NOV/DEC 2017

Today's CPA

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

Recent Independence Issues Under AICPA's Revised Code of Professional Conduct

Solving the Recruiting-Candidate Disconnect

CPE Article: Operating Leases Used to Be the Easy Ones

Do You Solemnly Swear?

A CPA's Primer on Delivering Truthful and Powerful Testimony

Also: **Together We Are Stronger**

"How do I make my practice more profitable and more relevant to my clients?"

by Dr. Chandra Bhansali, Co-founder and CEO, AccountantsWorld

This is perhaps the most acute strategic challenge facing professional accountants like you. Most firms spend over 80% of staff time on core services like tax, accounting, audit and payroll. These are all either compliance services, or services that are considered commodity services by clients. That makes it very difficult to "price your way to success" by raising rates on those services. Moreover, the fees that you and your peers have traditionally charged for these services have already set a precedent in the minds of your clients. That's naturally going to be very hard to change.

So if greater profits aren't achievable simply by changing our rates, what's the alternative?

Fortunately, there are simple techniques that virtually every CPA firm—large or small—can use to make their practices significantly more profitable. And you can accomplish this growth without increasing your fees, or adding any clients or staff. What's more, you'll also become a better advisor to your clients' businesses while you're raising your bottom line.

To learn how you can accomplish this, let's first accept a surprising reality of the digital age that we live in: the lack of correlation between value and price.

The common notion is that the price anyone pays for a product or service reflects its value in the buyer's mind. But today, companies such as Google and Amazon charge commodity prices, or even nothing, for highly valuable services. And they've become highly successful by doing so.

The common thread among all these companies is that they all used the cloud in innovative ways to defy conventional wisdom. What this means for you, the accountant: by using the cloud innovatively, you can convert commoditized accounting and payroll services into greater profits.

How to make accounting more profitable

Accounting is dominated by "Do-It-Yourself" software sold directly to small businesses. This model creates inefficiencies, making accounting a low profit-margin service. The only way to make accounting highly profitable for you, and make your services more relevant to your clients, is to put you – the accountant - back in the driver's seat. That's what we call an **Accountant-Centric** approach.

A professional system based on this Accountant-Centric approach provides everything you need for your professional work—write-up, trial balance, customizable financial statements, and analytics—along with a complete GL system for you and your clients. For clients who'd like to offload all their accounting work, your firm can now offer high-margin Client Accounting Services, including bill payments, bookkeeping, monitoring cash flow, and preparing financial statements. And you can do it all right from your office.

High-margin, headache-free payroll

Until recently, service bureaus monopolized payroll services, thanks to their unparalleled access to cutting-edge computing power. Now, accountants have access to the same level of processing power in the form of highly automated payroll systems. Accountants no longer have to worry about doing direct deposits, paying payroll taxes, filing payroll tax returns, or paying child support or garnishments. Advanced payroll systems can handle all of these automatically, electronically, and on time, with 100% accuracy. Since the cost of processing payrolls is so low, most of your payroll processing revenue goes right to your bottom line, making payroll processing a highly profitable service.

If you're dissatisfied with your firm's current level of profitability – and relevance to clients – now is the time to re-assess your software and processes. You can build more sustainable value for your clients – and your firm too.

About the author:

Dr. Chandra Bhansali (CBhansali@AccountantsWorld.com) is the Co-Founder and CEO of AccountantsWorld, a leader in cloud-based accounting and payroll solutions for accountants. Learn more at AccountantsWorld.com.

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Where Are We Going?

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

As a Boy Scout, I somehow managed to earn the orienteering merit badge. Using a baseplate compass and a topographic map, a scout must demonstrate the ability to move on foot from a starting point to a destination. Mapping a course requires reading the terrain from the map's elevation contour lines and getting bearings from landmarks, regularly checking and adjusting course to reach the destination.

Today, we use smartphones or car navigation systems to guide us to our destination. Accessing a satellite global positioning system (GPS) and relevant online information gives us a suggested route and projected arrival time. If conditions change or we make a wrong turn, new directions re-route us.

To carry out TSCPA's mission, our Bylaws require a written strategic plan that we update every three years. We check our bearings, evaluate landscape changes (or inadvertent detours), and determine adjustments to accomplish our mission of supporting our members and promoting their value and high standards.

With that mission, the Strategic Planning Committee, Executive Board and TSCPA staff had a destination for updating the strategic plan. Yogi Berra once said, "If you don't know where you're going, you might not get there." Knowing orienteering, owning a GPS or developing a strategic plan is useless without knowing the destination.

We still needed to understand where we are as an organization. Our process included surveying members and staff, gathering statistical data, analyzing trends, talking with key stakeholders (including chapter executive directors) and identifying environmental factors impacting the profession and the Society. From that information, a clearer picture emerged of where we are and of the terrain that we must travel.

During the two-day planning retreat, participants analyzed, evaluated, discussed and debated what the information and trends mean and how to adapt our plan. Our collective thoughts began coalescing around a strategic plan vision along with guiding principles and key pillars. Staff and committee members continued refining the vision statement, principles and pillars, working with the Executive Board for ongoing validation.

We also discussed what we should not be doing, which is as important as knowing what we need to do. Professor Michael Porter from Harvard's Institute for Strategy and Competitiveness states it simply: "The essence of strategy is choosing what not to do."

What emerged is this vision for our Society: "Empower our members to lead and succeed." Key principles include not only building leaders, but also leveraging and leading in technology, being a flexible organization and connecting members and resources. Those principles rest on three pillars: Professional Excellence, Advocacy, and Community and Connection. From these core concepts come our goals and success measures to determine our progress.

Even after all the discussion, debate and decisions, our "final" strategic plan is never truly final, nor are the plan details even of utmost importance. President Dwight Eisenhower stated: "In battle, the plan is useless, but the planning is indispensable." We will face circumstances for which we did not plan, but our principles and pillars should guide us in addressing those challenges.

Our strategic plan did not anticipate Hurricane Harvey, but we responded guided by our principles. Organizational flexibility and leveraging technology allowed us to connect our members and resources. We promoted Professional Excellence with webinars and online information to keep members informed. Advocacy efforts included two letters from TSCPA to Congress on tax disaster relief and phone calls with Congressional staffers. Community and Connection showed in our outreach to members needing help and linking them with members who could help.

Finally, a point of personal realization (and confession). Three rounds of TSCPA strategic planning in the last seven years have helped me see my own failure in consistently applying these concepts. I have not always made principle-based decisions that lead where I should go. My choices and tradeoffs (without wisely considering what not to do) negatively affect not only me, but also my team members and, most importantly, my family. D.L. Moody's words amplify that failure: "Our greatest fear should not be of failure, but of succeeding at something that doesn't really matter." The time has come for me to apply what I have learned and make my own long overdue course correction toward what truly matters.

Editor's Note: Please see page 33 of this *Today's CPA* issue for more information on TSCPA's new strategic plan.

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.

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Held Captive: Micro-Captive Insurance in the Aftermath of *Avrahami*

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

The IRS recently notched a victory in the much-anticipated tax court decision of *Avrahami v. Commissioner* – the first micro-captive insurance decision to go to press. The court's 105-page opinion dealt a blow to the micro-captive insurance industry, which has been under increased IRS scrutiny in recent years. And with several similar cases still in the pipeline, some have questioned whether it may be a harbinger of things to come.

A captive insurance company is an insurance company that is formed or owned by a related business owner or group of owners. It provides coverage to that business against risks – risks that are often not readily insurable in the commercial market. A micro-captive is a captive insurance company that has made a qualifying election under section 831(b) of the Internal Revenue Code. As explained below, that section allows the micro-captive to exclude premiums from income. Where the structure works, the business is allowed to deduct the insurance premiums that it pays to the micro-captive and the micro-captive excludes those premiums from income.

The use of captive insurance companies has grown in popularity over the years and there are many legitimate captive and micro-captive insurance arrangements. For instance, the overwhelming majority of *Fortune 500* companies utilize captives. And many mid-size and smaller companies have legitimately employed them, as well. But the IRS has placed micro-captives under scrutiny in recent years, adding certain micro-captive arrangements to its Dirty Dozen list of tax scams and declaring them "transactions of interest" in Notice 2016-66. For better or worse, the recent win in *Avrahami* is likely to embolden the IRS in its attack.

The Basic Statutory Structure

Premiums paid for insurance in connection with a trade or business are generally deductible under section 162(a) of the Code. In contrast, amounts that are merely set aside as a loss reserve – a form of self-insurance – are not deductible. This distinction is one of the fundamental legal issues in the captive context.

While a trade or business is entitled to deduct reasonable and necessary insurance premiums, the Code also generally taxes insurance companies on their receipt of such premiums. Section 831(a) generally provides for a tax on the taxable income of non-life insurance companies.

There is, however, a wrinkle for certain small insurance companies – an alternative tax regime that was added to the Code as part of the Tax Reform Act of 1986. Where available, section 831(b) provides an elective "micro-captive" tax regime that allows a qualifying insurance company with less than $2.2 million in annual net written premiums to exclude premiums from income. This $2.2 million threshold was recently increased from $1.2 million under the Protecting Americans from Tax Hikes (PATH) Act of 2015. The PATH Act also introduced certain new requirements to obtain micro-captive status that are beyond the scope of this article.

Captive Insurance Companies

The use of captive insurance companies has grown remarkably in recent decades. Fred Reis is traditionally credited with popularizing the concept when, in the 1950s, he helped Youngstown Sheet and Tube establish a captive in response to soaring commercial-insurance prices. The concept revolutionized the insurance industry.

A pure captive insurance company only insures the risks of related companies. Because the insured and insurer are related, such arrangements can sometimes blur the line between deductible insurance and non-deductible self-insurance. Over time, the IRS began to focus its attention on payments to captives, challenging whether such payments were deductible insurance expenses. For years, this has been one of the central issues in the captive context.

What is Insurance?

Remarkably, neither the Code nor the regulations define "insurance" for federal tax purposes. As a result, the development of its meaning has largely been left to the courts. The Supreme Court first articulated a definition of "insurance" for tax purposes in *Helvering v. Le Gierse,* 312 U.S. 531 (1941). That case and its progeny have given rise to four factors that determine whether an arrangement constitutes "insurance" for federal tax purposes: whether the arrangement involves (1) insurance risk, (2) risk shifting, (3) risk distribution and (4) commonly accepted notions of insurance.

Insurance Risk. As the tax court has held, "[b]asic to any insurance transaction must be risk ... If no risk exists, then insurance cannot be present."[1] Thus, where a transaction is structured in a manner that eliminates insurance risk, the arrangement does not constitute insurance for federal tax purposes. This was the case in *LeGierse,* where the taxpayer and insurance company simultaneously entered into an annuity contract and insurance contract that the court found counteracted each other's risks, leaving only an "investment" risk, which is distinct from an insurance risk. The IRS has also questioned whether certain types of insured risks are, in fact, valid risks faced by the taxpayer: For example, tsunami insurance for a company in the Midwest or terrorism insurance for a business in a rural area. In such cases, the IRS may challenge whether a valid insurance risk actually exists.

Risk Shifting. Risk shifting occurs when a taxpayer facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to an insurer. Courts have looked to several factors to determine whether a risk of loss has effectively been transferred. Perhaps chief among those factors is whether the

insurance company is adequately capitalized. An undercapitalized insurer would lack the ability to satisfy its obligations, leaving the risk with the taxpayer. Likewise, contractual caps on an insurer's liability or indemnification agreements by related parties may also jeopardize the presence of risk shifting.

Risk Distribution. Risk distribution, a separate and distinct element that is necessary to constitute "insurance," is focused on whether the captive insurance company has sufficiently spread its risk of loss. That is, has it pooled a sufficiently large collection of unrelated risks to distribute its risk among others. The concept incorporates the statistical phenomenon known as the law of large numbers, a theory that postulates that the average of a sufficiently large number of independent losses will approximate the expected loss. Courts tend to place an emphasis on factors such as the number of parties insured, the types of risk exposures insured and the portion of premiums received from unrelated parties.

Insurance in the Commonly Accepted Sense. Finally, courts look to whether the arrangement constitutes insurance in the commonly accepted sense. To address this question, courts have traditionally looked to whether the company is organized and operated as an insurance company and regulated as such, as well as whether its premiums were the result of arms-length transactions and actuarially determined. In addition, courts consider other factors, such as whether the insurance policies were valid and binding, whether the premiums were required to be (and were, in fact) paid timely and whether loss claims were timely satisfied.

Avrahami

The taxpayers in *Avrahami*, Mr. and Mrs. Avrahami, owned several shopping centers and jewelry stores. In 2006, the Avrahami entities spent about $150,000 insuring them. In 2007, they formed Feedback Insurance Company, Ltd., an insurance company incorporated in St. Kitts. Feedback made an election under section 953(d) to be treated as a domestic corporation for federal income tax purposes, and elected to be treated and taxed as a small insurance company (a micro-captive) under section 831(b). During 2009 and 2010, the years at issue, the Avrahami entities deducted insurance expenses of about $1.1 million and 1.3 million, respectively – most of which was paid to Feedback. Consistent with its election under section 831(b), however, Feedback only paid income tax on its investment income – not premiums.

The IRS challenged whether the arrangement with Feedback satisfied the criteria for "insurance" for federal tax purposes, arguing that the amounts paid to Feedback were not deductible business expenses and that the amounts should be taxable to Feedback as income. Among other things, the IRS pointed to the fact that a significant amount of the premiums paid to Feedback were directly or indirectly distributed or loaned back to the Avrahamis and that Feedback had not paid out any claims prior to the IRS audit of the arrangement. The IRS also argued that the types of risks that were insured – which included risks of litigation, terrorism and additional taxes resulting from adverse IRS determinations – undermined the taxpayers' claim that the arrangements were "insurance" for federal tax purposes.

The tax court, in a lengthy opinion, ultimately sided with the commissioner, finding that premiums paid by the Avrahami entities to Feedback were not for "insurance" for federal tax purposes. More specifically, it found that the arrangement failed to properly distribute risk and that Feedback was not selling insurance in the commonly accepted sense. However, all was not lost for the taxpayer. Although the IRS pressed for accuracy-related penalties under section 6662(a), the tax court refused to impose such penalties to the extent that the tax underpayments resulted from the court disallowing a deduction for the premiums paid to Feedback.

A Road Map for Compliance

The *Avrahami* decision was the first published micro-captive decision. While the case is likely to be appealed, it provides a working road map for micro-captive compliance. Indeed, those involved in current and future micro-captive arrangements should read and follow the opinion carefully.

It may also be the first in a line of cases to come. There are several similar cases still working their way through the tax court pipeline that may refine and further flesh out the teachings of *Avrahami*. So stay tuned for more.

Jason B. Freeman, JD, CPA is the managing member of Freeman Law PLLC, based in the DFW Metroplex, and an adjunct professor of law at Southern Methodist University's Dedman School of Law. He can be reached at Jason@freemanlaw-pllc.com.

Footnotes

1. *Amerco v. Commissioner*, 96 T.C. 18, 38-9 (1991)

Resolutions

By Mano Mahadeva, CPA, MBA | Column Editor

Today's finance role within an enterprise has transitioned into one that looks to its past, but helps shape its future. No longer the back water bad guys, department heads across organizations look to finance leaders as valued partners and collaborators to garner business insight and gain operational efficiency. This transition, however, does impact roles and responsibilities within the finance team – which may require the acquisition of new skills, capabilities or experience by team members for effective results.

To be relevant today, all of us need to professionally evolve and be proactive in doing so instead of waiting to be told. However, this is a challenge for us, because the commodity of time is insufficient to cater to the many conflicting priorities and distractors. So, as we wind down 2017, here is an opportunity for us to help reprioritize time and activities so that we can include such new skills and capabilities in the coming year. To help you on your way, below are some areas to consider, which may be very meaningful to your career.

Basic skills are still very important to one's career and they are easier "said" than done – those of communication, presentation, writing and presence! In simple terms, **communication** is knowing how to convey and receive messages in person, as well as by email, phone and social media. Communication skills include listening (being an active listener), non-verbal communication (hand gesture, eye movement), saying just enough with clarity, using a friendly tone and stating information with confidence, empathy, open-mindedness and respect. All of this sounds very simple and obvious, but it is the one area that trips us up the most.

Presentation skills help get our message across, clearly and effectively, to our audience, such as to our board, management members, investors or other constituents. This can be a daunting task to most anyone, but can be mostly mitigated by lots of preparation and work. Toastmasters International is a group that helps one develop public speaking and leadership skills through practice and feedback in a club setting. If you don't have the time to attend these meetings, set up your phone/camera and record yourself! I have done this many times and they can provide a very scary, but educational moment watching one's self perform poorly!

Writing skills are coming back in a big way. Employers have begun to ask potential employees to write answers to certain questions, such as on a project plan or a business plan, in <u>their</u> presence, to check on one's ability to write. It's no surprise that texting and Twitter messages have become almost simply acronyms and single alphabets these days. Finance team members correspond with numerous constituencies, internally and externally, so this required core skill set is receiving a higher status of importance.

Knowledge – Reading a variety of materials and classroom or online learning can help us keep up with the latest changes in the profession. The acquired knowledge helps change the way we think and helps to reframe questions and solutions. Good decisions come from knowledge and not pure numbers – in the real world, it is about making critical half-time adjustments that help our company stay in the game. A habit of voraciously reading (or listening to) quality journals, periodicals, research papers, business books and summaries helps us gain insight and perspectives to shake up any traditional, familiar or inert ways. Regardless of the way acquired, a nugget of critical information is worth its weight in gold.

Critical Self-Review – It is helpful for us to conduct our own honest look back over the past year to reflect on what worked and what did not. A useful tool that ably supplements our own review can be done with a 360 review that provides feedback on our performance by professionals within our department, as well as those outside. We can compare both results to assess our strengths and deficiencies and remedy any shortfalls.

Walking in Others' Shoes – Most of us like to stay in our comfort zone, since this is what we know and we do it well. Why not work with a colleague in another area to understand the challenges they face so that we might be more sympathetic to their needs? It also helped me to better understand our key business drivers and those factors that made them change. It gave me an opportunity to explain variances beyond mentioning a percent change.

Outstanding leaders drive business performance. They can turn around a business. They can build up teams and create a culture to foster innovation. It's all about one's mindset – we, as professionals, need to be nimble and willing to adapt to a changing ecosystem. The good news is that we have the capacity and capability to adapt, but how we disrupt ourselves is a skill that needs to be cultivated.

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

Data Analytics: The Wave of the Future for CPAs

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

Data analytics is becoming a way of life for all of us. Figuring out ways to analyze "big data" and use it effectively is transforming the business world, including our roles as CPAs.

It Starts in the Mind

The advocates of data analytics call it "the analytics mindset," but it really boils down to a process that has existed for many years, involving critical thinking and the ability to perform impactful research. Here are the steps.

1. Ask the right questions. Discern the issues facing your business. What solvable problems do those issues bring out? What do you want to accomplish with the data that are available? What would you like to know beyond the data that are available? Who are the stakeholders impacted by answering the questions? Formulate questions in such a way that answers can yield results that lead to an impactful decision.
2. Identify relevant and appropriate data sources. Gather the data and transform it into a usable format.
3. Apply appropriate data analytics techniques. This might require everything from simple sorting of the data to advanced mathematical or statistical analysis.
4. Evaluate the results and make a decision. Interpret results as you see them. Do they make sense to you? How might others view them? Be sure to relate the results to the questions that you asked and make a judgment as to whether the results of your research answered those questions or whether, in some cases, they raised new questions. Ask whether further analysis is required to meet the objectives raised by your original questions.
5. Communicate the results verbally and in writing to stakeholders in a way that will influence their judgment.

Can't I Outsource This?

Perhaps you're thinking that the above process is so specialized that it requires hiring a high-level IT professional or data analyst. Although this might be the right strategy for some complex questions, the point is that *mainstream business professionals of the future, including CPAs, need to adopt (or at least appreciate) the data analytics mindset*. With so much more data becoming available to us through use of technology, we all need to recognize its potential to do more for us and to adopt approaches to leverage it in a way that will add value to our businesses. Adopting the mindset is the first step on the journey.

How is Data Analytics Transforming Various Jobs in the Accounting Profession?

Data analytics is already having a significant impact on the accounting profession. Here are a few examples:

- Tax: Federal and state taxing authorities are finding new ways to collect tax data directly from companies and individuals in a real-time fashion and share it with other taxing authorities, creating more transparency and improving cash flows for taxing authorities. Major areas include transactions tax, tax reporting, risk analysis and monitoring, and transfer pricing analytics.
- Audit and compliance: Auditors can use data analytics to gain deeper insight into the risk profile of a company to better enable inherent and control risk assessments on audit engagements, and thus facilitate better audit planning. In addition, because of the proliferation of data analysis tools, audits are evolving toward the application of audit procedures to entire populations (rather than merely sample items) and identification of transactions with unusual characteristics, thus permitting more effective interpretation of audit results.
- Fraud: Companies are using data analytics to develop more proactive fraud monitoring and detection techniques. Fraud specialists are using textual and sentiment analysis programs to scan emails and other corporate data for key words or phrases that might signal fraudulent activity.
- Corporate strategy and budgeting: Sophisticated predictive data analytics techniques are being used in making forecasts and projections. Companies are developing tools to analyze customer data at a more granular level through broader sources of data, including social media, online shopping carts, etc. This allows companies to create and market customized solutions based on individual customer profiles.
- Operations: A much larger and wider variety of data is being made available, revealing details of processes, identification of bottlenecks and creation of efficiencies that lower costs and improve profitability.

Training the Future Talent Pool

Transitioning to a data-analytics driven world requires training of the workforce of tomorrow. Colleges and universities across the world are developing new data analytics curricula and drawing from a talent pool that is cross-trained not only in business, but in science, technology, engineering and mathematics (STEM) areas. Business schools are trying to attract more students trained in these areas, and to develop MBA and other masters' degree or certificate programs to prepare them for the challenges of the world of big data. ■

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Software's New World of Incremental Improvement

By Thomas G. Stephens, Jr., CPA, CITP, CGMA

In subtle and not-so-subtle ways, software – including operating systems – is changing. For many software publishers and many software titles, gone are the days of releasing a "major upgrade" every two to three years. Instead, publishers are turning to a model where "incremental improvements" are frequently released, often monthly, and the net effect of this approach is that it changes how we will acquire, update and use our software and operating systems in profound ways.

Comparing the Two Models

In the past, software publishers typically would create and publish a software title, and consumers would then purchase a perpetual right-to-use license of that software title and install the application onto their computer. Periodically, the software publisher would issue patches to resolve bugs in the application and to address any known security vulnerabilities. Meanwhile, in the background, the publisher would begin developing the next version of the application, by improving on existing features and adding new features in the hopes of enticing consumers to invest in an upgrade license when it became available. Often, this upgrade cycle ran about three years.

To the casual observer, this business model seemed to work relatively well for both the publisher and the consumer. However, there were significant weaknesses in this model for both parties. For example, from the publisher's perspective, this model created a cycle of cyclical and unpredictable cash flows and revenues. Many consumers chose not to invest in upgrades when they became available and would often skip one or two versions of the updated application in an attempt to increase their return-on-investment of the originally-purchased application. So, while the publisher would make significant investments in developing new features for the upgraded application, there was no guarantee that consumers would elect to spend the money on acquiring a "new and improved" version of the tool.

Additionally, from the vantage point of the consumer, upgrades were often viewed as problematic and risky. In some cases, newly released applications caused integrations with other applications to stop working or required upgrades to hardware also. Further, for team members to take advantage of new and improved features, they needed to be trained on what these improvements were, why they were important, and how they could and should be used to increase productivity. For these reasons, many individuals and organizations chose to defer upgraded applications for as long as they could.

Case Studies – Microsoft Office 2007 and Windows Vista

The release of Microsoft Office 2007 provides a vivid example that reinforces the points outlined above. Approximately 10 years ago, Microsoft released the upgraded version of its flagship Office suite of applications as an upgrade to Office 2013. Office 2007 contained many very significant new features that, over time, have proven to be exceptionally valuable. However, because Office 2007 included a radically different user interface than previous versions of Office and because the file formats were different than those found in prior versions of Office, many consumers and organizations deferred upgrading for several years after the original release.

Likewise, the 2007 release of the Windows Vista operating system was also widely ignored by many consumers and organizations. While Vista introduced some cutting-edge features that are considered by many to be mainstream today – BitLocker drive encryption and User Account Control, to name two – Vista was not compatible with many pieces of hardware in use at the time. Therefore, adopting organizations often incurred unanticipated investments in new hardware and spent countless hours on resolving issues such as updating drivers for existing hardware.

With both Office 2007 and Vista, the magnitude of the changes brought about by the upgrades created disincentives to taking advantage of the positive features made available in both tools. Thus, neither product was as well-received in the market as many had forecasted.

So, What's Different Now?

First, software publishers are moving away from the "perpetual license with a major upgrade every three years" model. Instead, they have begun offering their application on a subscription basis, through which users pay monthly, quarterly or annual subscription fees for the right to use the software. Of course, publishers of cloud-based Software As A Service (Saas) have always operated this way, but now many traditional, desktop-based applications can be licensed through subscriptions also. Examples of mainstream applications available through subscription licenses include Microsoft Office (through an Office 365 subscription), Adobe Acrobat DC and QuickBooks Enterprise Solutions.

Now, you can even license Microsoft Windows on a subscription basis. In general, the advantages of licensing software in this fashion include predictable cash flows, the ability to scale up or scale down the number of licenses as organizations expand and contract, and automatic upgrades when new major releases become available. However, as indicated below, the issue of automatic upgrades is not as straightforward as it might seem.

A second major change in software development is that of moving away from large-scale, major upgrades and adopting a policy of continual, incremental improvements that are released on a relatively frequent basis. Of course, this is the paradigm under which SaaS publishers have always worked. For example, if you subscribe to a cloud-based accounting application such as Xero, when engineers tweak the application and add new features, you receive the benefit of those new features automatically and without having to install any new software. Further, there is no separate charge for these incremental improvements – they are included with your subscription. Traditional publishers such as Microsoft and Adobe are now adopting the same strategy for their subscription-based customers.

For example, if you are an Office 365 subscriber, Microsoft is making available new features for that product every month, and many of these features are not being made available to those who choose to purchase traditional perpetual-use licenses. In fact, you can view summaries of these new features at https://blogs.office.com. Additionally, with Windows 10, Microsoft is pushing new features to users on a monthly basis, instead of saving them for release as a future major upgrade to the Windows operating system. This update process creates what many are now referring to as "Windows as a Service."

For the software publishers, these changes provide more predictable revenues and cash flows, while simultaneously minimizing the technical support issues previously associated with major releases. For consumers and organizations, doing away with major upgrades removes the barriers to taking advantage of new and improved functionality while the shift to subscription licenses helps to provide predictability and flexibility in software licensing expenditures.

Benefits for Everyone

The trend to subscription licenses and incremental improvements is one that appears to be accelerating and for a good reason – it seems to benefit both software publishers and their customers. As a consumer, you should carefully consider how you currently license your software and your existing upgrade strategies and policies. If you are still using traditional approaches to licensing and upgrading, perhaps now is a good time to consider taking advantage of the benefits made available in the new world of incremental improvement. ■

Tommy Stephens is a CPA and a shareholder at K2 Enterprises, where he develops and presents technology-focused CPE courses. You may reach him at tommy@k2e.com.

Together We Are Stronger

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

Members, their staff and their families reached out across the state to help fellow CPAs in Texas areas affected by Hurricane Harvey and the historic levels of flooding that followed. Many pitched in to donate money and supplies, to be taken to those in need in the coastal area. Others joined volunteer brigades traveling to help with the massive clean-up work.

To help its members on a personal level and learn who had specific needs, as well as who could help, TSCPA sent an electronic survey to approximately 9,000 members in the counties that had been designated for IRS tax relief as of early September. In their responses, member after member expressed appreciation for the concern and caring.

Below are stories from some of the chapters most affected by the storm and its aftermath.

Corpus Christi

Symbolizing Texans' dedication to helping wherever needed, the San Angelo Chapter donated $700 to the Corpus Christi Chapter to assist members in the hardest-hit areas there. The receiving chapter matched the gift, and used the money to support relief and rebuilding efforts in the area.

Volunteer groups were put together for two weekends in October to participate in clean-up efforts. For maximum effectiveness, they worked through an existing charitable organization rather than starting one of their own. The nonprofit selected was recommended by a recent chapter president who had participated in its work and felt it would be a good fit. The chapter will include disaster-recovery topics at their February tax conference.

Houston

The Houston Chapter developed several projects to help the thousands of members in its area, as well as their employers. They started by putting out an email alert looking for members in need and for those with help to give, and coordinating responses.

A large, local CPA firm had not been able to access its offices near flooded Buffalo Bayou in the month since the storm; extensive damage in the basement had caused operations in the building to fail. They contacted the chapter and were provided with office space for client meetings as needed and niches for staff to work.

The chapter helped Kingwood High School get its accounting honors program back on track. The school was flooded and is closed for the year, but almost 300 students who take the accounting course are continuing their studies at another school. The CPAs Helping Schools committee, along with local businesses, Insperity and GrowthForce, provided $15,000 for new computers and donated e-textbooks to help this honors program thrive despite the storm.

Many new nonprofit organizations have sprung up to help with disaster recovery. A good number of them, while well meaning, do not have the financial background to properly run such an organization. The chapter has CPA volunteers ready to help get them moving in the right direction so that all collected donations can be used as intended rather than having rebuilding efforts stall because of inexperience.

An event is planned for members in November, titled State of the Community: The Rebuild. Discussion will include Harvey relief, the work being done by the chapter and by TSCPA, and legislative updates, as well as membership survey results.

Southeast Texas

Those lucky enough to escape water damage in their own homes got to family and neighbors as quickly as they could, to begin the exhausting process of ripping out ruined flooring and sheetrock from houses before mold became too thick for work to be done without personal risk. Some were not so lucky. There were heartbreaking stories about members whose homes had water levels at heights causing a total loss. Many were without adequate insurance because they were not in a flood zone.

Out of respect for the time that so many were having to spend juggling work and recovery efforts on weekdays, the September chapter meeting was cancelled. However, to provide a respite and an opportunity for some much-needed fun, the Lamar University football tailgate party with the Beta Alpha Psi chapter at the end of the month was held as planned. There were lawn games and soft drinks and grilled food shared with all who passed by.

The chapter had just launched its expanded sponsorship program for Lamar accounting scholarships before the hurricane hit. But members and businesses responded generously to the request to participate. More than $7,000 was donated, despite the fact that so many had already dug deep into their wallets to give money to local recovery and relief projects.

Statewide

TSCPA developed and maintains a webpage focused on connecting members with resources for financial disaster recovery. Because recovery and rebuilding continue long after the floodwaters subside, a 501(c)(3) foundation is planned to receive tax-deductible donations and distribute funds to those in financial need. Work with elected officials and with agencies at the federal and state levels will be ongoing as the Society harnesses the power of its 28,000 members and taps every available resource to help in every way possible.

Goodman Financial Corporation
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Houston, TX 77056
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Toll Free: (877) 599-1778
www.GoodmanFinancial.com

Tear here to save for easy reference

November 1, 2017

Dear Fellow CPAs:

CPAs have a reputation of being the most trusted advisors to their clients. It is a reputation that is well deserved and protected. CPAs are professionals; they put their clients' interests first and utilize their deep knowledge and experience to serve their clients in areas within their specific expertise. When a client need falls outside that expertise, they look to refer them safely to a well-vetted fellow CPA that can best meet those specific needs.

There is a firm, our firm, that has been serving the investment management and financial advisory needs of clients for almost three decades. Our clients include individuals, trusts, foundations, endowments and pension funds. We have been a fee-only fiduciary since our firm's inception. We manage our clients' portfolios prudently, in a tax-efficient manner, with a great amount of oversight. We do not sell any investment or insurance products. While the majority of our client-facing professionals are CPAs, we are not a CPA firm and do not prepare tax returns or provide accounting services. We do, though, work closely with CPAs that refer clients so that we can best serve their clients.

While we are based in Houston (come visit us sometime), **we serve clients across Texas** and in 18 other states around the nation. Our professional team is highly credentialed, diverse, and includes members of multiple generations. We have experience serving multi-generational families and have built the firm to last.

We invite you to call on any one of us if we can be of assistance to you or your clients. You can learn more about our firm and gain access to our newsletter, market commentary, and economic reports at **GoodmanFinancial.com**.

Sincerely,

Steven R. Goodman, CPA, CFP®
President & Chief Investment Officer

Ed Roth, CPA, CFA, CFP®, CEBS
Vice President, Investment Advisory Services

Chris A. Matlock, CPA, CFA
Director-Portfolio Management

Charlotte M. Jungen, CPA, CFP®
Client Service Manager
Chief Compliance Officer

Wade Egmon, CPA, CFP®
Client Service Manager

Saving Graces

Beaumont CPA and Firm Face Down Harvey Aftermath

By Anne McDonald Davis

When **Josh LeBlanc**, CPA-Southeast Texas, came home to Beaumont in the week following Hurricane Harvey's hit on the Gulf Coast, he could see by the debris lines in the trees how high water had risen. The scope of devastation was hard to take in.

"A friend in Houston told me, 'Everything I've worked for is gone,'" LeBlanc says quietly. "There were dozens and dozens of boats … everywhere."

Josh LeBlanc, CPA-Southeast Texas

Although the firm where he's a partner, Edgar, Kiker & Cross, would remain closed for a week, all their crew members were safe and accounted for. One employee's home had experienced some flooding and nobody could get to work – or anywhere else for that matter. Chinooks were the only source of supplies for more than a week, but the water continued to recede and recovery efforts were swiftly underway.

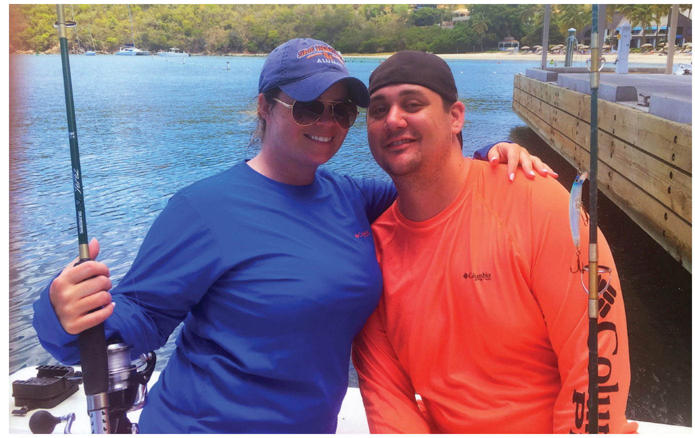
LeBlanc smiles: "Beaumont leaders should be very proud of the infrastructure here. Although nothing can fully prepare us for something like this, volunteers dug in. My wife and I were fully ready to deal; she'd been the one to convince me to slow down when I was in a rush to get back. Instead, we first made sure we had provisions – food, water, cleaning supplies. We just wanted to be able to help anybody we could."

He's proud that his 30-member firm, long dedicated to community, had the same attitude. All staff members were encouraged to make recovery outreach a priority during this crisis period.

"We realized pretty quickly that tax returns were not a primary concern for most anyone," LeBlanc nods. "We paid our staff if they wanted to get out and volunteer and help instead. All the resources we had available, we gave. We made sure our clients with payrolls could run, but pretty much everything else could wait."

In addition to his accounting skills, LeBlanc knows his way around a housing construction project. Alongside rescue workers from local businesses, churches and nonprofit organizations, he quickly fell into the rhythm and an orderly set of rules: Wear masks, wear goggles. Get the furniture out of the house, usually unsalvageable. Floors come out next, then walls and insulation.

LeBlanc reflects soberly: "By the end, you could see from one end of the house to the other. We used tractors with front bucket loaders so that we could just pile everything out windows and doors. Photographs, artwork, souvenirs – a lifetime of memories. Gone."



Cheryl LeBlanc and Josh LeBlanc, CPA

Gary Zimmerman, CPA, Ben Pousson, Melissa Stansbury and Josh LeBlanc, CPA

Beaumont CPAs were also in the unique position of being able to foresee the financial repercussions down the road. Gulf Coast professionals, sadly, have had too much experience dealing with taxes, insurance, FEMA, Red Cross, documentation, checklists and reconstructed records.

"Some of these great organizations were quick to jump in and do … but without having full comprehension of what was about to happen months from now," LeBlanc explains. "We had to get some of the volunteers to hold back. We would grab homeowners and pull them outside to take photos, point out where the debris needed to go, create as much documentation as possible. Most people have no concept of how casualty losses are handled. Yes, they had to get the houses mucked because of health concerns … but just an extra hour or two to document was crucial."

A Hometown Journey

LeBlanc is enthusiastic about his work in accounting and all things Beaumont. His life experiences make this understandable. Although originally from the Beaumont area, his family moved to Llano for several years before returning.

Cheryl LeBlanc and Josh LeBlanc, CPA

Josh LeBlanc, CPA, and Drew Miller

He muses: "In some ways, it was the best thing that ever happened to me. Beaumont was never a big city, but still a modern city and the only place I had ever known. When my father was transferred, before my parents were divorced, I went from a city that had five high schools to a place where the entire population was 3,000. I felt very out of place. But I made friends and learned to do hard country work. There were cold winters, hotter and drier summers. Those few years were very influential on me."

When he was a sophomore in high school, LeBlanc learned another hard lesson: the importance of financial stability for families and their future. His mother had to face serious financial hardship and move in with her parents back in Beaumont.

"We reset and had to start all over with nothing," LeBlanc remembers. "We left with our car and the clothes on our backs."

Although he had always dreamed of going to a big school like the University of Texas, out of necessity LeBlanc ended up attending Lamar University. Turns out, he wouldn't change that for anything.

He enthuses: "Lamar is one of the treasures of this community. I am very proud to be involved in the university and its growth. Some very reputable people and influential business leaders came from Lamar. We're becoming more of a college town every day, amid a flourishing community."

LeBlanc also resisted the push for accounting graduates to take advantage of the opportunities at bigger firms. He was determined to remain near his mother and younger brother. Then, when he interviewed with his current firm in Beaumont, he sensed immediately it was the right fit.

"I thought to myself, 'I hope that's the firm that calls.' And I'm a partner with that firm today," he exults. "All the partners in the firm I joined were involved with the community. I never wanted to run for president, but I did want to be part of a group of business leaders who were respected. And here I am, living the dream at the age of 32."

The New Horizon

Married for a year, LeBlanc says his wife, Cheryl, is the most important person in his life. "My wife is a very special and smart person, maybe smarter than me. I have to swallow my pride to admit that," he laughs.

The couple had many mutual friends, but had never met. Then at a wedding for one of those friends, instant romance. However, LeBlanc's new love had a powerhouse job in Houston – commercial operations manager covering the North America & Latin America regions for the PII division of GE Oil and Gas. Could he really bring himself to pull up his deep Beaumont roots?

"Before even figuring it out, I proposed," he shrugs. "I knew I wanted to spend the rest of my life with her. Later she told me, 'I have a great job. I have a good career. But I've never met anybody in my life who gets up with a smile on his face and goes to work and loves everything he does. I would never take that away from you.' She got approval to work remotely and moved to Beaumont! To this day, we're both still able to do everything we love."

With his firm's blessing, LeBlanc has been involved with numerous civic and charity organizations. (Cheryl says he needs to learn to say "no.") In addition to lots of volunteering at the local and state levels of TSCPA, he participates currently in leadership for Lamar University, Southeast Texas Estate Planners, a local cycling club, and many others previously.

"I cycled 5,000 miles the year before we met and was beginning to compete. I was on the verge of trying triathlons and I'll probably circle back to that someday. I want to hear the words, 'You are an Iron Man.' I also love fishing, being on the water. My wife and I made a pact that one hobby is cheaper than two, so I picked fishing. She likes to travel, so we agreed that the boat budget and traveling budget must be equal," he grins.

On that hopeful note, LeBlanc reflects again on this tragic disruption to life in Beaumont. "It's hard to speak about," he admits. "I can't even begin to explain how some people have come to terms with letting go. It's not human nature. Everything in us goes against that.

But for two weeks, I watched every other problem in everyone's lives here go away. Perfect strangers come up and perform the kindest gestures and simplest acts that mean everything. People are taking care of each other. I think that in times of desperation and devastation, we can see people's hearts. That's been one change for the good. It was refreshing to work with people I've never met, to see tears of appreciation and gratitude. Handshakes have gone out the window. It's hugs and kisses here." ■

TSCPA Launches New Online Community: TSCPA Exchange

We are excited to announce the recent launch of our new online community, TSCPA Exchange, where members can connect, engage and discuss critical accounting issues in real time. TSCPA Exchange is a powerful new resource that allows members to communicate with 28,000 accounting colleagues in a private, members-only forum. Some of the valuable features of this new community include:

TSCPA EXCHANGE
Where members connect and collaborate

- **All Member Forum** – Start a conversation, share your thoughts or participate in a discussion. This is the best way to get advice and input from your peers!
- **Member Directory** – Search for TSCPA members by name, chapter, company or email address. You can view members' profiles, send messages and add contacts to expand your network. Be sure your profile is up-to-date too!
- **Resource Library** – Upload, share or search for sample documents, industry-best practices, comment letters, spreadsheets, exam study guides or any other useful tools and templates.

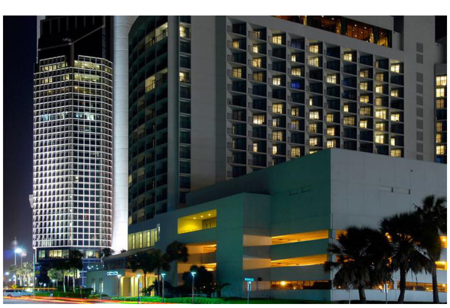
We know the value our members place on belonging to this professional network and we're excited to launch an online environment where you can lean on fellow TSCPA members as an industry resource. To get started, visit **exchange.tscpa.org** and sign in with your TSCPA member login credentials.

We encourage you to update your bio, add a profile photo, connect with colleagues and start a discussion on the main forum. The ways to engage are endless and the more members who contribute, the more valuable the community becomes. Visit the "Help" center on TSCPA Exchange for FAQs and a handy Quick Start Guide to get you started.

Notice of Midyear Board of Directors and Members Meeting

Make your plans now to attend our next Midyear Board of Directors and Members Meeting on Friday and Saturday, Jan. 26-27, 2018, at the Omni Corpus Christi Hotel. You'll learn more about how TSCPA is empowering members to lead, succeed and grow with programs and services that put you at the center of everything that we do. This terrific event gives you an ideal opportunity to connect with colleagues and friends, meet new contacts, have important discussions with TSCPA leaders and influence the future of your professional community. It's no wonder that more than 200 members attend this event each year.

The Omni Corpus Christi Hotel is located in the lively downtown Marina District and offers luxurious guest rooms with spectacular views of the Corpus Christi bay. Providing convenient access for guests, the hotel is located just 15 minutes from Corpus Christi International Airport.



Omni Corpus Christi Hotel

900 North Shoreline Boulevard

Corpus Christi, TX 78401

361-887-1600

Rate: $159 single or double plus taxes

Cutoff Date: Jan. 2, 2018

Corrections for September/October Issue of *Today's CPA* Magazine

On page 20 of the September/October 2017 issue of *Today's CPA,* **Ken Horwitz**, JD, CPA-Dallas, was recognized as a co-recipient of the award for Outstanding Committee Chair. It stated that he was chair of the Relations with IRS Committee, but he was actually chair of the Federal Tax Policy (FTP) Committee. He was recognized for his exemplary work on the FTP Committee. We apologize for the oversight in the magazine and congratulate him on receiving the award.

Also in the September/October 2017 issue of *Today's CPA*, it stated that the Corpus Christi Chapter received the award for Outstanding Medium-Sized Chapter. Instead, it was the El Paso Chapter that was recognized with the award for the 2016-2017 year. We apologize for this oversight and congratulate the members in the El Paso Chapter on being honored as the Outstanding Medium-Sized Chapter.

Membership Suspensions

Catherine A. Storm, Carrollton, entered into a settlement agreement effective Oct. 2, 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, Storm is hereby suspended from TSCPA and AICPA membership for two years, retroactive to Oct. 2.

The following people have had their membership in TSCPA suspended by the Executive Board for non-compliance with TSCPA Bylaws Article III, Section (4A)(1) for non-compliance with the Texas State Board of Public Accountancy's continuing professional education requirements.

Suspended for a period of three years –

- David Cohenour, CPA, Richardson
- Vincent A. Hummer II, CPA, CGMA, Houston

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 TSCPA's website at tscpa.org. Under the Resource Center tab, scroll down and click on Accountants Confidential Assistance Network.

Outstanding Educator Award Recipients Recognized

TSCPA presented three top Texas accounting professors with the organization's 2017 Outstanding Accounting Educator Award. The awards recognize accounting educators in Texas who have demonstrated teaching excellence and have distinguished themselves through active service to the profession. The recipients for 2017 are:

- Jennifer Johnson, CPA, CGMA – The University of Texas at Dallas (Large Four-Year College/University)
- Anne-Marie Teresa Lelkes, Ph.D., CPA – Texas A&M University – Kingsville (Medium Four-Year College/University)
- Gilbert C. Barrera Jr., JD, CPA, MPA – Texas A&M University – San Antonio (Small Four-Year College/University)

Criteria for judging include instructional innovation, student motivation and learning opportunities, professional and student accounting organization involvement, research and publications. At a ceremony held during the TSCPA Accounting Education Conference, the winners each received a $500 award and a recognition plaque provided by the TSCPA Accounting Education Foundation. For more information about the award, please visit TSCPA's website at tscpa.org and search Outstanding Accounting Educator Award.

Leadership Nominations Results for 2018-19 Positions

Terms Commence June 1, 2018

TSCPA's Nominating Committee recently chose the candidates for 2018-19 leadership positions, directors-at-large and Nominating Committee members. In accordance with TSCPA Bylaws Article IX, the candidates' election will be conducted through a secure electronic ballot on a TSCPA website area approved by the Executive Board. The electronic ballot will be open to all eligible members to vote. TSCPA will send communications to members regarding the electronic voting and will post information about it on the website at tscpa.org.

The following persons were nominated for terms beginning in fiscal year 2018-19 and have consented to serve if elected by the members.

Chairman-elect *(Chairman in 2019-20):* Lei D. Testa (Fort Worth)

Treasurer-elect *(Treasurer in 2019-20):* William "Billy" J. Kelley (Permian Basin)

Secretary *(Beginning June 2018 and Expiring May 2019):* William "Bill" D. Schneider (Dallas)

Executive Board *(Three-year Term Expiring 2021):*

Julia Hayes (Abilene)
Angela M. Ragan (Central Texas)

Director-at-Large *(Three-year Term Expiring 2021):*

Edith T. Cogdell (San Antonio)
Patricia "Trish" J. Fritsche (Central Texas)
Christy L. Gibson (East Texas)
Jennifer G. Johnson (Dallas)
Mary Pat Jones (Southeast Texas)
Stephanie McCasland (Houston)
Jeremy Myers (Austin)
Martha E. Piekarski (El Paso)
Jeannette P. Smith (Rio Grande Valley)
Mary A. Stanford (Fort Worth)
Susie Sullivan (Corpus Christi)
Lucretia "Diane" Terrell (Abilene)

Committee on Nominations *(Beginning June 2018 and Expiring May 2019):*

Arthur M. Agulnek (Dallas)
Dora Jean Dyson (Central Texas)
Elaine R. Hoffman (Corpus Christi)
Kristy K. Holmes-Hetzel (San Antonio)
Elena Levario (Permian Basin)
Jorge "Arturo" Machado (San Antonio)
Amy N. Restivo (Brazos Valley)
Norman B. Robbins (Fort Worth)
Debra D. Seefeld (Houston)
Veronda F. Willis (East Texas)

As TSCPA immediate past chairman in 2018-2019, Jim Oliver (San Antonio) will serve automatically as chair of the 2018-2019 Nominations Committee. Dora Dyson was appointed as vice chair.

The Nominations Committee also recommends that the names of the following individuals be forwarded to the American Institute of CPAs as representatives from Texas to serve on the **AICPA Council:**

Jim R. Oliver *(San Antonio)* – Three-year term expiring 2022

Charlotte M. Jungen *(Houston)* – Three-year term expiring 2022

Toni McBee Joyner *(Brazos Valley)* – Three-year term expiring 2022

Stephen G. Parker *(Houston)* – One-year designee (2019-2020)

John E. Baines *(Dallas)* – Replacement for Bill Reeb – term expires May 2019

Christi A. Mondrik *(Austin)* – Replacement for Brenda "Roxie" Samaniego – term expires May 2020

Recent Independence Issues Under AICPA's Revised Code of Professional Conduct

By Alan Reinstein, DBA, CPA, CGMA; Gerald W. Hepp, CPA, MBA; and Natalie Tatiana Churyk, Ph.D., CPA

AICPA revised its *Code of Professional Conduct (Code)* effective Dec. 15, 2014, and has since added additional interpretations that affect CPA practitioners, including several that impact independence issues. This article discusses independence as it is affected by:

- Mergers and acquisitions
- Employment and association situations
- Breaches
- Commission and referral fees

1.220.040 - Firm Mergers and Acquisitions

This Interpretation addresses needed safeguards for when threats arise when one CPA firm merges or acquires another firm (collectively a "merger"). The threat arises when a partner or professional employee of one firm has a prohibited relationship with an entity that is the other firm's attest client. The typical prohibited relationship includes association as a manager, director, officer, employee, promoter, underwriter, voting trustee, trustee of an entity's pension or profit sharing plan, or in any other capacity as a member of management for the period covered by the financial statements or the period of the professional engagement.

The Interpretation provides that threats will be at an acceptable level if all of the following safeguards are put in place:

a. Terminate the prohibited relationship prior to the merger or acquisition closing date;
b. Isolate the partner or professional employee from the attest engagement and position of influence over the engagement team;

“

THE FIRST STEP WHEN A BREACH OCCURS IS COMMUNICATION.

”

c. Implement the safeguards appropriate for a former attest client employee listed in Code paragraph 1.277.010.04 prior to the merger or acquisition closing date (e.g., the covered member disposes of any direct financial interest or material indirect financial interests in the attest entity client, and collects or repays any loans to or from the attest entity client, except for those specifically permitted or grandfathered by the interpretations of the Loans, Leases, and Guarantees);
d. Appoint a responsible individual to assess whether the threat was reduced to an acceptable level; and
e. Discuss prior to issuing the attest report by the responsible individual with those charged with governance as to the safeguards applied. [Code 1.220.040.03]

The threat to independence also could arise if a merger member performed bookkeeping or other nonattest services for the other member's attest client [Code 1.295]. Here, the parties should identify the acquirer and acquiree firms. Code section 1.220.040.02 refers to paragraph 11-15 of FASB ASC 805-10-55 to make this determination. If the acquirer provided prohibited (e.g., appraisal, valuation or internal audit) nonattest services, and it is not possible to attain an acceptable level of threat, the member cannot provide the attest service. Acquirees providing prohibited nonattest services should establish safeguards by applying all of the following:

- Terminate the banned nonattest services before the merger or acquisition closing date;
- Participators in providing the prohibited nonattest services must not be on the attest engagement team nor in a position to influence the attest engagement; and
- Perform an assessment as to the level of the threat and the adequacy of any safeguards [Code 1.220.040.07].

The Interpretation also calls for considering the following in the evaluation process:

- Whether the nonattest services or the results will be subject to attest procedures;
- The significance of the results of the nonattest services to the attest financial statements;
- The attest client's management's involvement and skills in overseeing the services; and
- Whether the nonattest services involved an assumption of management responsibility. [Code 1.220.040.08]

The overall process evaluates the level of threat before determining whether the firm can reach an acceptable level of safeguards, including reviewing the situation with those in the firm charged with governance. The Interpretation also cautions that other interests and relationships with an attest client can create threats for the CPA to consider, such as relationships with close relatives holding key attest client positions; e.g., a CPA firm's manager married to a new audit client's controller.[1]

1.275.005 - Simultaneous Employment or Association with an Attest Client

This section examines issues when a CPA works concurrently for both a CPA firm and a firm's attest client as a director, officer, employee, promoter, underwriter, voting trustee, trustee of the attest client's pension or profit-sharing trust, or equivalent member of client management during the financial statements or engagement periods. It provides that the threats in such situations cannot be at an acceptable level and that no safeguards would be adequate; independence would be impaired. However, it provides a carve-out for educational institutions. A CPA firm employee can serve concurrently as an adjunct faculty member of the employer-CPA firm's educational institution attest client, as long as the firm employee:

- Holds no key position at the educational institution;
- Is not part of the attest engagement team;
- Is not in a position to influence the client's attest engagement;
- Works for the educational institution only on a part-time and non-tenure basis;
- Does not participate in the educational institution's required employee benefit plans, unless participation is required; and
- Assumes no management or policy responsibilities for the educational institution. (Code 1.275.005.03)

Code 1.275 deals specifically with such other attest client employment situations as:

- 1.275.010 – Honorary Director or Trustee of a Not-for-Profit Organization
- 1.275.015 – Member of Advisory Board
- 1.275.020 – Member of Governmental Advisory Committee
- 1.275.025 – Individual in a Campaign Treasurer or Similar Financial Position
- 1.275.030 – Member of Federated Fund-Raising Organization
- 1.275.035 – Member of Organization that Receives Funds From Fund-Raising Organization

continued on next page

The Code also discusses, separately, Former Employment or Association With an Attest Client (Code1.277) and Subsequent Employment or Association With an Attest Client (Code1.279). The Code refers to non-authoritative guidance for many such relationships.

1.298 - Breach of Independence

This guidance, effective March 31, 2016, addresses situations where a CPA firm finds that its employees have breached attest engagement independence standards; e.g., purchased a client's stock. It helps assess the consequences of a breach and its effect on the attest engagement team's integrity, objectivity and professional skepticism – and provides specific actions upon finding the breach. The guidance is founded on the requirements under Quality Control [QC] section 10, *A Firm's System of Quality Control* (AICPA, Professional Standards) for a firm to establish policies and procedures designed to provide reasonable assurance that the firm, its personnel, and others subject to independence requirements, maintain those standards.

The Interpretation culls out two types of breaches: (1) those that can significantly compromise the engagement team's integrity, objectivity and professional skepticism, and (2) where an engagement partner or individual in a position to influence the attest engagement (1) commits or (2) knows about a breach but fails to deal with it. The first type can terminate the attest engagement and the second creates a rebuttable presumption that the game is over.

The first step when a breach occurs is communication. The information should be provided to the attest engagement partner or an individual with responsibility for independence policies and procedures, who should inform all appropriate parties that the issue affects. This individual should be satisfied that the interest or relationship that caused the breach was terminated, suspended or eliminated, and should address the consequences of the breach.

The significance of the breach should be evaluated, considering factors such as:

- The nature and duration of the breach;
- The number and nature of prior breaches with respect to the current attest engagement;
- Whether someone knew the details of the breach;
- Whether the individual who caused the breach is a member of the attest engagement team or another individual for whom there are independence requirements;
- The individual's role if the breach relates to a member of the attest engagement team;
- If the breach was caused by nonattest services, the effect of the service on the accounting records or the attest client's financial statements;
- Whether a firm partner or partner equivalent knew about the breach and did not promptly communicate to an appropriate individual within the firm;
- Whether the breach involved solely an affiliate of a financial statement attest client and, if so, the nature of the affiliate relationship; and
- The extent of self-interest, advocacy, undue influence, or other threats from the breach (Code 1.298.010.07).

While many appropriate actions exist, the key is whether some action will be sufficient to overcome the effects of the breach. Actions that should be considered include:

- Remove the relevant individual from the engagement;
- Have different people re-perform any questionable work;
- Recommend the client hire another firm to re-perform any questionable work; or
- Engage another firm to deal with questionable nonattest services (Code 1.298.010.09).

If no available action can overcome the effects of the breach, the firm may need to terminate the engagement. However, there are situations where laws or regulations do not permit termination. It is critical to be aware of any such situations and any reporting or disclosure requirements.

The guidance in this area is extensive. The material in the Code should be consulted upon the discovery of any independence breach.

1.520 - Commissions and Referral Fees

While not under the independence rules, the subject of commissions and referral fees still forms much concern for CPA attesters. In general, a CPA can receive commissions for referring products or services; a CPA can also accept a referral fee for recommending or referring a CPA to any person or entity or pay a referral fee to obtain a client.

A commission is deemed as received upon completing the service. The Interpretation gives the example of a fixed percentage of a future renewal insurance policy premium as received when the policy is originally sold. (Thus future commissions do not affect future periods' engagement.) It also distinguishes a spouse's commissions when such activities are separate from the CPA's practice and the CPA is not significantly involved in those activities.

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While as a general principle commissions and referral fees are allowable, they are prohibited if they involve a client for whom the CPA provides an audit or review of financial statements. A CPA providing compiled financial statements that a third party might expect to use can accept such commissions and referral fees only if the compiled statements disclosed a lack of the CPA's independence therein.

It is important to recognize two exceptions to the above prohibitions. First, if *a member* purchases a product, taking title to the product and assuming all the associated risks of ownership, any profit the *member* receives on reselling to a *client* would not constitute a commission.[2]

Second, if in providing *professional services* to a *client, a member* subcontracts the services of another person or entity, any mark-up of the cost of the subcontracted services would not constitute a commission.[3] Under these circumstances, there would be no prohibitive effect on an attest engagement.

Where the commissions and referral fees are allowable, the CPA must disclose their existence to the client. Effective with commissions and referral fees in arrangements entered into on or after Jan. 31, 2017, the disclosure is required to be in writing.

Ethics Resolution

These four areas provide guidance to help resolve some potential ethical questions regarding a member's independence. The revised Code provides relatively easy access to search for rules and guidance on all ethics questions and is available at the following website:

http://www.aicpa.org/Research/Standards/CodeofConduct/DownloadableDocuments/2014December15ContentAsof2016June21CodeofConduct.pdf. ■

Footnotes

1. See Code 1.270 – Family Relationships with attest Clients.
2. Code 1.520.060.01
3. Code 1.520.070.01

A Great Man Passes and Sunset Review

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

It is with deep sadness that I report that my predecessor in writing this column, Bob Owen, passed away on Aug. 24, 2017. Bob's dedication to his profession was exemplary. He served as the president of TSCPA's Dallas Chapter in 1988-89 and he was president of TSCPA in 1994-95. He was recognized with two of the highest awards given by TSCPA – as an Honorary Fellow and for Meritorious Service to the Profession.

The CPA profession has some core values and ideals that it challenges its members to follow, ethical concepts like integrity, honesty, objectivity and independence. On each one of these tenets, Bob scored an A+. And these traits certainly served him well in his role as the primary advocate for TSCPA for 19 years as managing director of governmental affairs.

We talk a lot these days about a need for heroes, that there are no national heroes or leaders we can look up to anymore. I disagree. I think that we just aren't looking in the right places. The past few months in the aftermath of Hurricane Harvey here in Texas, we have seen how ordinary people can be heroes as they stepped up when confronted with a challenge or disaster. And there are other people around us who are heroes by how they live their lives each day and set an example for others to follow.

Bob was one of those people. He was a hero to me and I believe to many others who got to know and work with him. He set an example of professional excellence in how we should go about doing our jobs and leading our lives with a sense of grace and gratitude, in serving others and striving to be the best we can be – and doing it all with a sense of humor and wisdom.

I will dearly miss Bob, but I will never forget him. And I know I am a better person having had the opportunity to know him and call him my friend.

The TSCPA Accounting Education Foundation (AEF) has established an accounting scholarship in Bob's memory. Those who knew Bob and would like to donate to this tribute to him can send contributions to the TSCPA AEF at 14651 Dallas Parkway, Suite 700; Dallas TX 75254-7465. Make checks payable to the TSCPA AEF and note the donation is for the Bob Owen Scholarship Fund. Thanks for your consideration.

New Appointments to the Texas State Board

Gov. Greg Abbott completed his appointments to the Texas State Board of Public Accountancy (TSBPA). The *Public Accountancy Act* provides for 15 Board members appointed by the governor, with the advice and consent of the Senate, for six-year staggered terms.

The following appointments were made for terms expiring Jan. 31, 2023:

- Manuel "Manny" Cavazos, IV, Esq., CPA-Austin, will serve as presiding officer
- Lisa A. Friel, CPA-San Antonio, managing partner, Ernst & Young LLP
- James D. "Jim" Ingram, IV, CPA-Brazos Valley, shareholder, Ingram, Wallis & Co., P.C.

Public members of the Board for terms expiring Jan. 31, 2023 include:

- Jamie D. Grant, Arlington, Jamie D. Grant Wealth Management Group
- Debra S. Sharp, Houston, owner, SCI, Inc., ERISA Consulting

The following people have terms that have expired and their service as a Board member is complete:

- J. Coalter Baker, CPA-Austin, who served as presiding officer
- Jonathan Ballenger Cluck, Fair Oaks Ranch
- John Richard Broaddus, CPA-El Paso
- Rocky Lynn Duckworth, CPA-Houston
- Phillip W. (Phil) Worley, Hebbronville

We welcome the new TSBPA members and thank those who have served the Board and the profession. A list of the current members and their term expirations can be found on the TSBPA website at www.tsbpa.state.tx.us/board/board-members.html.

Sunset Review – What is it?

As I mentioned in my last column, the Texas State Board of Public Accountancy (TSBPA) and the Texas Public Accountancy Act (TPAA) will undergo the sunset review process over the upcoming year. Hopefully, it will culminate in legislation being introduced and passed in the 2019 legislative session to reauthorize TSBPA and the TPAA. Otherwise, the licensed CPA profession as we know it in Texas will cease to exist.

What is the sunset process? For those who are unfamiliar with it, the Texas Legislature established the Texas Sunset Advisory Commission in 1977 as part of the *Texas Sunset Act*. This law established a process for the regular review of state agencies and their operations and spending. Every state entity other than universities, courts and agencies established by the state constitution is subject to periodic review by the Sunset Commission – about 130 agencies in all. The law also calls for the automatic end of an agency's operations, unless the legislature specifically reauthorizes the agency.

The Sunset Commission is an agency governed by legislative appointees. The lieutenant governor appoints five senators and one public member to serve as commissioners; the speaker of the House appoints five representatives and another public member. A staff of about 30, including a director, policy analysts and administrative staff, reports to the commission and provide administrative and operational support.

Agencies generally undergo a sunset review once every 12 years. An agency's sunset date is specified in its enabling statute. However, the legislature can change that timing if it so chooses. If you look at the Texas Public Accountancy Act (TPAA) Sec. 901.006, it states that TSBPA is subject to Chapter 325 (*Texas Sunset Act*) and unless continued in existence as provided by that chapter, the board is "abolished and this chapter expires September 1, 2015." But in 2013, the legislature passed legislation extending the timing for the sunset review of TSBPA to 2019.

So in 2019, it will be 16 years since TSBPA and the TPAA underwent this process, the last time in 2003.

How the Process Works. As part of the sunset process, the agency under review must complete a self-evaluation identifying problems and opportunities it faces. TSBPA recently completed this self-evaluation process and sent its report to the commission staff. Then the sunset staff conducts interviews, field visits, focus groups, surveys and extensive analysis to determine whether an agency needs any structural changes or is needed at all. Sunset staff also gathers input from the public, interest groups and professional organizations, like TSCPA. Performance and operational data are collected, as well. Finally, the sunset staff releases its recommendations in a report to the commission. We anticipate that will happen later this year or early in 2018.

After the staff report is published, the Sunset Commission holds a public hearing on the agency under review. At the hearing, sunset staff members present their recommendations and the agency then formally responds. The public can submit written or oral testimony during the hearing on these recommendations or any other issues regarding the agency under review. This will be an opportunity for TSCPA and other interested parties to weigh into the process.

Finally, the commission votes on the staff recommendations, including its decision as to whether the agency should continue. The approved recommendations are then drafted into the agency's sunset bill. The legislature must pass each sunset bill or the agency in question will cease operations after a one-year wind-down period. This year, that vital sunset bill for the Texas Medical Board and several other state agencies was not passed during the regular legislative session. That ended up being the main driver for Gov. Greg Abbott to call a special session of the legislature so the Medical Board would not cease to exist.

During the legislative phase of a sunset review, the public and other stakeholders can participate by providing input on each sunset bill as it is deliberated in the House and Senate. TSCPA certainly plans to weigh in during the 2019 legislative process to assure that TSBPA and the TPAA are continued.

Generally, it takes around a year and a half to two years from the time agencies prepare their initial self-evaluation reports to when the full legislature considers the resulting sunset bills to reauthorize an agency. In recent years, the legislature has enacted about 80 percent of the Sunset Commission's recommendations. Compared to the passage rate of most bills, that's a pretty good outcome. But we don't plan to take this process for granted and TSCPA will be working diligently over the upcoming months to assure a successful end to the sunset process for the profession. We will certainly keep TSCPA members informed along the way. ■

John Sharbaugh, CAE is TSCPA's managing director of governmental affairs. Contact him at jsharbaugh@tscpa.net.

Solving the Recruiting-Candidate Disconnect

How to Help Your Organization Stand Out in the Crowded Job Market

By Chris Baudler

At any given time, there are 22,000 accounting jobs posted on LinkedIn and another 55,000 posted on Indeed.[1] The accounting profession is experiencing what some partners and recruiters are calling a talent drought, and the repercussions are hitting hard. Many firms in Texas are having such trouble finding additional talent that they are being forced to turn away new clients, rely on expensive staffing agencies and, in the worst cases, require senior staff to work exhausting schedules well beyond tax season.

Over the last few years, firms have been trying to find new ways to attract experienced and collegiate-level talent, but in the end most are resorting to offering higher and higher salaries or providing more extravagant perks. There is no question that these practices will quickly become unsustainable, but many partners feel they have no choice.

Recently, we spoke with a managing partner who even went so far as to say his firm no longer tried to recruit experienced or collegiate-level talent. In his mind, these candidates were non-existent. His mid-sized firm instead focused their energy exclusively on recruiting interns from the local high schools. He knew it was a big bet, but he believed his firm does not have any other choice.

During our conversation with him, he proudly showed us his firm's Best of the Best® award and for the first time that day, his face lit up with a smile. They had won the award a few years back and it was one of the best days of his life. However, he also knew dozens of other firms in Texas that had won similar awards and they were struggling to find talent just like him. After a brief pause for reflection, his smile quickly faded. His firm's plan to grow this year by 7 percent was looking more and more unlikely, and it was little solace for him to know they were not alone.

The Profession's Disconnect

Recruiting in the accounting profession is experiencing its most challenging period in recent memory and firms across the nation are bracing for a tough road ahead. At the same time, according to a recent LinkedIn survey, an overwhelming 90 percent of employed professionals said they are open to hearing about new job opportunities. Therein lies a massive disconnect that firms are desperate to solve.

Over the last two years, we have surveyed and interviewed almost 100 partners, recruiters, candidates and staff members to better understand the factors contributing to this disconnect. The findings have been very surprising. One theme that stood out above all others: candidates and staff view most firms' job opportunities as generic or indistinct from competitors. In other words, in the eyes of candidates and staff, firms lack unique messaging and experiences to stand out from other firms. This finding has been very concerning for partners and recruiters trying to attract the best talent.

The following article will help you better understand why there is a disconnect between firms and candidates, and steps you can take to stand out from competitors.

Recruiting Best Practices are No Longer Sufficient

During recruiting, firms often emphasize the following aspects:

- A family-like culture;
- Strong customer focus;
- Top-notch training;
- Above average salaries;
- Competitive benefits and perks;
- Involvement in community outreach;
- Personalized career paths;
- Flexible work schedules;
- Mentoring programs;
- CPE reimbursement;
- Work/life balance;
- Signing bonuses.

Unfortunately, almost every firm communicates these aspects and as a result, candidates now see them as "par for the course." In fact, in a recent comparison of 340 accounting firms across Texas and the U.S., we found 95 percent of them tried to entice potential job candidates with all or some of these perks and benefits.

Many forward-thinking firms are once again reevaluating how they approach recruiting, how they differentiate their firm

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Employer Branding

According to *Harvard Business Review*, employer branding is "an organization's reputation as an employer, as opposed to its more general corporate brand reputation … defined by the key benefits, or value propositions, offered by the company as an employer." ("CEOs Need to Pay Attention to Employer Branding," HBR, 2015.)

from competitors and most importantly, for a way out of the vicious cycle of "one-upping" competitors' pay and perks. For some, the future of their firm depends on it.

Looking for Answers Outside of the Accounting Profession

If there is one glimmer of hope for firms it is that the accounting profession is not the first to experience recruiting challenges. The technology, financial services, engineering and medical industries have been struggling with similar problems for decades, and the lessons they have learned along the way are priceless.

The main lessons are:

- Perks and benefits are not the solution. Yes, it is nice to offer perks that will make employees' careers more enjoyable, but a flexible work policy or a ping-pong table are not effective ways to demonstrate to candidates how a company provides meaningful work or an engaging long-term career choice.
- Paying top dollar for talent attracts the wrong talent. Without a strong mission-driven and attractive employer brand, employees will quickly jump ship when more lucrative job offers arise.
- A company's reputation on Glassdoor.com impacts recruiting more than an award for Great Places to Work®. In today's day and age, candidates are quick to fact check an employer's reputation. According to LinkedIn, 80 percent of candidates look at online peer-reviewed sites before applying for a job.
- Attracting top talent takes rethinking the whole recruiting experience. A plain Jane job posting or standard interview process will not create a memorable experience that WOWs candidates, gets them excited about working for your company and ultimately, inspires them to accept a job offer.

These lessons have driven employers to take a more proactive and sustainable approach to attracting and recruiting top talent by relying less on pay, perks and awards, and focusing more on developing a strong, unique employer brand.

What is an Employer Brand?

An employer brand (a business to employee strategy, or B2E if you will) is a comprehensive, marketing-infused HR strategy that communicates a clear, unique and attractive message to job candidates. When employer brands are developed properly, job candidates have

How an employer brand works:

1. The unique, firm-specific value propositions help your firm stand out from the crowd.
2. Internal recruiters and employees understand which topics to emphasize when talking with prospects.
3. Candidates understand what it's like to work in your firm.
4. Candidates are excited about working for you and they spread the good news to their network.

a clear understanding of the firm's culture, how the firm provides a unique, meaningful and exciting employment experience, and how the firm's culture and job opportunities stand out from competitors. Coincidentally, these points are where most firms currently struggle.

How to Develop Your Employer Brand

The following five steps will allow your firm to attract higher quality candidates in less time, with less hassle and with a lot less money.

1. **Interview and survey current employees, recent hires and former job candidates to better understand what influenced them to join your firm or a competitor.** This information, along with information from online review sites, will help you have a clear idea about what is attractive (and not so attractive) about your firm. Also, review materials from competitors' websites and Glassdoor.com to learn how they are "marketing" their job opportunities and how your employment experience compares.
2. **Create unique, firm-specific statements that resonate with your job candidates and employees.** Develop three to five brand statements based on cultural values and experiences unique to your firm, and meet job candidates' needs, values and desires. Keep the statements simple, aspirational and attractive to candidates, yet grounded in the reality of working for your firm.
3. **Integrate brand statements into all candidate-facing communications to create consistent brand messaging.** The best firms realize top talent may not even make it to their career page if their job postings and brochures do not provide messaging that is unique, meaningful, consistent, engaging and most importantly, memorable.
4. **Champion your current staff members to write and share complimentary, "real-life" messaging.** This step is critical for the successful implementation of an employer brand. Your staff members' perspectives will resonate with job candidates in a way no recruiter, HR employee or partner can. Your staff knows what it is like to work for your firm and can tell stories that will bring your employer brand to life. Advocate

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for them to write white papers, case studies and day-in-the-life articles to share with their network and the community. This staff-driven content allows your firm to demonstrate their intent as employers, staff expertise and the value your firm delivers to staff. These resources will also garner free marketing and publicity to current and potential clients.

5. **Create an interview process that is also memorable and highlights how important top talent is to your firm.** Candidates want more than just the same old one-on-one or panel-based interviews. They want an opportunity to demonstrate what they can do for clients and how they will contribute to your firm's success. For example, one firm developed an interview experience that allowed candidates to informally work on client tax returns and sit in on client meetings (you can stage them if necessary). Create an experience that WOWs interviewees and watch how quickly your openings get filled.

Impacting Bottom-Line Growth

Employer branding also came with an added benefit no firm expected, significant business growth. Through the staff-driven communications, clients became more aware of firms' products, services and benefits, and were more likely to trust staffs' expertise and judgment.

Stand Out

As many firms continue struggling to attract top talent, some firms are standing out from competitors by developing stronger employer brands. These brands communicate how their job opportunities are unique, meaningful, attractive and ultimately, worthy of a candidate's consideration. This approach has immediate and lasting effects on both recruitment and enhanced bottom line growth – all without compromising on the quality of new hires or offering outlandish salaries or extravagant perks. ■

Footnotes

1. In Texas alone, there are 17,000 accounting-related jobs posted on LinkedIn and 13,900 on Indeed.

Do You Solemnly Swear?

A CPA's Primer on Delivering Truthful and Powerful Testimony

By Todd E. Betanzos and Christina L. Betanzos

Inherent in any CPA's work is the likelihood that he/she will need to answer questions about his/her work, whether those questions come from clients, management, the government or other tax professionals. The professional communications involved in the daily practice of accountancy most likely become commonplace and second nature to CPAs within a few years. However, even the most experienced CPAs may not know what to expect when the questions posed to them are part of an experienced attorney's deposition or trial examination.

Like many other individuals, CPAs possess tremendous technical and professional expertise, but often lack the skill or experience necessary to manage an attorney's examination and communicate their truth in a manner that is clear and incapable of mischaracterization. This article is intended to provide CPAs with a primer on the unique communication rules applicable to legal proceedings in which they are called to testify, the rights and responsibilities of a witness under oath, and the skills that will help them to make truthful, accurate and powerful testimony.[1]

Understanding the Real Ground Rules of a Deposition

First and foremost, it is crucial for anyone anticipating that they may have to sit for a deposition to understand some of the essential ground rules governing the proceeding. This is essential, because examining attorneys often neglect to reveal *all* of the dynamics and rules that should guide the witness as they endeavor to offer truthful and accurate testimony.

At the beginning of most depositions, the attorney conducting the examination will typically ask a litany of questions intended to establish a set of ground rules for the deposition. These questions commonly include things such as:

- Do you understand that the oath you have taken is the same as would be given to you by a judge in a court of law?
- And you understand that the penalty for perjury is the same in this deposition as it would be at a trial or hearing?

Listen Think Speak

- If you don't understand one of my questions, will you agree to tell me so that I can rephrase it?
- And if you don't tell me that you don't understand my question, is it fair to conclude after this deposition that you did in fact understand my question?

While the attorney might ask these questions in a nonthreatening, perhaps friendly tone, make no mistake: they are intended to establish not only a set of understandings between the attorney and witness, but a sense of control over the proceeding. The attorney absolutely intends for the witness to feel as though it is the attorney who will direct the examination and exercise control over the deposition. This is the paradigm most favorable to the attorney, and these questions (admonishments, even) often reinforce preconceptions held by many witnesses. Specifically, witnesses frequently report that they feel powerless to control anything about the examination and that they simply need to "do their best to answer the questions" asked of them by the attorney.

It can be dangerous for a witness to operate under such assumptions and subject to the control exercised by the examining attorney, because – despite what one might expect when imagining the civil litigation process in an idealistic manner – many attorneys conducting depositions are not, in fact, engaged in a search for truth. Not entirely, anyway. To understand how this could possibly be, one must first consider the roles of the individuals involved in the taking of a deposition.

The examining attorney has a client whom he/she represents. The deposition is conducted within the context of a lawsuit – a dispute between parties in which one (or both) of the parties has alleged that the other has committed some wrong for which monetary damages or some sort of injunctive relief are sought. In most cases, the attorney was not present at the time the dispute arose and may not have had any involvement in or connection to the underlying relationship or transaction at issue. In other words, the attorney's understanding of the facts that underlie the case are based upon the client's description of the dispute, the damages they have suffered, and the relief they wish to obtain. Of course, the attorney probably has access to contracts, emails, correspondence and other materials that may also shed light on the dispute.

Ultimately, however, the attorney is tasked with identifying all potential remedies available to the client and pursuing those through any legal means. Because the attorney's duty is to zealously represent their client and, in so doing, to develop evidence that proves the facts most favorable to his/her client, the attorney sets out in a deposition to do just that – to develop sworn testimony that supports the client's claims or defenses.

Cynical as it may seem, this doesn't necessarily mean that the attorney endeavors to obtain pure, objectively "truthful" testimony. If a witness is mistaken about a material fact, and that mistake happens to lend support to the client's case, one should not expect the attorney to interrupt the witness and generously correct his/her error. To the contrary, in that situation a clever attorney is likely to recognize the witness's error and ask additional questions intended to lock the witness into that testimony so that the witness will find correcting themselves at a later date to be difficult or impossible. Likewise, there will be many matters – events, conversations, jobs, tasks, etc. – that are subject to more than one version or interpretation.

Given this reality, witnesses should expect an examining attorney to advance a version of those disputed facts most favorable to his/her client. If a witness is not sufficiently prepared to identify those characterizations and reject them as inaccurate or incomplete, the attorney's version of the facts may ultimately be established as undisputed.

It is equally important that anyone who anticipates having to sit for a deposition understand the significant limitations placed upon the other attorneys present for the examination, including any attorney actually representing the witness himself/herself. In many jurisdictions today, including both the state and federal courts of Texas, an attorney participating in a deposition may only object to questions by making a very brief statement of objection on the record. For example, the Texas Rules of Civil Procedure, which govern all procedural aspects of civil litigation in Texas state courts, read as follows.

199.5 Examination, Objection and Conduct During Oral Depositions

(e) **Objections.** Objections to questions during the oral deposition are limited to "Objection, leading" and "Objection, form." ... Argumentative or suggestive objections or explanations waive objection and may be grounds for terminating the oral deposition or assessing costs or other sanctions. ...

(f) **Instructions not to answer.** An attorney may instruct a witness not to answer a question during an oral deposition only if necessary to preserve a privilege, comply with a court order or these rules, protect a witness from an abusive question or one for which any answer would be misleading, or secure a ruling . . . The attorney instructing the witness not to answer must give a concise, non-argumentative, non-suggestive explanation of the grounds for the instruction if requested by the party who asked the question.[2]

It is true that witnesses may speak with their attorneys during breaks in the deposition, but there is a split of authority among courts across the country as to the extent to which witnesses and their attorneys may discuss substantive matters relating to the examination without waiving the attorney-client privilege. Consequently, there is a wide range of attitudes among practicing attorneys as to how much guidance

continued on next page

they are comfortable providing to witnesses during the pendency of a deposition.

Seeing these dynamics – the examining attorney on the offensive and the defending attorney restrained by rules of procedure – more clearly, witnesses can better understand that they are, in many ways, on their own throughout the deposition.

The Role of the Witness

Having set forth some of the more fundamental ground rules for a deposition and the roles of the attorneys therein, the witness should understand precisely what truly is his/her role during the deposition. While the attorney conducting the examination would like the witness to believe that his/her sole role is to answer whatever questions might be asked, that is not entirely accurate. A review of the witness oath provides a solid foundation for a more accurate understanding of the witness's responsibility.

The oath calls for the witness to swear or affirm that their testimony will be the truth, whole truth and nothing but the truth. There are three basic elements of all testimony, captured by this oath:

- The Truth: These are the facts to which the witness can speak with personal knowledge;
- The Whole Truth: Additional information that gives the facts greater meaning; and
- Nothing But The Truth: Anything the witness knows is <u>not</u> true.

To satisfy their oath completely, the witnesses must do three things throughout their testimony:

- Report and describe the facts precisely (i.e., tell the truth);
- Give those facts the necessary context and background in order to be understood fully and fairly (i.e., tell the whole truth); and
- Protect against inaccuracy and mischaracterization of the facts (i.e., tell nothing but the truth).

The witness is the only person sitting in the deposition who is charged with that duty. And, because attorneys quite often ask leading questions that in and of themselves are tantamount to testimony, it is the witness who must serve as a gatekeeper.[3] Witnesses must protect the record of the proceeding to ensure as best they can that *everything* said during the deposition is truthful and accurate in every respect.

This duty to ensure truth and accuracy in the deposition record is strikingly similar to the ethical obligations of CPAs both here in Texas and throughout the United States. The Texas State Board of Public Accountancy's Rules of Professional Conduct mandate is to "establish and maintain high standards of competence and integrity in the practice of public accountancy."[4] The Rules of Professional Conduct set forth the responsibility owed by a CPA licensed in Texas to his/her clients, the public and the board/profession. Directly relevant to providing sworn testimony, the rules define a "discreditable act" to include:

(13) intentionally misrepresenting facts or making a misleading or deceitful statement to a client, the board, board staff or any person acting on behalf of the board; [and]

(14) giving intentional false sworn testimony or perjury in court or in connection with discovery in a court proceeding or in any communication to the board or any other federal or state regulatory or licensing body [5] ...

Furthermore, all licensed Texas CPAs who are members of AICPA are subject to that organization's Code of Professional Conduct. AICPA's Code provides guidance on the ethical and professional responsibilities of a CPA and begins with broad statements of principle that obligate AICPA members to "[assume] an obligation of self-discipline above and beyond the requirements of laws and regulations" and to maintain an "unswerving commitment to honorable behavior, even at the sacrifice of personal advantage."[6] The principles set forth a comprehensive ethical framework for a CPA focusing on independence, objectivity and integrity. The Code's Integrity Principle explicitly states that "[t]o maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity ... Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality."[7] Consistent with the oath taken by witnesses in legal proceedings, the common theme throughout the AICPA Code is one of honesty.

Powerful Deposition Testimony Begins with Listening

If the witness is truly to embrace the role of gatekeeper during the deposition, and fulfill his/her ethical obligations as a CPA to the best of his/her abilities, he/she must understand that being a witness in a deposition is a listening exercise first and a speaking exercise thereafter. This runs counter to many people's sense for what a witness does ("I'm supposed to answer questions, so that means I'll be doing a lot of talking"), but it makes more sense when one thinks about the rudimentary mechanics of a deposition.

A deposition is essentially a legal interview (with, as noted earlier, a healthy dose of leading or suggestive questions included throughout the dialogue). To be an effective witness, one must understand that they have to perform three key functions involved with listening and responding to a question in the following order: listen, think, speak.

While this may strike some readers as elementary to the point of being insulting, they would be surprised at how many witnesses allow themselves to begin responding to questions without taking the time necessary to *listen* to the entire question and *think* about both what they want to say and *how* they want to say it. The reality is that failing to process carefully and purposefully each question posed to them during a deposition examination – speaking before listening or thinking – literally allows one's mouth to get ahead of their brain. And that rarely, if ever, yields a desired result.

When a witness is truly committed to listening carefully to each question, and to thinking about how to respond, he/she requires a tremendous amount of concentration. This means discipline and patience. It means understanding that a witness can only answer one question at a time. And it means realizing that a witness should not attempt to beat the attorney to where the witness believes the attorney is going with his/her line of questioning. A truly disciplined witness – one in command of his/her testimony and of the record as a whole – understands that he/she must take his/her time, breathe, listen, analyze and then decide the appropriate response to the question at hand.

Witnesses Have Rights

While there are certainly plenty of attorneys practicing in civil litigation today who are happy to work with witnesses to ensure that they understand a question before feeling obligated to answer it, the adversarial nature of litigation generally, and depositions specifically, lends itself to attorneys wanting to exercise as much control over the proceeding and the witness as possible. Unfortunately for witnesses, this doesn't always translate into a deposition examination geared toward making things particularly easy for witnesses.

For that reason, witnesses should keep in mind that their job is not to answer every question posed to them by an attorney – no matter how confusing, misleading or otherwise defective the question might be. The witness is not obligated to overlook the flaws in a question simply because an attorney asked it during a deposition. To the contrary, witnesses are entitled to questions that enable them to fulfill their oath. We call these "answerable questions."

An "answerable" question is one that a witness *can* answer truthfully and accurately without any necessary clarification, correction or other modification. Of course, many lawyers may be tempted to challenge a witness by suggesting that it should not be difficult to answer a question truthfully, but the manner and conditions under which attorneys ask questions of witnesses often make it difficult or impossible to do so. (Attorneys don't always like to acknowledge this fact.) To be answerable, each question must meet certain requirements: (1) it must be understandable; (2) it must be free of errors and (3) it must be free of distractions.

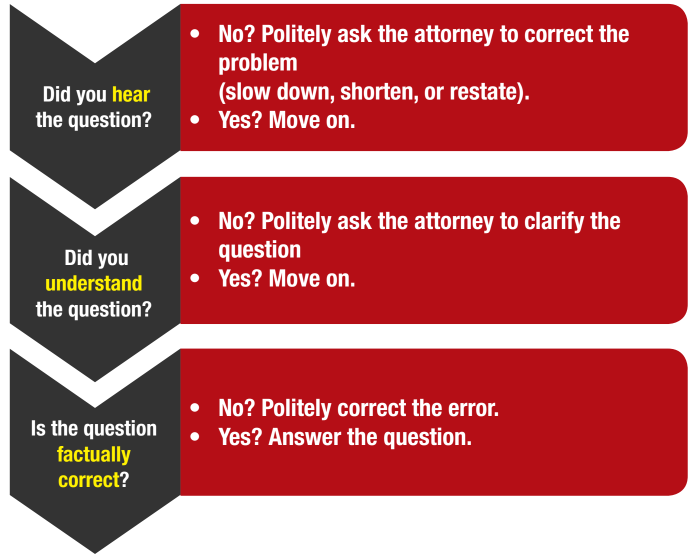
A question is understandable to a witness when it is asked in such a way as to allow the witness to hear it completely and determine precisely what is being asked of him/her. This means that the question (or series of questions) should not be asked too quickly for the witness to "keep up" with the attorney; it should not be so long or multifaceted as to be impossible to analyze, and it should not be unclear or confusing to the witness in any way. If the question poses any of these challenges to the witness, he/she must request that the attorney remedy the problem before answering. If the witness fails to insist on a question that is understandable, he/she cannot possibly ensure that the answer provided will be truthful and accurate. Witnesses should never attempt to answer the "gist" of a question. They must be precise in their understanding and in their delivery of testimony.

Likewise, a witness should never ignore factual errors that are embedded in an attorney's question. This might seem simple, but attorneys frequently ask questions that contain a faulty premise of some kind. If the witness focuses on the question posed, but fails to correct the factual error, inaccuracy or mischaracterization, he/she essentially adopts and endorses the veracity of the attorney's statement. For this reason, witnesses must be prepared to identify such errors and insist that they be corrected before answering.

Finally, the importance of being free from distraction cannot be overemphasized. Too often, witnesses do not give a question their undivided attention. Without realizing it, they are distracted in some way. They are thinking about their previous answer. They glance at a document shown to them earlier and think about it momentarily. They need to stand up and stretch, but are trying to be brave and wait for one of the attorneys to suggest a recess. Whatever the distraction may be, no matter how minor, it breaks the witness's concentration. And if witnesses did not hear the precise question asked of them, they cannot possibly know whether they are answering it correctly.

To think about how to "audit" the questions asked of them during a deposition, witnesses sometimes find the checklist in Figure 1 to be helpful. It becomes possible for a witness to undertake this kind of an auditing process with an attorney's questions when they approach the deposition with patience and discipline, and when he/she realizes that he/she must listen first, then think and finally speak.

Figure 1: Auditing Deposition Questions.



Toward that end, it should be noted that auditing an attorney's questions and insisting that they be asked in such a way as to be "answerable" should not be misinterpreted as an invitation to be rude to – or play games with – an attorney. To the contrary, a witness should always strive to be the most courteous person in any deposition. One's insistence on answerable questions should be expressed politely and with the genuine aim of ensuring that the deposition record be as truthful and accurate as possible.

Preparation is Key

Making testimony is no different than any other acquired skill. It requires preparation, through learning skills like those discussed herein and some amount of practice. It is not sufficient simply to "know what you know" or to be generally familiar with the key facts and documents in a case. In fact, if a witness hasn't thought about precisely how he/she will address the key events, communications, actions, documents, etc., it is more likely than not that he/she will have a very difficult time finding the right words when required to do so under oath.

Witnesses often find themselves at a loss for the right words when the moment requires it. They misspeak. They agree to characterizations offered by an attorney, because they come close to capturing the truth. Or, they come across as less than in command of the facts in the case and their (or their employer's) fundamental position on the issues.

For these reasons, witnesses should ensure that their attorneys take the time necessary to prepare them thoroughly for the deposition. The witness and his/her attorney should dedicate ample time to deconstruct the witness's role in the case, as well as the issues and facts the examining attorney is expected to cover during the deposition examination and to think carefully about both what the witness wants to say about those matters and how he/she wants to say it.

continued on next page

One thing must be clear about this process, however: it is absolutely not about "spin." The preparation process should provide the witness with the tools he/she needs to communicate his/her truth as clearly and accurately as possible. It should be borne out of each witness' genuine, personal sense of what is true, regardless of whether it is identical to the testimony of other witnesses in the case. (In fact, the witness will be far more successful if he/she is able to distinguish thoughtfully between his/her own perspective on disputed facts and issues, and that of other witnesses.) The goal of thorough preparation is to maximize the witness's credibility by helping them to develop a clear and honest telling of his/her truth.

Communications experts teach that repeated telling of a story creates increased efficiency. Over time and repeated telling, the speaker will find more appropriate words and phrases, as well as clearer and more concise explanations. Making testimony is no different. The preparation process should involve digging beneath the surface of the witness's initial retelling of the pertinent events or details and challenging themselves to think about their experience from a number of different perspectives. Once the witness begins to find language that feels comfortable and captures his/her truth accurately, he/she should be asked to do it repeatedly in the form of mock question and answer sessions that simulate as closely as possible the anticipated deposition examination.

The key to the mock question and answer process is repetition, because the act of hearing questions, identifying problems with them, and retrieving specific words and phrases to answer certain questions is a neurolinguistic skill. This listening and speaking with precision is muscle memory. It is no different than a golf swing or a swimming stroke or a free throw. Initially, it will feel clumsy to the witness, but once learned, it can be refined and ultimately mastered.

Likewise, the examination any witness faces in his/her preparation should be at least as difficult as the questions they will be forced to answer during the actual deposition. The goal here is for witnesses to leave the deposition feeling not as though they were prepared for each and every question asked of them throughout their deposition, but rather as though there was nothing more challenging than they were asked to contend with during their preparation.

Every witness must understand that he/she should insist that his/her attorney take the time necessary to ensure he/she is properly prepared to testify. Too often, preparation meetings take place either the day of, or perhaps the afternoon before, a deposition and last just a few hours. This simply is not sufficient to ensure that witnesses are comfortable and prepared for their testimony. Depending upon the complexity of the issues to be covered, the number of documents the witness is likely to be asked about during the examination, and the contentiousness of the dispute, proper preparation will require a full day to several days of work. The witness must be his/her own advocate when discussing the preparation plans with counsel. Only they will be required to fulfill the oath administered to them once the deposition has begun.

Empowering the CPA as a Witness

We hope that sitting for a deposition or testifying at trial is a rarity for CPAs – unless, of course, they choose service as an expert witness as a professional pursuit. Regardless of the circumstances giving rise to such obligations, however, CPAs should take comfort in the understanding that with patience, discipline and proper preparation, they can manage the examination process to ensure that the record of the proceeding is clear and their testimony is truthful and accurate.

The concepts addressed in this article represent somewhat of a paradigm shift from what some who have testified previously may have thought or experienced. In truth, these lessons are about witness empowerment, because we believe the most accurate testimony is delivered by witnesses who embrace their role as gatekeepers and guardians of truth. ■

Footnotes

1. While this article may prove interesting or helpful to CPAs whose practice involves frequent testimony in an expert or consulting capacity, it is aimed primarily at those for whom offering testimony in a deposition or at trial is more of a departure from their typical professional activities.
2. TEX. R. CIV. P. 199.5 (Sept. 2016). The Federal Rules of Civil Procedure, which govern conduct during depositions in federal civil proceedings, set forth substantially similar restrictions on attorneys. *See* FED. R. CIV. P. 30(c)(2) (Dec. 2016).
3. Examples of leading questions that are, for practical purposes, testimony on the part of the attorney, include "Isn't it true that today is Friday?" and "You would agree, wouldn't you, that the sky is partly cloudy today?" In asking questions like this, the attorney is offering testimony about facts and asking the witness to endorse their truthfulness and accuracy.
4. 22 TEX. ADMIN. CODE § 501.51(a) (Aug. 2016).
5. *Id.* at § 501.90.
6. AICPA Code of Professional Conduct, Preface: 0.300.010 (Preamble) and 0.300.020 (Responsibilities) (December 15, 2014). Retrieved February 28, 2017 from: http://www.aicpa.org/Research/Standards/CodeofConduct/DownloadableDocuments/2014December15ContentAsof2014June23CodeofConduct.pdf.
7. *Id.* at 0.300.040.01 and 0.300.040.03.

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TSCPA 2020 is a dynamic three-year plan we have created to take our organization into a vibrant future. The plan is the product of research, listening and thought-provoking conversations with members and volunteers from across the state.

Our new vision – Empower Members to Lead and Succeed – succinctly sums up our most important charge. TSCPA is for you, our members, and helping you with success and growth is at the heart of all we do.

We have four guiding principles that will shape our program and service development: Leverage & Lead Technology, Building Leaders, Organizational Flexibility and Connecting Members & Resources.

There are three pillars that our member service will be based upon and how we plan to deliver on our promise to you: Professional Excellence, Advocacy and Community & Connection. Key initiatives support each pillar of success.

We're confident that your engagement and support of the initiatives in TSCPA 2020 will enhance the value of your membership. TSCPA and our statewide network of 20 chapters will support you and serve with and for you representing the collective voice of 28,000 members.

To learn more about TSCPA 2020, visit our website at www.TSCPA.org/TSCPA2020 or email us at TSCPA2020@tscpa.net.

TSCPA 2020

CPE ARTICLE

Operating Leases *Used* to Be the Easy Ones

By Walter R. Teets and Matthew Hoag

Curriculum: Accounting and Auditing

Level: Intermediate

Designed For: Business and industry; public practice (audit)

Objectives: Explain and illustrate new requirements for accounting for operating leases under FASB Accounting Standards Codification Topic 842, Leases

Key Topics: Capitalization of ROU asset and lease liability; determination of ROU asset amortization directly, rather than as a plug; illustration of complexity added increasing-payment leases; illustration of complexity added by initial direct costs and lease incentives

Prerequisites: Basic knowledge about leases and leasing transactions

Advanced Preparation: None

Under the new lease accounting guidance issued by the Financial Accounting Standards Board (FASB) in 2016, the accounting for operating leases is set to change considerably. Operating leases will require straight-line lease expense recognition, similar to the current guidance, but companies will be required to capitalize lease liabilities and right-of-use (ROU) assets. A lease liability will be reported at the present value of the future lease payments and the ROU asset will be reported at the value of the lease liability, adjusted for items such as unamortized lease incentives or initial direct costs. Therefore, the ROU asset value is inextricably linked to the lease liability value. The new lease guidance requires the effective interest method of accounting for lease liabilities, which implies asset amortization will follow a decelerated pattern not before used in the accounting for long-term assets.

In this article, the determination of the yearly asset amortization is illustrated for increasingly complex (and realistic) leases. The asset amortization is calculated directly, rather than as a change in ROU asset balance sheet values, as is done in the FASB guidance and in other material explaining the new standard.

Leases that will be used in the development of an understanding of the requirements of the new standard include three leases consistent with FASB's numerical example, starting at Accounting Standards Codification™ paragraph 842-20-55-40, which has lease payments at the end of the period, and three leases with payments at the beginning of the period.

A. Leases with payments at the end of the period:

- A level-payment lease with no initial direct costs or lease incentives
- An increasing-payment lease with no initial direct costs or lease incentives
- An increasing-payment lease with initial direct costs and lease incentive

B. Leases with payments at the beginning of the period:

- A level-payment lease with no initial direct costs or lease incentives
- An increasing-payment lease with no initial direct costs or lease incentives
- An increasing-payment lease with initial direct costs and lease incentive

Overview

The new lease accounting guidance for operating leases, at a high level, has two requirements: (1) a lease liability must be capitalized, along with a related right-of-use (ROU) asset and (2) a periodic lease expense must be recognized as a single amount on a straight-line basis. While these two requirements seem straightforward individually, putting them together leads to some surprising results.

The capitalization of an ROU asset and a lease liability are quite familiar from current guidance on accounting for capital leases. But a single straight-line lease expense – conceptually consisting of interest expense on the liability and amortization expense on the asset – is new. The guidance stipulates that the lease liability should be accounted for using the effective interest method, so the interest component of the straight-line lease expense is well known. But coupling this requirement with the requirement of a single straight-line lease expense implies that the amortization of the asset must follow a decelerated pattern not seen before in long-term asset accounting.

The new guidance focuses on end-of-period liability and asset values, but it is the *changes* in those values that are used in journal entries. Specifically, the end-of-period lease liability is defined as the present value of remaining lease payments in Accounting Standards Codification™ (ASC) paragraph 842-20-35-3(a) and the end-of-period asset value is defined as the end-of-period liability value, adjusted for prepaid or accrued lease payments, and unamortized lease incentives and initial direct costs in ASC 842-20-35-3(b). Given the end-of-period asset and liability values for consecutive periods, it is, of course, trivial to determine the changes in those values. But it seems preferable to determine the amortization amounts directly. The examples that follow illustrate how simple extensions of familiar amortization tables can be used to determine the ROU asset amortization amount directly, rather than as the difference between two end-of-period ROU asset values.

All examples assume operating lease treatment is appropriate. They also assume there are no ROU asset impairments or modifications to the lease, which raise issues beyond the scope of this article.

Leases with Payments at End-of-Period

Example 1: A lessee enters into a 10-year operating lease requiring $10,000 in annual lease payments. The lessee's implicit rate is assumed to be 6 percent and the lessor's rate is unknown. Therefore, the beginning lease liability is the present value of the 10 $10,000 payments, discounted at 6 percent, or $73,601. The new guidance prescribes the initial asset value should be equal to the amount of the initial measurement of the lease liability, plus any lease payments made to the lessor at or before the commencement date, minus any lease incentives received, plus any initial direct costs incurred by the lessee. For simplicity, in this example, we assume no up-front payments, lease incentives or initial direct costs incurred; the initial asset value is therefore simply equal to the initial lease liability, $73,601.

The difficulty in the new standard is not in determining the straight-line lease expense that should be recognized; as under current guidance, it is simply the sum of all lease payments, divided by the number of periods under the lease. In the case of a level-payment lease, this is simply equal to the periodic cash payment. The difficulty lies in determining the periodic reductions in the lease liability and the ROU asset. However, the lease liability amortization table, familiar from current capital lease treatment, provides the needed values. See Table 1.

Conceptually, the straight-line lease expense consists of two

Table 1

Year	Lease Liability, BOY	Interest	Cash Payment	Lease Liability Amortization
1	73,601	4,416	10,000	5,584
2	68,017	4,081	10,000	5,919
3	62,098	3,726	10,000	6,274
4	55,824	3,349	10,000	6,651
5	49,173	2,950	10,000	7,050
6	42,123	2,527	10,000	7,473
7	34,650	2,079	10,000	7,921
8	26,729	1,604	10,000	8,396
9	18,333	1,100	10,000	8,900
10	9,433	567	10,000	9,433
Total			100,000	73,601

components, the interest on the lease liability and amortization of the asset cost. At a high level, this is familiar from current capital lease treatment. However, in current capital lease treatment, the interest expense and the asset amortization are not related to each other and

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the combined lease expense will vary from period to period. In the new operating lease treatment, the sum of the periodic interest expense and asset amortization must be constant each and every period. The new guidance stipulates that the lease liability be accounted for using the effective interest method. Therefore, the first component of the lease expense is the interest cost for the period. This amount will decrease over time as the periodic cash payments reduce the liability. Given a straight-line lease expense, the asset amortization component must therefore *increase* over time.

Since the operating lease guidance defines the ROU asset value in relation to the lease liability value, the *change* in the ROU asset must be related to the change in the lease liability value. The change in the lease liability for an end-of-period-payment lease is simply the lease liability amortization, provided in the last column in Table 1. Therefore, the ROU asset amortization must be related to lease liability amortization. In the case of a level-payment lease with no initial direct costs or lease incentives, the ROU asset amortization is exactly equal to the lease liability amortization.

If one were to consider only the asset amortization, it follows a pattern not seen before: decelerated (as opposed to accelerated) amortization. The change in ROU asset value is lower in early years and increases over the life of the lease.

The journal entry at inception of the lease is:

ROU Asset	73,601	
Lease Liability		73,601

The journal entries throughout the lease are shown in Table 2.

Table 2

Year	Lease Expense Dr	Lease Liability Dr	Cash Cr	ROU Asset Cr
1	10,000	5,584	10,000	5,584
2	10,000	5,919	10,000	5,919
3	10,000	6,274	10,000	6,274
4	10,000	6,651	10,000	6,651
5	10,000	7,050	10,000	7,050
6	10,000	7,473	10,000	7,473
7	10,000	7,921	10,000	7,921
8	10,000	8,396	10,000	8,396
9	10,000	8,900	10,000	8,900
10	10,000	9,433	10,000	9,433
Total	100,000	73,601	100,000	73,601

Example 2: This example uses the same basic lease used in Example 1, but incorporates a lease feature common in practice, increasing lease payments. The lease payment is $10,000 in the first year; payments increase by 5 percent each subsequent year for the 10-year lease term. The total lease payments are $125,780; that total is recognized straight-line across the 10-year lease period, resulting in a $12,578 lease expense per year. In an increasing payment lease, the annual cash payments are not equal to the year-by-year straight-line lease expense. Under current operating lease accounting, this difference between cash payment and lease expense is recognized as a lease payable.

Under the new guidance (specifically ASC paragraph 842-20-35-3(b)(1)), the difference is not included as part of the lease liability, which measures the present value of future lease payments at the reporting date. Rather, the difference should be netted with the ROU asset. Since the cumulative difference is generally a credit, it reduces the ROU asset. In the journal entry, that ROU asset reduction is accomplished through the credit effecting the asset amortization. An expanded amortization table is required, given the increasing lease payments.

Table 3

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Year	Lease Liability, BOY	Interest	Cash Payment	Lease Liability Amorti-zation	Straight-line Lease Expense	Increase (Decrease) in “Lease Payable” included in ROU Asset	ROU Asset Amorti-zation
Computation		(1) × .06		(3) – (2)		(5) – (3)	(4) + (6)
1	90,434	5,426	10,000	4,574	12,578	2,578	7,152
2	85,860	5,152	10,500	5,348	12,578	2,078	7,426
3	80,512	4,831	11,025	6,194	12,578	1,553	7,747
4	74,318	4,459	11,576	7,117	12,578	1,002	8,119
5	67,201	4,032	12,155	8,123	12,578	423	8,546
6	59,078	3,545	12,763	9,218	12,578	(185)	9,033
7	49,860	2,992	13,401	10,409	12,578	(823)	9,586
8	39,451	2,367	14,071	11,704	12,578	(1,493)	10,211
9	27,747	1,665	14,775	13,110	12,578	(2,197)	10,913
10	14,637	877	15,514	14,637	12,578	(2,936)	11,701
Total			125,780	90,434	125,780	0	90,434

As observed in Table 3, the difference between the lease payment and the straight-line lease expense adjusts the lease liability amortization, to arrive at the asset amortization. In the early years, the lease payments are smaller than the straight-line lease expense requiring an additional credit entry (i.e., additional asset amortization). In later years, the lease payments will be larger than the straight-line expense resulting in reduced asset amortization.

At the inception of the lease, the lease liability and ROU asset are recorded at the present value of the increasing lease payments, discounted at the lessee’s implicit rate (6 percent):

ROU Asset	90,434	
Lease Liability		90,434

The journal entries throughout the lease are shown in Table 4.

Example 3: This example builds upon Example 2, adding both initial direct costs and a lease incentive. The initial direct costs are assumed to be $5,000 and the lease incentive is assumed to be $10,000. Both cash flows are assumed to have occurred prior to the date the

Table 4

Year	Lease Expense Dr	Lease Liability Dr	Cash Cr	ROU Asset Cr
1	12,578	4,574	10,000	7,152
2	12,578	5,348	10,500	7,426
3	12,578	6,194	11,025	7,747
4	12,578	7,117	11,576	8,119
5	12,578	8,123	12,155	8,546
6	12,578	9,218	12,763	9,033
7	12,578	10,409	13,401	9,586
8	12,578	11,704	14,071	10,211
9	12,578	13,110	14,775	10,913
10	12,578	14,637	15,514	11,701
Total	125,780	90,434	125,780	90,434

Table 5

Year	(1) Lease Liability, BOY	(2) Interest	(3) Cash Payment	(4) Lease Liability Amorti-zation	(5) Straight-line Cost in Lease Payments	(6) Increase (Decrease) in "Lease Liability" included in ROU Asset	(7) Amorti-zation of Initial Direct Costs	(8) Amorti-zation of Lease Incentive	(9) ROU Initial Amorti-zation	(10) Straight-line Lease Expense
Computation		(1) × .06		(3) – (2)		(5) – (3)			(4) + (6) +(7) - (8)	(5) + (7) - (8)
1	90,434	5,426	10,000	4,574	12,578	2,578	500	1,000	6,652	12,078
2	85,860	5,152	10,500	5,348	12,578	2,078	500	1,000	6,926	12,078
3	80,512	4,831	11,025	6,194	12,578	1,553	500	1,000	7,247	12,078
4	74,318	4,459	11,576	7,117	12,578	1,002	500	1,000	7,619	12,078
5	67,201	4,032	12,155	8,123	12,578	423	500	1,000	8,046	12,078
6	59,078	3,545	12,763	9,218	12,578	(185)	500	1,000	8,533	12,078
7	49,860	2,992	13,401	10,409	12,578	(823)	500	1,000	9,086	12,078
8	39,451	2,367	14,071	11,704	12,578	(1,493)	500	1,000	9,711	12,078
9	27,747	1,665	14,775	13,110	12,578	(2,197)	500	1,000	10,413	12,078
10	14,637	877	15,514	14,637	12,578	(2,936)	500	1,000	11,201	12,078

ROU asset and liability are recorded; when the cash flows occurred, deferral accounts were established.

The journal entry at inception is:

ROU Asset	85,434	
Deferred Lease Incentive	10,000	
Lease Liability		90,434
Deferred Initial Direct Costs		5,000

Per ASC paragraph 842-20-30-5, the initial direct costs and lease incentive are embedded in the cost of the ROU asset, as adjustments to the initial lease liability. Since these items are included in the initial measurement of the ROU asset, they will affect the amortization of the ROU asset.

Per ASC paragraphs 840-20-25-6 and 25-8, the lease expense is equal to the total lease payments, plus initial direct costs, less the lease incentive, recognized on a straight-line basis over the life of the lease (unless another pattern better reflects the benefits derived from the ROU asset).

An expanded version of the lease liability amortization table used in Example 2 can be used to determine the values needed to account for this more complicated, and more realistic, lease.

Note the difference in column headings for column (5) in Table 5 for example 3 and Table 3 for example 2. Example 3 adds initial direct costs and a lease incentive; the lease expense is affected by those items, but the payments to the lessor are not. The "lease payable" amount relates to the difference between the cash paid to the lessor and the straight-line cost of the lease payments. In example 2 (Table 3), there are no initial direct costs nor lease incentive, so the straight-line lease expense and the straight-line cost of the lease payments were the same. Finally, note that column (10) may also be calculated as (3) + (6) + (7) – (8).

Table 6

Year	Lease Expense Dr	Lease Liability Dr	Cash Cr	ROU Asset Cr
1	12,078	4,574	10,000	6,652
2	12,078	5,348	10,500	6,926
3	12,078	6,194	11,025	7,247
4	12,078	7,117	11,576	7,619
5	12,078	8,123	12,155	8,046
6	12,078	9,218	12,763	8,533
7	12,078	10,409	13,401	9,086
8	12,078	11,704	14,071	9,711
9	12,078	13,110	14,775	10,413
10	12,078	14,637	15,514	11,201
Total	120,780	90,434	125,780	85,434

Based on the information from the above table, the journal entries throughout the lease are shown in Table 6.

Note that the difference in total lease expense over the 10 years, $120,780 and total cash paid out over the 10 years, $125,780, is explained by the $5,000 initial direct costs included in the lease expense, but not in the total cash paid out, as well as the $10,000 lease incentive, again included in the total lease expense, but not in the cash paid out. Those two items also explain the difference between the initial lease liability and initial ROU asset.

Leases with Payments at Beginning-of-Period

When lease payments occur at the beginning of the period, the only shift in thinking required is to recognize that the amortization of the lease liability in the typical leasing schedule occurs in two pieces: reduction of the lease liability, followed by an increase due to accrued interest during

continued on next page

Table 7

Year	Payment	Beg. Liability after payment	Interest	End. Liability	Liability Amortization
0				78,017	
1	10,000	68,017	4,081	72,098	5,919
2	10,000	62,098	3,726	65,824	6,274
3	10,000	55,824	3,349	59,173	6,651
4	10,000	49,173	2,950	52,123	7,050
5	10,000	42,123	2,527	44,650	7,473
6	10,000	34,650	2,079	36,729	7,921
7	10,000	26,729	1,604	28,333	8,396
8	10,000	18,333	1,100	19,433	8,900
9	10,000	9,433	567	10,000	9,433
10	10,000	0	0	0	10,000
Total	100,000				78,017

Table 8

Year	Lease Expense Dr	Lease Liability Cr	ROU Asset Cr
1	10,000	4,081	5,919
2	10,000	3,726	6,274
3	10,000	3,349	6,651
4	10,000	2,950	7,050
5	10,000	2,527	7,473
6	10,000	2,079	7,921
7	10,000	1,604	8,396
8	10,000	1,100	8,900
9	10,000	567	9,433
10	10,000	0	10,000
Total	100,000		78,017

Table 9

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Year	Payment	Beginning Liability, after payment	Interest	Ending Liability	Lease Liability Amorti-zation	Straight-line Lease Expense	Increase (Decrease) in “Lease Payable” included in ROU Asset	ROU Asset Amorti-zation
Computation		Previous (4) - (1)	(2) x .06	(2) + (3)	(1) - (3)**		(6) – (1)	(5) + (7)
0				108,929				
1	10,000	98,929	5,936	104,865	4,064	14,486	4,486	8,550
2	10,800	94,065	5,644	99,709	5,156	14,486	3,686	8,842
3	11,664	88,045	5,283	93,328	6,381	14,486	2,822	9,203
4	12,597	80,731	4,844	85,575	7,753	14,486	1,889	9,642
5	13,605	71,970	4,318	76,288	9,287	14,486	881	10,168
6	14,693	61,595	3,696	65,291	10,997	14,486	(207)	10,790
7	15,868	49,423	2,965	52,388	12,903	14,486	(1,382)	11,521
8	17,137	35,251	2,115	37,366	15,022	14,486	(2,651)	12,371
9	18,508	18,858	1,130	19,988	17,378	14,486	(4,022)	13,356
10	19,988	0	0	0	19,988	14,486	(5,503)	14,486
Total	144,860				108,929	144,860	0	108,929

*** These numbers can also be calculated as Previous (4) – Current (4), that is, last year's ending liability balance less this year's ending liability balance.*

the period. The following examples go into this in more detail.

Example 4: An example of a leasing schedule that might be prepared for a lease with payments at the beginning of the period follows. Table 7 includes two columns relating to the lease liability. The first is the beginning of the year liability, after reflecting the payment, upon which the interest cost is computed. The second is the end of period liability after accretion due to the interest cost. An additional column has been added, which highlights the lease liability amortization. The amounts in this column are determined by subtracting the current year ending liability from the previous year ending liability. They can also be determined in the same way as for end-of-period payments, where the cash payment for the period, less the interest for the period, provides the liability amortization amount. The example assumes a 10-year lease with $10,000 payments at the beginning of the year, and an interest rate of 6 percent.

The $78,017 in the “Ending Liability” column for year 0 is the present value at 6 percent of the 10 required payments of $10,000. The journal entry made at lease inception is:

ROU Asset	78,017	
Lease Liability		68,017
Cash		10,000

The journal entries at the beginning of each year, years 2 through 10, when the payments are made are simply:

Lease Liability	10,000	
Cash		10,000

The journal entries at the end of each year (a) recognize the straight-line lease expense of 10,000; (b) increase the liability by the amount of the interest accrued; and (c) amortize the asset by the amount of the liability amortization. The schedule of entries is shown in Table 8.

Example 5: This example moves a little bit closer to leases observed in practice, in that an escalator of 8 percent per year is included in the leasing contract. Once again, the initial payment is $10,000 and the lease is a 10-year lease. The straight-line lease expense is $14,486, the sum of the lease payments ($144,860) divided by 10. The present value of these payments at a 6 percent implicit rate is $108,929.

Table 9 provides the values needed to account for this example. It is a typical lease amortization table for beginning-of-period payments, with the amortization highlighted in an additional column. Another additional column is added, tracking the difference between the straight-line cost of the lease and the increasing payments.

As in example 4, Table 7, the 108,929 in the "Ending Liability" column for year 0 is the present value at 6 percent of the 10 required payments. The journal entry at the beginning of year 1, when the lease is signed, is:

ROU Asset	108,929	
Lease Liability		98,929
Cash		10,000

Note that the total of the "Lease Liability Amortization" column in Table 9 is 108,929, which is $10,000 more than the amount at which the original Lease Liability was recorded. The $108,929 does match the present value of the 10 lease payments, but that amount is never recorded, since there is an up-front cash payment at lease inception. Column (5) does not provide the basis for debits to the lease liability in the following journal entries. Rather, it serves as a basis for determining the credits to the ROU asset, shown in column (8).

The remaining journal entries all use numbers from the above extended amortization table. Table 10 incorporates these journal entries, in two sets of columns. The journal entries made at the beginning of the year record the yearly payments; the journal entries at the end of the year record the straight-line lease expense, the increase in the lease liability (from the interest column above) and the ROU asset amortization, equal to the liability amortization plus the change in the "lease payable."

Note that the cash credits included in Table 10 total to $134,860, which is $10,000 less than the total Lease Expense of $144,860. This is because the cash paid at the inception of the lease is not included in Table 10, but is clearly part of the overall lease cost.

Table 10

	Beginning of year		End of year		
Year	Lease Liability Dr	Cash Cr	Lease Expense Dr	Lease Liability Cr	ROU Asset Cr
1			14,486	5,936	8,550
2	10,800	10,800	14,486	5,644	8,842
3	11,664	11,664	14,486	5,283	9,203
4	12,597	12,597	14,486	4,844	9,642
5	13,605	13,605	14,486	4,318	10,168
6	14,693	14,693	14,486	3,696	10,790
7	15,868	15,868	14,486	2,965	11,521
8	17,137	17,137	14,486	2,115	12,371
9	18,508	18,508	14,486	1,130	13,356
10	19,988	19,988	14,486	0	14,486
Total		134,860	144,860		108,929

Example 6: In this example, initial direct costs and a lease incentive are added. The extended amortization Table 9 used in example 5 is the basis of the numbers used in this example, as well. The initial direct costs and lease incentive adjust the initial asset value recorded at lease inception. The journal entry at inception (again assuming the cash flows associated with the initial direct costs and the lease incentive occurred earlier and were recorded in deferral accounts) is:

ROU Asset	103,929	
Deferred Lease incentive	10,000	
Cash		10,000
Lease Liability		98,929
Deferred Initial Direct Costs		5,000

Since the initial direct costs and lease incentive are embedded in the initial asset value, and are amortized on a straight-line basis, the initial direct costs increase the asset amortization shown in example 5 by $500 per period, while the lease incentive reduces the asset amortization by $1,000 each period, for a net decrease of $500. In addition, the initial direct costs increase the overall lease cost by $5,000, while the lease incentive decreases the overall cost by $10,000, a net decrease of $5,000. Therefore, the straight-line lease expense is $500 per year lower than that shown in Table 9, or $13,986 instead of $14,486.

The journal entries at the end of year 1, and during years 2 through 10, are shown in Table 11. Note that the numbers are identical to those for example 5, except the credit to the ROU Asset is $500 less each period, as is the debit to Lease Expense.

Table 11

	Beginning of year		End of year		
Year	Lease Liability Dr	Cash Cr	Lease Expense Dr	Lease Liability Cr	ROU Asset Cr
1			13,986	5,936	8,050
2	10,800	10,800	13,986	5,644	8,342
3	11,664	11,664	13,986	5,283	8,703
4	12,597	12,597	13,986	4,844	9,142
5	13,605	13,605	13,986	4,318	9,668
6	14,693	14,693	13,986	3,696	10,290
7	15,868	15,868	13,986	2,965	11,021
8	17,137	17,137	13,986	2,115	11,871
9	18,508	18,508	13,986	1,130	12,856
10	19,988	19,988	13,986	0	13,986
Total		134,860	139,860		103,929

A Foundational Understanding

With the accounting for operating leases set to change considerably, this article should assist practitioners in developing a foundational understanding of the new leasing standard before its mandatory adoption by public companies for fiscal years beginning after Dec. 15, 2018.

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By Walter R. Teets and Matthew Hoag

Operating Leases *Used* to be the Easy Ones

All of the following questions assume operating lease treatment under the newly issued (February 2016) lease standard and no modifications to the lease during the lease term

1 The amortization of the ROU asset follows which of the following patterns over the lease term (assume no up-front payments, lease incentives or initial direct costs)?

A. Straight-line recognition
B. Accelerated recognition (higher amortization in early years, lower in later years)
C. Decelerated recognition (lower amortization in early years, higher in later years)
D. Cannot determine the recognition pattern without additional information

2 Loughlin Motors LLC signs a level-payment operating lease with no up-front payments, lease incentives or initial direct costs. Loughlin will account for this lease using the new leasing standard (issued in February 2016). Based on the information provided, the amortization of the lease liability in year one:

A. Equals the amortization of the ROU asset in year one
B. Exceeds the amortization of the ROU asset in year one
C. Is less than the amortization of the ROU asset in year one
D. Cannot be determined relative to the ROU asset amortization from the information provided

3 In an escalating/increasing payment operating lease, the lease payable (the difference between the straight-line cost of the lease and the cash paid) for year one is recorded as a:

A. Credit to lease liability
B. Credit to lease payable
C. Credit to ROU asset
D. Debit to lease liability

4 In an escalating/increasing payment lease with no initial direct costs or lease incentives, the change in lease payable is computed as the difference between the:

A. Cash lease payment and the computed interest expense
B. Cash lease payment and the straight-line lease expense
C. Cash payment in the first period and the cash payment in the last period
D. Computed interest expense on the lease liability and the computed depreciation on the leased asset

5 The new lease guidance essentially spells out multiple requirements for operating leases. Which of the following is NOT one of these requirements?

A. The lease liability must be capitalized
B. A right-of-use (ROU) asset must be capitalized
C. A periodic lease expense must be recorded as a single amount on a straight-line basis
D. All of the above are requirements spelled out in the new operating lease guidance

6 In an escalating/increasing payment lease with no initial direct costs, prepayments and/or lease incentives, the amortization of the lease liability will initially be ______ than the ROU asset amortization. In later years, this pattern/relationship ______.

A. Less; persists
B. Less; reverses
C. Greater; persists
D. Greater; reverses

7 For leases with beginning-of-period payments, the periodic lease liability adjustment occurs in two steps at different points in time: (1) ______ and (2) ______.

A. A reduction for the accretion of interest, embedded in lease expense; an increase at the time of the lease payment
B. A reduction corresponding with the recording of the periodic lease expense; an increase for the accretion of interest
C. A reduction at the time of the lease payment; an increase for the accretion of interest embedded in the lease expense
D. A reduction corresponding with ROA asset amortization/depreciation; an increase corresponding with the recording of the periodic lease expense

8 For leases with payments at the beginning of the period and no initial direct costs, prepayments and/or lease incentives, the initial entry to record the lease liability, ROU asset and first lease payment results in recording ______.

A. A lease liability that exceeds the ROU asset
B. An ROU asset that exceeds the lease liability
C. A lease liability, but no ROU asset
D. An ROU asset, but no lease liability

9 Under the new leasing guidance, for operating leases, interest expense is ______.

A. Only recorded for leases with increasing/escalating payments
B. Only recorded when the lessor's rate is known to the lessee
C. Only recorded when there is an interest rate stated in the lease contract
D. Embedded as a component of the straight-line lease expense

10 Under the new leasing guidance, leases requiring payment at the beginning of the period require entries to ______ at the beginning of the period and entries to ______ at period end.

A. Both the lease liability and ROU asset; the ROU asset
B. Both the lease liability and ROU asset; the lease liability
C. The lease liability; both the lease liability and ROU asset
D. The ROU asset; both the lease liability and ROU asset

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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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