrate the need for improvement. Firms conducting BD audits in the future should carefully read them so they can take appropriate action before the inspection team arrives.

PCAOB Standards vs. GAAS

The first major difference between generally accepted auditing standards and PCAOB standards is the very nature of the standards themselves. The phrase *Generally Accepted Auditing Standards (GAAS)* means that the standards derive their authority from the fact that they are generally accepted practice among auditors. In contrast, PCAOB standards are regulatory requirements promulgated by a regulatory body for a regulatory purpose.

The second major difference between these standards lies in the nature of the respective processes that assure compliance. The AICPA peer review process ensures that audit teams perform the right procedures. In contrast, the PCAOB inspection process ensures that teams perform not only the right procedures but that they are performed the *right way*. For example, while the documentation standards of the two groups appear to be similar, PCAOB's inspection process takes the position that not fully documenting a procedure is just as bad as *not performing* the procedure. The AICPA peer review process is less rigorous in this area. The rigor of documentation supporting auditor judgment is especially important in a PCAOB audit. Auditors should assume that PCAOB will question every decision they make and their documentation should sufficiently support their judgment.

As of this writing, PCAOB has released two new attestation standards specifically applicable to BDs. Attestation (AT) Standard 1 establishes the standards firms should follow when performing an examination of the BD's compliance report[9] and therefore only applies to "carrying" BDs. AT Standard 2 includes the standards that a firm should follow when performing a review of the exemption report,[10] and therefore only applies to "non-carrying" BDs. The importance of obtaining and documenting specific evidence supporting each BD assertion is the underlying message in both standards. Engagement teams need to carefully consider the statements their clients make in these reports.

Auditing Standard (AS) 17 establishes the standards governing audit procedures over supplemental information.[11] Although released the same day as the two attestation standards, it is not specific to BDs. It does, however, specifically apply to the net capital computation included in BD reports and materiality considerations are vital. For example, a misstatement that does not meet the documented audit materiality threshold may be considered material if it changes the outcome of the "net capital" test. The Board considers these standards to be key audit areas and they will continue to be areas of focus during PCAOB inspections. Although these standards are new, compliance is relatively simple if firms can show that they are professionally skeptical, that they do the right things the right way and that they fully document the procedures performed and the resulting conclusions.

Inspection Results – Common Findings

To date, the BD audit inspection reports reveal repeated deficiencies in the same audit areas. For example, inspectors have consistently found firms violating the SEC's independence requirements by preparing the client's financial statements. The SEC considers any form of preparation to be a violation, including word processing and printing assistance. For small BDs who currently use their auditing firm as a one-stop shop, appropriate adherence to independence will require a paradigm shift for both auditors and their clients. PCAOB Rule 3526 states that audit teams are required to communicate that the firm is independent in writing to the audit committee or those charged with governance. The letter should also discuss any threats to independence and explain how the firm has addressed these risks.[12]

Another common finding in the inspection results pertains to the engagement quality review partner requirement established in Auditing Standard 7.[13] A partner, other than the engagement partner, is required to be appointed to perform additional review of the financial statements and key audit work papers. This partner is required to be independent, and teams should carefully consider the applicable cooling off requirements if the partner has previously served as the lead engagement partner. Also, the quality review partner should perform a thorough review, particularly in light of the fact that their review can be considered insufficient by default if other deficiencies are found. For example, BD auditors who fail to update the wording in their opinion to reference PCAOB Standards instead of US GAAS, a common inspection finding, will have a deficiency related to the ineffectiveness of the quality review.

The BD inspection reports also contain deficiencies pervasive to the overall profession. For example, the testing and consideration of an entity's internal controls is a common deficiency. Proper testing of internal controls can be difficult and require complex considerations. However, the majority of BDs are exempt from the internal control reporting requirements. Therefore, the internal control deficiencies likely occur when teams fail to connect identified misstatements (especially misstatements below their documented materiality) to the underlying control deficiency, a requirement even for non-carrying BDs.

Teams fail to properly assess the information provided to them by their client or their client's service provider. When the client provides the engagement team with any report from any source, the team is responsible for assessing the completeness and accuracy of the data. Additionally, teams commonly fail to consider all classes of

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revenue transactions in both their risk assessment and in performing substantive testing.

Lastly, PCAOB standards require auditors to perform testing of details to address any significant risk, whereas auditors commonly rely solely on substantive analytics to test the risk of fraud in revenue recognition. The deficiencies described in the inspection report will continue to be target areas during subsequent inspections until the profession shows improvement. In the most recent inspection report this summer, PCAOB staff said they are still seeing signs of impaired auditor independence. They found problems with revenue recognition, financial statement presentation and disclosures, and the assessment of risks of material misstatement due to fraud.

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What's Next?

PCAOB's next step is to establish a permanent inspection program. There are a couple of inherent difficulties in scoping the permanent program. First, it is difficult to draw a line that would not have excluded Bernie Madoff's auditor, and the Board is unwilling to implement a program that would not have solved the problem that gave rise to their oversight. Second, deficiency data points within the recent inspection results make it difficult to narrow the scope of the permanent program. Specifically, limiting the scope based on the characteristics of the BDs under audit is difficult. Whereas larger BDs present the greatest risk to investors, there have been fewer deficiencies in their audits than those of smaller BDs. Also, excluding BDs who claim an exemption from customer protection rules presents problems because this population of BDs contributes to a higher number of deficiencies than the firms not claiming an exemption.[14] It is illogical to expect the Board to remove the audits with the highest deficiency rates from the scope of their review.

Additionally, although exempt BDs do not hold customer funds and thus pose little risk to the investors, auditors are the primary source of assurance over the accuracy of the assertions made in BD reports, and the Board views the procedures performed over these assertions to be key. Scoping based on firm characteristics is also challenging. The Board notes in its 2015 progress report that 83 percent of firms auditing BDs audit fewer than five each. Thirty-three percent of these firms only audit one BD, and that BD is the only audit subject to PCAOB standards.[15] Firms not auditing public companies also have higher deficiency rates than registered firms that audit public companies.[16] The majority of these firms are small, with limited exposure to PCAOB. Carving out small firms with few PCAOB audits not only eliminates the majority of the population, it eliminates the portion of the population showing the most difficulty with compliance.

The Board is considering all of its options. They have indicated that even if they do not scope out specific types of BDs or specific types of firms, they may modify how often they inspect smaller firms, and they may narrow the scope of the actual inspection. For example, instead of inspecting an entire audit, they may only inspect the audit procedures supporting the review report. Currently, the Board plans to increase the number of inspections and gather more data. Although the Board indicates they hope to gather enough information to properly scope the permanent inspection program, they will likely see similar results. BD audit firms, especially those with little PCAOB experience, should operate with the expectation that each of their audits will be subject to inspection every year. Although that will likely not be the case, operating in such a manner should increase the likelihood of compliance.

A Necessary Inconvenience

Firms auditing BDs should take advantage of the resources found on PCAOB's website, which includes a page dedicated to BD auditors and provides the inspection reports, FAQs and all related standards. The Board also hosts forums for BD auditors throughout the year at multiple locations. These forums include input from the Financial Industry Regulatory Authority (FINRA) as well as the SEC. They highlight and summarize key items in the standards, and provide a forum for asking questions.

The Bernie Madoff scandal has had a lasting impact on the auditing profession as a whole, and it directly resulted in the oversight of BD audits by PCAOB. The inspection results to date have revealed poor quality audits, and they highlight the growing chasm between the standards of PCAOB and the standards generally accepted by the rest of the profession. Few of these differences lie in the written standards; therefore, in order to improve audit quality and achieve compliance, audit firms should carefully consider PCAOB's unwritten expectations and read the available inspection reports in order to avoid similar mistakes. Auditors should understand that PCAOB oversight, while potentially inconvenient, will help ensure the auditing profession fulfills its responsibilities and maintains its relevance in this vital industry. ■

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Footnotes

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Promises Kept

Incoming Chairman Discusses Turning Points, Priorities, Commitment & Providence

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By Anne McDonald Davis

When his daughters were young, incoming TSCPA Chairman **Jim Oliver**, CPA-San Antonio, CGMA, promised his wife that he wouldn't accept any more intensive Society volunteer positions until all three were grown and out of the nest. Nine years ago, his word made good, he renewed his commitment to give back to the accounting profession; he'll be leading our association for the 2017-18 fiscal year. Here he shares his professional and personal journey.

Q: You have more than 40 years of experience working in public accounting and industry. Why and how did you choose a career in accounting?

A: Yes, I've been doing this a long time. (laughs) I started out as a reluctant engineering major. My goal at the time was law school and I was told that engineering students had an edge getting into the best ones. With my math and science background, it was a reasonable choice.

However, I quickly realized engineering didn't feel right. I wanted a career that would largely involve interaction with people and I was skeptical to what extent engineering would be a "people" career if I didn't make it to law school. I had also taken a couple of economics courses and loved those, but didn't want to be an economist either.

That's when I met Tavia, my future wife. Suddenly what became most important to me was not who I was going to be or what I was going to do, but who I was going to be with. My attention became focused on how I was going to support a family. Business school seemed like a good idea. Problem was, I had left home in Texas for a college in New Jersey … that didn't have a business school.

So it was back to Texas and on to Baylor. Initially, I was interested in a program there that combined getting an accounting degree with getting a law degree. But accounting came naturally to me and I decided to concentrate on that.

Q: You started out in public accounting?

A: Yes, I went into one of the big firms – I was actually an auditor for several years. Tavia and I wanted to start a family, though, and I wasn't earning quite enough to make that happen. I wasn't really cut out to be an auditor long term anyway. It just wasn't a fit for me.

So I went to the partners in the firm and said: "Hey, I've decided this is not where I want to be. Can you help me find something else?" (laughs) Fortunately there was a shortage of people who were doing what I was doing at the time, so I felt fairly confident that I wasn't going to get fired the next day. The partners did try to help, but I ended up landing something on my own, in industry.

Our oldest, Mikhail, was born and for a couple of years, I was director of finance and controller with Harte Hanks in cable TV operations. It was an opportunity to do something really different, but was still not the fit I was looking for. I was working a lot of hours, still wasn't sure exactly what I wanted to do and didn't have a lot of time to interview elsewhere. The simplest solution seemed to be: start my own CPA practice.

Q: You thought that would be "simple?"

A: (laughs) I might have been somewhat naïve, but that's how I became a sole practitioner. I decided to develop a tax practice, which is actually what led me to getting involved with the Texas Society of CPAs.

Q: A good resource for someone just hanging out his shingle.

A: Yes, I had people I could talk to and learn from. In fact, the committee I volunteered for was charged with educating the public about taxes. So I had to learn more than just what pertained to my own practice and I had to learn it quickly. I eventually ended up chairing the committee.

Q: That was the start of a long history of service to the Society. You chaired and served on a number of San Antonio Chapter and state-level committees, TSCPA's Board of Directors, TSCPA's Executive Board and more. You even worked as the technical editor for this publication, *Today's CPA*, and have been a legislative key person since 2004. What are some of the volunteer experiences that stand out in your mind?

A: I had the opportunity to do some pretty interesting things. We had a statewide call-in show about taxes on public broadcasting stations. We put out public service announcements with tax information across the state. We did a symposium back in the early '90s on the whole Texas tax system involving the State Senate Finance Committee, the House Ways and Means Committee and the comptroller's office. Made some good inroads with the Legislature.

Being president of the San Antonio Chapter led to one of my more unusual experiences. *Money Magazine* tested tax preparers from all 50 states by asking them to prepare a tax return based on a hypothetical family with multiple complex tax issues. When they called the chapter, I volunteered to subject myself to what turned out to be a far more demanding challenge than I expected. The magazine ultimately declared me the winner based on being the closest to the true tax liability with fewest errors – off by $4. It was nice publicity for us and I even got some clients out of it. It had been such an interesting exercise that I'd kept a sort of diary – a timeline of what I was doing and how I was thinking – and we adapted that for an article in *Today's CPA*.

Q: What aspects of volunteering for TSCPA had the biggest impact on you?

A: Leadership training. I wasn't at the level to receive that training when I started out at a big accounting firm nor was it part of my industry experience. After that, I was out on my own. So there had been no one to mentor me, to show me how to be a leader. Being involved in the Society gave me an opportunity to learn how to facilitate committees, to try out ideas with people, to improve my communication skills, to interact with the media and to watch experienced leaders in action. Gaining the ability to lead ultimately helped me to grow a larger practice.

I also value the friendships I ended up with, the people I got to know. I can't think of anything accomplished that didn't involve working with other members and staff. It's always a team effort. That's why when my firm finally got around to launching a website, we adopted the domain name "Team Oliver." My name was in there, but I knew I couldn't and didn't do it all.

Q: Not a superhero?

A: (laughs) No, I don't wear a cape. Want to hear about my most memorable TSCPA meeting?

Q: Absolutely.

A. In 1989, we had a council meeting scheduled for mid-October in

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Jim and Tavia Oliver in Alaska on a glacier with Mt. Alyeska (previously Mt. McKinley) in the background

Guatemala trip, in the village of Cheel

northern California. My connecting flight was delayed by fog and when I finally landed in Oakland, I went straight to get my rental car to head to Santa Rosa. But realizing it was going to be over an hour drive, I headed back into the men's room. Then I began to feel like, "Oh man, something's wrong." I felt woozy. Then I looked over and saw the sliding glass doors just opening and shutting, opening and shutting. That's when I realized, "Oh … this is an earthquake. Hey, this happens all the time around here."

Q: Oh no.

A: Yes, I didn't realize this was the "World Series" earthquake. I tried to use a payphone right outside the airport to call my wife (this was before cellphones) and it was dead … hmmm … so I got in my rental and started driving north on the freeway towards the Oakland Bay Bridge on the double-decked Nimitz Freeway. I'd probably gone three or four miles when suddenly there were police cars turning drivers around.

If my plane had been on time, if I hadn't gone back to the restroom, I might have been on that freeway when the upper level collapsed on my northbound lower level, killing 42 people. To think how I was complaining about the flight delay … fog in LA may have kept me from being crushed. Surreal, yet I could see God's providential protection in those circumstances.

Q: Wow.

A: That's what keeps going through your mind. What's next on our list? Yes, let's discuss some of the challenges facing TSCPA over the next several years.

Q: At least we don't have earthquakes.

A: What we do have is a changing demographic and increasing competition in the continuing professional education market. One of TSCPA's hallmarks has been providing quality CPE; it's one of the benefits that our members say they value most. Plenty of the CPE out there isn't of comparable quality to ours, but there are some quite worthwhile classes and seminars being offered at very low or no cost. Attorneys, for instance, offer CPE simply to promote their law firms. So how does that affect us? In what unique ways can we tailor our CPE programs to meet members' needs and maintain the financial health of our organization? Technology may provide some of the answers. The Texas State Board of Public Accountancy recently approved nano learning … CPE in 10-minute increments!

Q: You mentioned TSCPA's changing demographics?

A: As our senior members, baby boomers, begin to retire from the profession, how do we engage the upcoming generations? For instance, consider all the millennials out there. How do we attract them to membership and Society leadership? How do we keep them? It's going to be a challenge. A lot of organizations are having to deal with this same issue: how to stay relevant.

Personally, the new CPAs I've met at both the chapter and state levels just blow me away with how involved they want to be. I look at how young they are … and yet they're president of this or that organization, or they're starting some charitable group. I sometimes wonder, how do they do all that? (laughs) How do they have that much energy and find that many hours in the day?

As I see it, our future as an association is bright. When meeting with Leadership Development Institute attendees in May, I realized how many of them hadn't been born when I first became active in TSCPA. Soon we will be able to pass the torch to enthusiastic and strong leaders.

That said, as I discuss in my chairman's column this issue, recruiting new members and Society leadership even farther down the road depends on convincing students, early on, to major in accounting. And when those accounting students graduate, we have to convince them to sit for the exam and become CPAs.

Q: What if someone is already committed to majoring in accounting and sitting for the exam? What's your advice to those students?

A: First thing they should do is become a student member of their TSCPA chapter. Get involved and get to know CPAs. In fact, I would suggest that they talk to as many CPAs as they can, because I think students sometimes have a very limited view of the many ways they will be able to apply their accounting education. They narrow their focus and don't realize all the opportunities that becoming a CPA will provide. They should be talking to people in industry, people in public accounting, people who do taxes, people who audit, entrepreneurs. They should get the clearest idea possible of different CPA career experiences.

I'd also like to remind them that even once they make a choice, it

Tavia and Jim Oliver from the Greek island of Santorini in the village of Fira

doesn't mean they have to do that for the rest of their lives. Look at me! I started out on the audit side for a big firm, then went into industry and did controllership, finance, merger and acquisitions work, then came back into public practice as a tax person, then got my CFP® certification and opened a wealth management practice, then sold that off, and now I'm a partner at Calvetti Ferguson.

Another way to hear fascinating stories from CPAs with diverse experiences can be found at WhereAccountantsGo.com. The podcasts offer insight into how different each CPA's journey can be.

Internships are also a great opportunity for students. Some universities offer their own mentorship programs. I told the TSCPA leadership group in May, "I'm going to encourage students to call you. Please take their calls." I think most CPAs, as long as you don't catch them during the busy season, will talk to students. We like what we do and we want to share what we do with others.

Oh and there's one more – a simple one. Make sure they have a LinkedIn profile and try to link to CPAs. That may make it easier to get a foot in the door.

Q: Other issues facing the Society?

A: Changes in peer review – there are efforts underway to strengthen the peer review process, to make it even more real time than it is now to enhance the quality of the audit profession. Given the size of our state Society, there may even be opportunities to provide these services to some of the smaller states.

As always, it's vital that we continue our advocacy efforts on behalf of CPAs with the Texas Legislature. There's this movement toward deregulation and that could conceivably raise the question of whether CPAs should continue to be regulated the way we are at present. Should CPAs just simply be licensed, without a State Board? Should people with no formal education be allowed to call themselves accountants, people who aren't required to be tested in any meaningful way? We have to be prepared to push back, if necessary. Remember, we're less than two years from Sunset Review. It's our responsibility to ensure that no one tries to make changes that would be harmful to the accounting profession or to the public.

Q: On a personal note, I understand you and your wife are empty nesters now?

A: Yes, Mikhail is 36, Landry's 31 and Aubrey's 27 … and we have six grandchildren between them.

Q: How do you spend all that leisure time?

A: (laughs) We like movies. When tax season was over, we hit four movies in two weeks. At some point, I'd like to just sit down and read. Books, I mean. Now I mostly read to stay up-to-date with work.

Tavia is a Bible Study Fellowship substitute teaching leader. They've got a large class, five or six hundred, so she also has some fairly substantial management duties. I've also had past leadership roles, but currently am just in a class that meets right across from my office.

We travel, mostly to see the kids and grandkids. We did our dream trip 10 years ago when we went to Athens, Santorini, Mykonos and Crete. Oh, and remodeling our house. (laughs) Hopefully, we'll be done soon; it's been an extended process taking far longer and far more money than we expected.

Q: What have been some of your personal milestones?

A: Memorable for many reasons … 1989 … it was not only my earthquake year, but also the year our last daughter, Aubrey, was born. When Tavia was about seven months along, we decided it would be OK for me to go on a mission trip to the Guatemalan jungle for a clean water project. Our group had no contact, no cell phones, no way to really know of anything going on in the world. The Tiananmen Square Massacre happened while we were gone. We were in the middle of nowhere with no communication. But it was life altering to see the difference it made for people to have clean water. Twenty-eight years later, I'm still involved with the pastor who took me on that mission, assisting with the financial oversight for his ministry that now does water projects in a Honduran village.

Of course, I most fondly look back on so many times with Tavia and the girls, times that are just joyful … the girls' track meets, basketball and soccer games, weddings, our vacations and now the grandkids. If I had a highlight reel, those are the times I'd want to see again. ■

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Reputation Matters – Company Reputation Effects on Labor Efficiency and Productivity

By Marty Stuebs, Li Sun and C. William (Bill) Thomas

Anyone who's ever held a job knows that working in an organization with a good reputation makes one feel good and just makes work more enjoyable. However, the benefits of having one goes beyond just producing a "warm fuzzy feeling." Research shows that companies with good reputations are often more efficiently run than those without them.

In today's challenging economy, utilizing resources and managing costs is more important than ever. Effectively and efficiently managing labor resources is critical for service-oriented entities of all types – for-profit, as well as nonprofit. This article shows how building a good reputation as an entity helps build not only more effective, but more efficient relationships (both internal and external), improving labor efficiency, enhancing productivity and improving profitability.

An Increasing Struggle

Businesses are increasingly struggling with the challenges of a volatile global economy. Often, however, discretionary expenditures directed toward protecting an entity's reputation can take a back seat to other seemingly more urgent issues in an effort to control costs. As CPAs, we recognize the importance of building and maintaining integrity even during turbulent economic times. Several recently published professional articles document the value of reputation.[1] This article offers additional support for the argument that it's usually good business.

The reality is that reputation can become even more valuable during tough economic times. We document the labor management benefits of investment in an entity's reputation, and offer some suggestions for incorporating strategies to build a corporate reputation and to foster strong stakeholder relationships.

During economic downturns, revenue growth in many industries tends to stagnate. Therefore, controlling costs, like labor, and improving efficiencies often becomes the key to continued improvement in business performance and profitability. Labor costs are a likely target for efficiency and control efforts, because labor often represents the most significant of all operating costs. This is particularly true for service firms like CPA firms, but it is also true across a broader spectrum of both for-profit and nonprofit enterprises.

Because labor costs are a significant production cost, effectively and efficiently using resources to manage labor costs is important. One recent study of starting salary data from the National Association of Colleges and Employers (NACE) found that the average annual growth rate for starting salaries in human resources positions was between 6 and 6.5 percent from 1998 to 2008, and that human resources was consistently among the top five categories for largest salary growth rates[2]. Therefore, managing labor costs is important and doing so has become more expensive over the last decade.

The Value of Reputation

As professionals, CPAs recognize the value of integrity and maintaining one's reputation. A number of recent articles document that being recognized as a trusted business partner improves relationships with a number of stakeholders.[3]

For example, a reputation grounded in objectivity and integrity forms the foundation for the CPAs' relationship with the public. Former American Institute of CPAs (AICPA) Chairman S. Scott Voynich recognized that "a CPA's most important asset is his or her reputation."[4] It is critical in creating an efficient, effective relationship with the public that is based on trust.

Similarly, a good reputation can create efficient, effective client and customer relationships. "Successful businesses are built on reputation,"[5] which, in turn, can be used to gain more business through increased contacts with potential clients. It generates business in two primary ways:

- The *attraction* effect. For example, potential clients are attracted to a CPA in public practice because of his/her reputation in the community. Alternatively, current clients may refer other potential clients to a CPA because of his/her reputation.
- The *loyalty* effect. Clients or customers who are initially attracted to a CPA by a good business reputation, and who continue to be satisfied, keep coming back for additional services. Thus, it tends to stabilize revenue streams, an important advantage in today's economy.

In an auditing practice, a good reputation can improve the efficiency and effectiveness of the business relationship between auditee entities and independent auditors. Auditors recognize its impact on audit risk.[6] Client integrity and reputation can often decrease the amount of necessary audit evidence collected and thus reduce fees charged by independent auditors.

Labor Management

There is reason to believe that a good reputation can improve

Figure 1: Labor Benefits for High-Reputation Firms

Labor Measure	High-Reputation Company Average	Matched Company Average	Percentage Change
Efficiency	1.571	1.033	52.08%
Productivity	118.469	68.354	73.32%
Cost	73.362	69.449	5.63%

EFFICIENCY = OPERATING INCOME PER LABOR COST DOLLAR = (OPERATING INCOME / LABOR COSTS)
PRODUCTIVITY = OPERATING INCOME PER EMPLOYEE = (OPERATING INCOME / EMPLOYEES)
COST = LABOR COSTS PER EMPLOYEE = (LABOR COSTS / EMPLOYEES)

Figure 2: Labor Benefits Within High-Reputation Firms

Labor Measure	Excellent-Reputation Company Average	Good-Reputation Company Average	Percentage Change
Efficiency	1.801	1.340	34.40%
Productivity	142.200	94.719	50.13%
Cost	77.317	69.408	11.39%

EFFICIENCY = OPERATING INCOME PER LABOR COST DOLLAR = (OPERATING INCOME / LABOR COSTS)
PRODUCTIVITY = OPERATING INCOME PER EMPLOYEE = (OPERATING INCOME / EMPLOYEES)
COST = LABOR COSTS PER EMPLOYEE = (LABOR COSTS / EMPLOYEES)

labor management and efficiency. Labor efficiency measures the relative production of goods and services (i.e., *labor productivity*) per unit of labor input (i.e., *labor cost*). The idea is that a good reputation can attract more and better employees who then compete for future employment opportunities. The increased labor supply tends to keep labor costs under control. Additionally, employees may work harder for reputable firms, because good employees are motivated by the firm's reputation (i.e., *increased labor productivity*). Lower labor costs and increased labor productivity should increase labor efficiency.

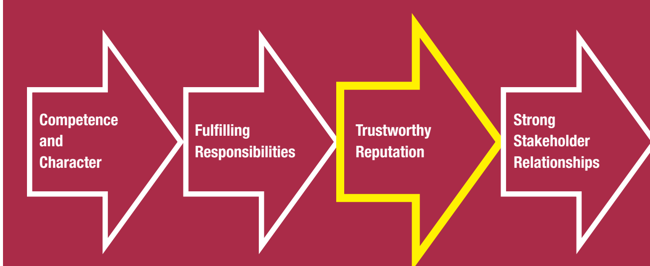
Southwest Airlines provides an example of how a good reputation can affect labor efficiency (http://www.cbsnews.com/stories/2007/08/30/sunday/main3221531.shtml). Throughout its history, Southwest has built partnerships with employees. Even in the difficult period after the 9/11 terrorist attacks, the company never laid off employees or cut salaries. "You put your employees first and if you take care of them, then they will take good care of you," Herb Kelleher, Southwest's former chairman once said. "Then your customers will come back, and your shareholders will like that, so it's a real unity." This reputation fosters increased labor productivity, labor efficiency and business success. Southwest Airlines has been continuously profitable every year since 1973, a statistic that is shared by no other airline.

Our analysis of firms on *Fortune's* Most Admired Companies list from 2006 to 2008 shows that good reputation improves labor productivity and labor efficiency. We compared the average labor efficiency, labor productivity and labor cost for high reputation firms on *Fortune's* Most Admired Companies list to a representative matched sample of firms not on *Fortune's* list.

Although labor costs are slightly higher for high-reputation firms, Figure 1 shows that these firms have a 73.32 percent higher average labor productivity and a 52.08 percent higher average labor efficiency than firms that did not make the high-reputation list.[7]

We further divided the sample of high-reputation companies into two sub-groups based on *Fortune's* average-reputation score. We placed companies above the average-reputation score in a sub-group we called the "excellent" group. We placed companies below the average-reputation score in a category called the "good" group. We then compared labor costs and labor productivity for these two sub-groups.

Figure 3: Reputation-Building Process



The results shown in Figure 2 are similar to those shown in Figure 1. Specifically, although labor costs are slightly higher for "excellent-reputation" companies, we find that excellent-reputation companies have 50.13 percent higher average labor productivity and 34.40 percent higher labor efficiency than those marked "good." Our analysis thus shows that the better the reputation a company has, the higher its labor productivity and labor efficiency.

Steps for Building and Maintaining Reputation

To re-phrase the words of Abraham Lincoln, a good reputation is the result of good character. The first step, then, is building a strong character. Figure 3 presents the steps in the process.

Building a strong reputation begins with developing the character of an entity's workforce and acquiring the competencies needed to fulfill responsibilities. Competencies are comprised of the knowledge, skills and abilities that meet responsibilities. Character is having the integrity to actually use one's competencies to fulfill his/her responsibilities. Activities to build a company's character and culture can include establishing an ethics code for conduct and consistently communicating its importance, ethics

continued on next page

Figure 4: Reputation-Building Strategies

		Time	
		Present Short-Term **Develop**	Future Long-Term **Deliver**
Focus	Internal	I Dynamic Exploitation of Existing Assets	II Develop and Utilize Core Competencies
	External	III Image Management	IV Strategic Alliances

"CHARACTER IS LIKE A TREE, AND REPUTATION IS LIKE ITS SHADOW."
—ABRAHAM LINCOLN

training programs, rewarding ethical conduct, fair treatment of employees, positive and open communication, and feedback systems. Meeting those responsibilities is a process that takes time, but as time goes by, it builds trust, which in turn forms the bedrock of strong stakeholder relationships.

Strategies for developing a positive corporate reputation can bring this process to life. Four possible strategies, focused on different time horizons (short-term vs. long-term) and different focus areas (internal vs. external) are presented in Figure 4.[8]

The short-term strategies are strategies for developing and communicating responsibilities to stakeholders. Dynamic exploitation of existing assets involves utilizing current internal resources to rapidly seize market opportunities. Using forms of compensation (e.g., salary, bonuses, benefits, etc.) and descriptive, aspirational job titles would be examples related to employees. Image management involves short-term development and marketing of visionary advertising associated with successful firms. Publicizing and marketing employment opportunities and benefits would be an example involving employees. Both short-term strategies develop and communicate aspirational responsibilities.

The long-term strategies develop competencies and character to consistently deliver on responsibilities to stakeholders resulting in a trustworthy reputation and strong stakeholder relationships. Developing core competencies involves significant investments in building internal capabilities. Building flexible work options, work challenge, job security and career opportunities would be examples of corporate competencies related to employees.

Strategic alliances involve networking and joint ventures that develop and share in a strong name. An alliance changes the form, or character, of the company. A corporation could form alliances with human resource firms to better meet responsibilities to employees. These long-term investment strategies in developing corporate character and competencies help a business consistently deliver on responsibilities that engenders a reputation of trust and fosters strong stakeholder relationships.

A tangible example of using these reputation-building strategies to improve employee relationships is KPMG's recent efforts to change its reputation and communicate a higher visionary purpose to employees to improve retention.[9] KPMG invested in initiatives to reframe and elevate the meaning and purpose of its employees' work. They actively engaged employees in this process by encouraging employees to share their own stories about how their work is achieving a higher purpose and making a difference. Results exceeded expectations. Morale scores soared; turnover plummeted; productivity and efficiency improved.

This approach of using responsibilities to build a reputation of trust shifts the focus of the firm. Often, the focus is on the corporate right to maximize profits. Managers use resources to maximize profit from stakeholder relationships with customers, employees, suppliers and others. This is predominantly a transactional approach. Focusing on using resources to fulfill responsibilities to stakeholders shifts strategy to a relational approach. Resources used to fulfill responsibilities are viewed as investments in developing the intangible asset of reputation.

The Pay-Off

It takes a long time to build a good reputation, but it can be lost overnight. It matters all the time, but is particularly important when times are tough. Good reputation preserves the confidence and trust of various stakeholders, as well as the public. It can preserve the loyalty and trust of customers and stabilize revenues during turbulent times.

Good reputation can also affect costs. For example, a business's good reputation as a client can impact perceived audit risk and

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reduce audit fees, and we document that it improves labor productivity and efficiency.

These benefits should provide incentives for not only accounting firms, but other types of entities (both for-profit and nonprofit) to build and maintain good reputations. Employees are a primary production cost in service firms like accounting firms. We provide practical suggestions for building and improving relationships with employees by incorporating reputation-building processes and strategies.

Footnotes

1. For example, see: Marty Stuebs' and Li Sun's 2010 *Journal of Business Ethics* article, "Business Reputation and Labor Efficiency, Productivity and Cost" for discussion of the documented effects and value of reputation.
2. See Kent Gilbreath's forthcoming *Journal of Legal Economics* article, "Trends in Starting Salaries of College Graduates 1970 – 2004."
3. For example, see Joel Podolny's 1993 *American Journal of Sociology* article "A status-based model of market competition" for a discussion of the effects of good reputation on stakeholder relationships.
4. See Robert Tie's November 2003 *Journal of Accountancy* article, "The Profession's Roots," p. 57.
5. See Stephen Godfarb's and Linda Dunbar's July 2002 *Journal of Accountancy* article, "Meet the Press," p. 39.
6. See: Philip Beaulieu's *Journal of Accountancy* January 2002 article, "Reputation Does Matter."
7. See: Marty Stuebs' and Li Sun's 2010 *Journal of Business Ethics* article, "Business Reputation and Labor Efficiency, Productivity and Cost" for more details.
8. See: Albert Goldberg et al.'s 2003 *Journal of Small Business Management* article, "Reputation building: Small business strategies for successful venture development."
9. See Bruce Pfau's 2015 *Harvard Business Review* article, "How an accounting firm convinced its employees they could change the world."

Collaborative Arrangements

– A Fine Line in Revenue Recognition

By Josef Rashty

Curriculum: Accounting and auditing

Level: Basic

Designed For: CPAs in industry and public practice

Objectives: To provide background information for the interface between collaborative arrangements and revenue recognition guidance

Key Topics: Collaborative arrangements, revenue recognition and gross versus net revenue recognition

Prerequisites: None

Advanced Preparation: None

A contract with counterparties to participate in an activity where both parties share in the risks and benefits of that activity (such as development of a technology or a product) is a collaborative arrangement and not usually within the scope of revenue recognition guidance. In such arrangements, counterparties usually do not meet the definition of customers and, as a result, the contract does not fall within the scope of revenue recognition guidance.

However, there may be collaborative arrangements where, in substance, an entity sells goods or services to counterparties. In such instances, the arrangement could become within the scope of revenue recognition guidance even though it is referred to as a "collaborative" arrangement. Generally, revenue recognition guidance applies to all contracts, including transactions with collaborators and partners, as long as they are considered to be customers.

In November 2016, the Financial Accounting Standards Board (FASB) decided to add a project to its agenda to clarify when transactions between partners in a collaborative arrangement (that is within the scope of Topic 808, *Collaborative Arrangements*) should be accounted for as revenue transactions in Topic 606, *Revenue from Contracts with Customers*. As of the date of this article, FASB has not issued its exposure draft on this project.

This article will discuss the fine line that divides a customer from a collaborator based on the existing guidelines in collaborative arrangements and revenue recognition guidance.

Collaborative Arrangements

Entities often enter into arrangements with other entities to, for example, develop and commercialize a specific drug candidate, an intellectual property (such as a computer software) or jointly manage an operating facility (such as a factory or a distribution center). One of the counterparties may have the primary responsibilities for certain activities, for example, research and development, or two or more participants may jointly share such responsibility. These arrangements are very common in the technology industry, and particularly in pharmaceutical and bio technological companies.

Accounting Standards Codification (ASC) 808, *Collaborative Arrangements*, defines "collaborative arrangement" as a contractual arrangement that involves two or more parties who are actively participating in a joint operating activity and are exposed to significant risks and rewards depending on the commercial success of the arrangement (ASC 808-10-20).

ASC 808-15-8 identifies the following as evidence of active participation:

- Directing and carrying out the activities of collaborative arrangements.
- Participating in governance and oversight of collaborative arrangements.
- Holding an exclusive contractual right to the underlying technology or intellectual property.

However, the above list is not intended to be a comprehensive list and FASB has identified them only as examples.

ASC 808-15-11 also identifies some of the terms and conditions of the arrangement that may indicate that participants are not exposed to significant risks and rewards and, as a result, are not in a collaborative arrangement:

- Services are performed in exchange for fees paid at market rates.
- A participant is able to exit the arrangement without cause and recover all (or a significant portion) of its cumulative economic participation to date.
- Initial profits are allocated to only one participant.
- There is a limit on the reward that accrues to a participant.

Collaborative arrangements within the scope of ASC 808 are not typically conducted through a separate legal entity and if they are, should be accounted for under ASC 323, *Investments*, and ASC 810, *Consolidation* (ASC 808-15-4).

Management exercises significant judgment to consider all facts and circumstances to determine whether a contractual arrangement is a collaborative engagement at the outset, and reevaluates the arrangement as facts and circumstances change.

Accounting for Collaborative Arrangements

ASC 808 does not provide any specific guidance for presentation of collaborative arrangements on the income statement. However, any revenues on collaborative arrangements that are not within the scope of the revenue recognition guidance are generally presented separately from revenues for customers' contracts on the income statements and costs associated with collaborative arrangements are usually reflected as operating expenditures, whereas costs associated with generation of revenues from customers are reflected in cost of sales. Thus, the classification of revenues as collaborative arrangements versus revenues may impact the gross margin of companies significantly.

ASC 808-10-45-3 requires that transactions between collaborators pursuant to any collaborative arrangement that are deemed to be within the scope of other authoritative guidance shall be accounted for using the provisions of that guidance. Counterparties may be collaborators or customers, or be collaborators for certain parts of an arrangement and customers for other parts of it. Management assesses, on a case-by-case basis, whether certain counterparties are customers and that, as a result, their activities lead to revenue generating activities.

Revenue Recognition Guidance

A portion of a collaborative arrangement contract that is intended for the sale of goods and services between counterparties may be within the scope of the revenue recognition guidance if it meets the revenue recognition criteria.

Revenue Recognition Criteria

If a collaborative arrangement, or any part of it, is identified as a transaction with customers, the following revenue recognition criteria must be applied to that particular transaction.

SEC's Staff Accounting Bulletin (SAB) 104, *Revenue Recognition* (codified under Topic 605), outlines the general principles of revenue recognition under the current guidance, which requires the following four criteria for revenue recognition:

- Persuasive evidence of an arrangement exists.
- Delivery has occurred or services have been performed.
- The seller's price to the buyer is fixed and determinable.
- Collectibility is reasonably assured.

In May 2014, FASB and the International Accounting Standards Board (IASB) jointly released their new standard for revenue recognition. The new revenue standard is effective for public business entities (PBEs) for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2018. The new revenue standard for nonpublic entities is effective for fiscal years and interim periods within those fiscal years beginning after Dec. 15, 2019.

continued on next page

The core principle of the new guidance is to recognize revenues based on the transfer of promised goods or services to customers in an amount that reflects the consideration for transfer of such goods or services. The revenue recognition criteria under ASC 606 are as follows:

- Identification of contract(s) with customers.
- Identification of performance obligations.
- Determination of the transaction price.
- Allocation of the transaction price to performance obligations.
- Recognition of revenue as company satisfies performance obligations.

What has changed is that the new guidance (ASC 606) is a model based on control rather than the current guidance (ASC 605), which is based on risks and rewards.

Customer Criterion in ASC 606

The key in classification of a contract as a collaborative arrangement versus a revenue contract is to identify if a collaborator meets the definition of a customer under the new revenue guidance (ASC 606).

ASC 606-10-20 and International Financial Reporting Standards (IFRS 15), Appendix A, defines a customer as a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. Counterparties in collaborative arrangements could be considered customers under certain circumstances. ASC 606 applies to all contracts, including collaborative arrangements, as long as they are transactions with customers.

A customer is a party that obtains goods and services from an entity, which are the result of entity's ordinary activities and business. The scope of ASC 606 includes some transactions with collaborators that are engaged with the entity to obtain such goods and services. However, ASC 606 excludes collaborators that share the risks and rewards of certain activities or actively participate in such activities.

A contract with counterparties to participate in an activity where both parties share risks and rewards of the activity (for example, development of an intellectual property or technology) is considered a collaborative arrangement and is unlikely to meet the definition of customer under ASC 606. However, a collaborative arrangement where, in substance, one party sells goods and services to another party is likely to be within the scope of the revenue standard, even though the contract has been identified as a collaborative arrangement.

The general framework of customer definition in ASC 606 also applies to ASC 605; however, the real distinction between a collaborator and a seller in ASC 605 is based on a shift and different exposition to risks and rewards.

Risks and Rewards Criteria in ASC 605

As was discussed earlier, ASC 605 is a revenue model based on risks and rewards, and collaborative arrangements are based on risks and rewards, as well. The distinction is that when a collaborator becomes a customer, the facts and circumstances change, and the role of the counterparty and its participation in risk and reward changes. In collaborative arrangements, collaborators participate in the risk and rewards of conducting certain activities, whereas in revenue transactions, sellers are engaged in the risks and rewards of output (i.e., selling goods to customers).

Management should analyze all aspects of collaborative arrangements to determine if all or a portion of a collaborative arrangement is within the scope of ASC 606 or ASC 605. It is feasible that a portion of the collaborative arrangement shares risks and rewards on an activity outside the scope of the revenue standard, but another portion, for the sale of goods and services, falls within the scope of the revenue standard.

Agent vs. Principal Consideration

ASC 808 requires that collaborators in sales to third parties follow the revenue recognition guidance. More specifically, ASC 808-10-45-1 requires that participants in a collaborative arrangement report costs incurred and revenue generated from transactions with third parties (that is, the parties that are not collaborators) in their earnings pursuant to Subtopic 605-45 (*Revenue Recognition – Principal versus Agent Considerations*) and Paragraphs 606-10-55-36 through 606-10-55-40 (*Revenues from Contracts with Customers, Principal versus Agent Considerations*).

In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with a corresponding offset to cost of sales (e.g., a travel agency that sells an airline ticket to a customer). In this example, the travel agency recognizes the net revenue (the gross revenue less of cost of sales).

Nevertheless, regardless of the method of accounting, the net income remains the same under either method. However, many analysts may judge the performance of an entity based on top line (i.e., revenues) instead of bottom line (i.e., net income).

It is not within the scope of this article to discuss the detail criteria for principal vs. agent considerations. The criteria for principle versus agent distinction appear to have changed very little in ASC 606 compared to ASC 605, if any; nevertheless, the revenue model itself has changed from a risk-and-reward model to a control-based model.

Today's CPA in its January/February 2017 issue published an article on implications of reporting revenue transactions on gross versus net basis (Josef Rashty, "Amendment to Gross Versus Net Revenue Recognition"). This article discussed in detail the implications of dealing with these two different accounting methods. Nevertheless, regardless of the method of accounting that companies use, the net income remains the same under either method. However, many analysts may judge the performance of an entity based on its top line (i.e., revenues) instead of its bottom line (i.e., net income).

Illustration

The following two scenarios clarify the concepts discussed earlier in this article.

First Scenario

Biotech enters into a collaborative arrangement with Pharmco to jointly develop a drug for cancer treatment. They equally participate in costs for development of this drug. Subsequent to successful development of the drug, Biotech obtains a patent for the drug and later transfers the patent to Pharmco for a fee.

The amount that Biotech receives from Pharmco for the patent is unlikely to be within the scope of the revenue standard; therefore, Biotech records the patent fee received as collaboration revenue for the sale of the patent and reflects the associated costs for the development

Table 1

	Revenues from Customers	Cost of Sales	Gross Margin
Biotech – Principal	$170 (1)	$160 (4)	$10
Pharmco – Agent	$60 (2)	$20 (5)	$40
Pharmco – Principal	$170 (1)	$130 (6)	$40
Biotech – Agent	$110 (3)	$100 (7)	$10

(1) The gross amount of revenue for products sold to third parties.
(2) Pharmco's cost of sales and profit ($170 less $10 cost of sales less $50 profit margin of Pharmco).
(3) The selling price of products for Biotech sales to Pharmco.
(4) Biotech's costs of sales for $100 plus $60 for Pharmco's cost of sales and profit.
(5) Pharmco's cost of sales.
(6) $110 payout to Biotech plus Pharmco's cost of sales for $20.
(7) Biotech's cost of sales.

of the drug as operating expenses. Pharmco, on the other hand, may capitalize the cost of the patent acquired from Biotech and amortize it to the cost of sales as it manufactures and sells the drug to third parties.

Pharmco accounts for the sale of the drug to third parties in accordance with revenue recognition guidance, since these transactions occur within the normal course of Pharmco's business (i.e., selling drugs to customers).

The determination to classify the revenue as a collaborative revenue is based on the premise that if counterparties participate in an activity to develop an asset in a collaborative arrangement instead of obtaining the output of the entity during the course of their ordinary activities, the agreement would not be within the scope of the revenue recognition guidance (ASC 606-10-15-3).

Second Scenario

Biotech enters into a collaborative arrangement with Pharmco to jointly develop a drug for cancer treatment. They equally participate in costs for development of this drug. Subsequent to successful development of the drug, Biotech continues its research and development activities on the drug and also assumes responsibility for the manufacturing of the drug.

Assuming that the cost of the manufacturing of the drug per unit for Biotech is $100, Biotech sells the drug exclusively to Pharmco for $110. Pharmco, in turn, sells the drug to third parties for $170 per unit and its cost of sales is $20 per unit. Biotech maintains the right to use the research and development know-how on this project on its other projects.

In this scenario, it could possibly be argued that the contract is within the scope of the revenue recognition guidance and Pharmco is Biotech's customer (ASC 606), and risks and rewards are no longer associated with the development of the drug, but participation in the output (ASC 605). Therefore, both Biotech and Pharmco reflect these transactions as revenues from customers.

However, the question remains which entity is the principal and should reflect its revenues on a gross basis, and which entity is the agent and should reflect its revenue on a net basis.

Table 2

	Revenues from Collaboration (ASC 808)	Revenues from Customers (ASC 606 or 605)	Cost of Sales	Operating Expenditures	Gross Margin	Net Income
Biotech as Collaborator	$110	-	-	$100	-	$10
Pharmco as Principal	-	$170	$130	-	$40	$40

Table 1 and Table 2 reflect the financial presentation of Biotech and Pharmco under different scenarios.

The gross margin (and eventually net income) does not change regardless of gross versus net election; however, the top line (i.e., revenues) changes based on the selection of each particular method.

The determination of principal versus agent depends on which entity has the risk and reward (ASC 605) or which entity has control (ASC 606) and is based on the criteria stated in the revenue recognition guidance.

If Biotech sales to Pharmco were within the scope of ASC 808 and revenues were recognized as collaborative revenues, the financial presentation of Biotech and Pharmco is shown in Table 2.

If an entity reflects revenues from customers as part of a collaborative arrangement, it must meet all the revenue recognition criteria under ASC 605 or ASC 606 discussed earlier in this article.

Final Remarks

The revenue recognition guidance excludes from its scope contracts with a collaborator; however, a contract with a collaborator is within the scope of revenue recognition if the collaborator meets certain conditions. The counterparty can be a collaborator for certain parts of the contract and a customer or seller for other parts of the arrangement.

FASB and IASB decided not to provide any specific guidance for determining whether certain collaborative revenues would be within the scope of ASC 606. Thus, making the assessment of whether the counterparty is a collaborator or a customer or seller requires judgment and consideration of all applicable facts and circumstances. This judgment impacts the classification and presentation of the statement of income under both ASC 605 and ASC 606.

Companies currently apply different approaches to account for collaborative arrangements. This has led FASB to undertake a project to clarify when transactions between partners are within the scope of a collaborative arrangement (that is within the scope of Topic 808, *Collaborative Arrangements*) or whether they should be accounted for as revenue transactions under Topic 606, *Revenue from Contracts with Customers*. This article attempted to identify some of the issues involved. ■

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By Josef Rashty

Collaborative Arrangements – A Fine Line in Revenue Recognition

1 The article claims that FASB has added a project to its agenda to:

A. eliminate collaborative arrangements.
B. enhance revenue recognition guidance.
C. clarify when collaborative arrangements can be accounted for as revenue transactions.
D. none of the above.

2 The article claims that collaborative arrangements are very common in:

A. the transportation industry.
B. the technology industry.
C. the airline industry.
D. all of the above.

3 According to ASC 808, a collaborative arrangement is a contractual agreement that involves:

A. two or more parties.
B. parties that are actively participating in joint operations.
C. parties that are exposed to risks and rewards.
D. all of the above.

4 Active participation in a collaborative arrangement means, among other things, participating in governance and oversight of a collaborative arrangement.

A. True
B. False

5 Collaborative arrangements within the scope of ASC 808 are:

A. not typically conducted through a separate legal entity.
B. typically conducted through a separate legal entity.
C. all of the above.
D. none of the above.

6 Counterparties in a collaborative arrangement:

A. could be collaborators.
B. could be customers.
C. could be collaborators for certain parts of an arrangement and customers for other parts of it.
D. all of the above.

7 The article claims that a portion of a collaborative arrangement contract that is intended for the sale of goods and services between counterparties:

A. may be within the scope of the existing revenue recognition guidance (ASC 605).
B. may be within the scope of the new revenue recognition guidance (ASC 606).
C. either a or b.
D. neither a nor b.

8 ASC 606 ________ collaborators that share the risks and rewards of certain activities or actively participate in such activities.

A. excludes
B. includes
C. identifies
D. describes

9 According to ASC 605, revenue transactions sellers are engaged in risks and rewards of ________ (i.e., selling goods to customers).

A. arrangements
B. output
C. input
D. management

10 In certain revenue arrangements, an entity may not necessarily perform all the revenue-related tasks to be able to recognize the whole sales price as revenues on a gross basis with a corresponding offset to cost of sales.

A. True
B. False

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Answers to last issue's self-study exam: **1. B 2. C 3. D 4. B 5. D 6. A 7. C 8. A 9. C 10. D**

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August 2	Personal and Professional Ethics for Texas CPAs	Fort Worth
August 3	Revenue Recognition: Mastering the New FASB Requirements	San Antonio
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August 21	Financial Statement Presentation and Disclosures: A Realistic Approach	Dallas
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Date	Course	City
August 25	Financial Statement Presentation and Disclosures: A Realistic Approach	Houston
August 28	Revenue Recognition: Mastering the New FASB Requirements	Fort Worth
August 28	Annual Yellow Book Update and Review: A Realistic Approach	San Antonio
August 28	The Construction Process of Fraud Prevention	Houston
August 29	Common Frauds and Internal Controls for Revenue Purchasing and Cash Receipts	Fort Worth
August 30	Group Webcast: Financial Statement Preparation, Compilation and Review	Various
September 18-19	2017 Financial Institutions Conference	Dallas
September 25	Personal and Professional Ethics for Texas CPAs	San Antonio
September 26	Personal and Professional Ethics for Texas CPAs	Houston
September 26	Advisor's Workshop: Helping Small-Business Clients Navigate Health Insurance and Fringe Benefits	Austin
September 27	Social Security, Medicare and Prescription Drug Retirement Benefits	Austin
September 27	The Construction Process of Fraud Prevention	Dallas
September 28	Personal and Professional Ethics for Texas CPAs	Dallas
September 28	Preparation, Compilation and Review Annual Update and Review	Austin
September 29	Annual Yellow Book Update and Review: A Realistic Approach	Austin

Positions Available

Rio Grande Valley CPA firm is currently seeking 2 senior tax managers/tax partners for their Valley offices. Please email resume to HRforCPAs@gmail.com.

Staff Accountant - Bragg & Davison, Dalhart, TX, BBA in Accounting or Business. QuickBooks and Microsoft Office experience. Small public firm. Good work environment. Fax/email resume to 806-244-7202 or bdcpa@xit.net.

SENIOR TAX ACCOUNTANT - Ellinger & Mumme, P.C. – CPA Firm

Position: Senior Tax Accountant, Public Accounting, 5+ years experience required

Location: Uvalde, TX

Salary: Competitive compensation based on experience and work ethic

Required Experience: 5+ years experience preparing federal, state, corporate and partnership tax returns. Must be proficient with navigating various tax preparation and research software. Proficient knowledge of Microsoft Office (Excel/Word), QuickBooks, Lacerte.

Required Education: Bachelor's degree in accounting from an accredited university

Job Type: Full Time/Permanent

Requirements:

- Strong ethics/integrity
- Strong communication skills with clients and staff
- Excellent attention to detail
- Experience in income tax preparation and knowledgeable in federal income tax laws
- Licensed CPA or CPA candidate preferred

Ellinger & Mumme PC is a local CPA firm serving small to mid-sized clients in a relaxed atmosphere. Good potential for partnership opportunity. Email resume and cover letter to empc@sbcglobal.net.

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Tarrant County tax and accounting practice, gross $667k
Bryan-College Station area CPA firm, gross $635k
St. Thomas, Virgin Islands CPA firm, gross $75k
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$48,000 gross. East Ft. Worth tax firm. Individual and business client base offers opportunity for expansion of services and growth through referrals. TXN1390

$100,000 gross. Weatherford CPA firm. Tax (90%), accounting/bkkpg (10%), loyal client base, experienced staff in place. TXN1391

$250,000 gross. Van Zandt Co. tax and accounting firm. Stable, loyal client base, primarily tax, but plenty of expansion opportunity. Ideal starter practice. TXN1418

$178,000 gross. Allen CPA firm. 90% derived from monthly bookkeeping and accounting services, year-round cash flow, quality client base. TXN1419

$216,000 gross. Ft. Worth CPA firm. Nearly 90% derived from monthly accounting services, solid fee structure, location flexible in or around Ft. Worth area. TXN1426

$164,000 gross. NE Dallas CPA firm. Loyal client base, strong fee structure and cash flow around 60%, turn-key opportunity available after 4/15/17. TXN1427

$350,000 gross. Wood Co. CPA firm. 78% tax, 22% accounting, good fee structure and knowledgeable staff in place, well positioned for additional growth. TXN1436

$383,000 gross. N. suburb of Ft. Worth tax and accounting firm. (53%) tax, (47%) bookkeeping, good fees yield strong cash flow, turn-key practice. TXN1437

$960,000 gross. Dallas area property tax consulting firm. Cash flow about 75%! Strong fees per engagement, minimal overhead costs, tenured staff. TXN1438

$60,000 gross. North Arlington CPA firm. 44% tax, 56% accounting, 85% of the revenues are derived from businesses, turn-key. TXN1440

$442,000 gross. North Dallas CPA firm. Tax (65%), accounting/bookkeeping (17%), consulting (12%), audits and reviews (6%), cash flow near 70%! TXN1443

$330,000 gross. Mid-Cities area CPA firm. Tax (81%), accounting (14%), other services (5%), cash flow around 45%, knowledgeable staff in place, turn-key. TXN1444

$656,000 gross. North Dallas CPA firm. 65% tax, 35% accounting, strong fee structure produces cash flow around 50%, knowledgeable staff in place. TXN1446

$149,214 gross. East Texas CPA firm. Tax (69%), accounting (31%), quality client base and staff available to assist with smooth transition. TXS1161

$365,800 gross. Near downtown Houston accounting firm. Tax (39%), Bkkpg (37%), payroll (11%), other (13%), flexible transition, available after 4/15/17. TXS1174

$934,500 gross. W. Houston tax and accounting firm. 81% IRS representation, 14% tax, 5% bookkeeping, staff and advertising methods in place, location flexible. TXS1177

$360,000 gross. Champion Forest area CPA firm. 25% tax work, 75% accounting/bkkpg, knowledgeable staff in place, strong growth in recent years. TXS1191

$713,000 gross. Rural SE TX CPA firm. Tax (45%), accounting (24%), payroll (18%), misc. (13%), staff in place and owner available for extended transition. TXS1192

$94,000 gross. Columbia-Sweeny-Lake Jackson-Brazoria area tax firm. Tax (96%), bkkpng (4%), staff in place and owner available up to two years for transition. TXS1193

$608,500 gross. Friendswood - Clear Lake area CPA firm. Tax (76%), bkkpng (20%), other (4%), desirable location, staff available to buyer with extra capacity. TXS1194

$493,000 gross. Memorial-Galleria area CPA firm. Tax (83%), bkkpng (14%), audit (3%), part-time CPAs staff during tax season, nice location, high-net-worth clients. TXS1195

$111,000 gross. Clear Lake/League City area CPA firm. Bkkpng (58%), tax (26%), other (16%), staff in place, asking less than one times annual revenues for quick sale! TXS1196

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Miscellaneous

Do you have questions about sales tax? Taxability issues? Audit defense? Refunds? Voluntary disclosure?

Let us be a resource for your firm and your clients. Our owner is a CPA with a BBA in Accounting and Master of Science in Taxation. He spent 10 years in public accounting, working for both national and large, local CPA firms prior to forming Sales Tax Specialists of Texas in 2005. Feel free to contact us with any questions.

Stephen Hanebutt, CPA
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