MARCH/APRIL 2018

Today's CPA

TEXAS SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS

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Tax Reform Law

Understanding and Preparing for the New Lease Accounting Standard

How to Deter Fraud in Not-for-Profit Organizations

Also: Reducing Outsourcing Cyber Risks

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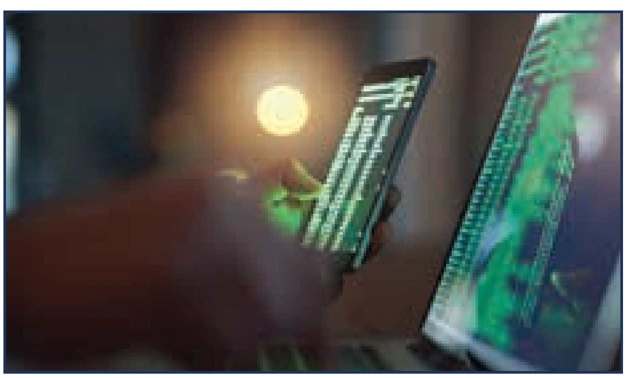

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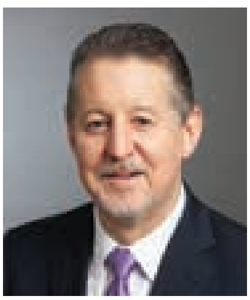
The Times They Are a-Changin

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

As Professors Don Carpenter and Tim Thomasson discuss in their article on page 38 and Jason Freeman covers in his Tax Topics column this issue, the Tax Cuts and Jobs Act (TCJA) of 2017 has substantially modified and eliminated major sections of the tax code. Additionally, entirely new provisions will require clarification from the Internal Revenue Service through regulations and will likely necessitate a technical corrections act to correct what Congress actually intended, but did not accomplish, in the drafting.



The uncertainty and changes brought by the TCJA will demand a major shift in mindset for CPAs advising their clients on various tax savings moves, from when (and even how) to make charitable contributions to which type of business entity provides the maximum tax savings. What we once took for granted no longer will necessarily be true, which compels deeper thought and analysis, at least until the new becomes normal.

Our profession has always been one engulfed in and responding to change. There are tax law changes every year; the latest accounting and auditing standards require study and implementation; and new regulations bring different challenges to business and industry. How we work today only holds faint resemblance to how CPAs worked a century ago.

New technology has particularly transformed our work. We have adapted to and adopted cloud-based solutions, mobile technology, scanning solutions and paperless offices. We deliver information through portals and secure emails; we answer emails on our phones and access what we need without ever being in an office. As implementation of artificial intelligence, machine learning, blockchain, cryptocurrencies, autonomous transportation, big data analytics and robotics grows, CPAs must continue to respond to the challenges and opportunities that new technology brings. Even the alarming rise in cybercriminals brings another opening to be key advisors to clients and employers as we identify and address cyber risks or to report on the adequacy of a company's cybersecurity risk management.

To address and exploit these changes involves learning and applying different skills than those we may have needed in the past. A World Economic Forum (WEF) report, *The Future of Jobs*, identified 10 skills needed to thrive in the Fourth Industrial Revolution: complex problem solving, critical thinking, creativity, people management, coordinating with others, emotional intelligence, judgment and decision making, service orientation, negotiation and cognitive flexibility.

> **"TSCPA COMMITS TO EMPOWERING MEMBERS THROUGH SUPPORTING PROFESSIONAL EXCELLENCE AND CONNECTING MEMBERS TO RESOURCES AND EACH OTHER."**

The abilities that I thought I needed when I started in the profession (remembering debits on the left, credits on the right; running a 10-key; ticking and tying; cutting and pasting, and following the prior year workpapers) no longer seem even remotely relevant to what we do and will do as CPAs.

Far more important to what we do today are those WEF's recognized skills. We seek those capabilities in the people we hire, retain, develop and promote. Those competencies break into essentially two equally important categories: how we think and how we relate to people. Trusted advisors will solve problems not by processing data (which machines will do), but by applying critical and creative thinking and judgment to complex circumstances. People skills will continue to grow in importance to our success. So-called soft skills are now the new hard skills.

As circumstances and technology evolve, the profession and we as individual CPAs will continue to adapt to meet new requirements and demands. TSCPA will as well. Organizational flexibility is one of the guiding principles in our TSCPA 2020 strategic plan. As CPAs continue in their commitment to lifelong learning, the Society commits to empowering members through supporting professional excellence and connecting members to resources and each other.

Our work will continue to change, likely at an even more furious pace. Yet we remain anchored in the constancy of those values inherent in who we are as CPAs. Our commitment to integrity, objectivity and competence must endure even as we adjust to the new challenges of these changing times.

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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Tax Reform is Here: A Brief Primer on the Key Business Provisions

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

Just before the turn of the new year, Congress passed – and the president signed – the Tax Cuts and Jobs Act of 2017 (TCJA). The TCJA represents the most extensive rewrite of the U.S. tax code in over 30 years. The new act contains a number of important provisions that will impact business tax planning for years to come. Below are some highlights from the business-related provisions that practitioners need to know.

21 Percent Corporate Rate. The new act eliminates the progressive corporate tax rate system, which imposed a 35 percent maximum tax rate. In its place, it provides a flat 21 percent corporate rate. This change, which is not set to phase out, will play a significant role in choice-of-entity decisions.

Corporate Alternative Minimum Tax. The new law repeals the corporate Alternative Minimum Tax for tax years beginning after Dec. 31, 2017.

Dividend Received Deduction. The TCJA reduces the general corporate dividends received deduction rates. Existing law generally provides corporate taxpayers with a dividend received deduction equal to 70 percent of dividends received from another corporation; 80 percent of dividends received from a 20 percent owned corporation; and 100 percent of dividends received from a corporation that is a member of the same affiliated group. The new act reduces the general corporate dividends received deduction to 50 percent and reduces the deduction applicable to 20 percent owned corporations to 65 percent.

Cost Recovery. The new act allows for first-year "bonus" depreciation of 100 percent of the cost of qualifying property. The 100 percent bonus depreciation rate is phased down to 80 percent beginning in 2023 and is ultimately phased out by 2027. Notably, under the new act, used property that was not previously used by the taxpayer and that is not acquired from a related party may be eligible for bonus depreciation.

The new act also expands the availability of section 179 expensing, increasing the maximum amount that can be deducted under section 179 to $1 million and raising the dollar-for-dollar phase-out threshold to $2.5 million.

Net Operating Losses. The new law limits future net operating loss deductions to 80 percent of taxable income with respect to losses arising in tax years that begin after Dec. 31, 2017. Existing law generally provides for a two-year carryback and 20-year carryforward for NOLs. The new law, however, does not allow for carrybacks with respect to losses arising after Dec. 31, 2017. Instead, it allows for an indefinite carryforward period. Thus, taxpayers will be required to separately track NOLs from prior periods.

Section 174 Research and Experimentation. The new act provides that research and experimental expenditures incurred in tax years beginning after Dec. 31, 2021, must be capitalized and amortized over a five-year period. These changes mark a significant break from current law, which permits taxpayers to immediately expense, amortize or capitalize such expenditures. In addition, under the new law, certain research and experimental expenditures that are attributable to research conducted outside the United States are required to be capitalized and amortized over a 15-year period.

Accounting Methods. The act expands the availability of the cash method of accounting for corporations with average gross receipts over a three-year period that do not exceed $25 million. It also eliminates the requirement to comply with the inventory tracking rules and the section 263A uniform capitalization rules for producers and resellers that meet the $25 million test.

Limitation on Net Interest Deduction. The new act replaces the "earnings stripping rules" under section 163(j). In their place, it provides a new limitation on deductible interest. The new limitation disallows a deduction for net business interest expense in excess of 30 percent of adjusted taxable income plus floor plan financing interest. However, the new limitation does not apply to taxpayers that have average annual gross receipts of less than $25 million. Certain taxpayers, such as certain real estate businesses and farming businesses, may elect out of the interest expense limitation. Such electing businesses are required to use the alternative depreciation system with respect to certain property.

Excessive Employee Remuneration. The TCJA expands and strengthens the section 162(m) limitation on the deduction of compensation paid by publicly traded corporate employers to covered employees. The act expands the definition of "covered employee" to include both the principal executive officer and principal financial officer, as well as the three most highly compensated officers for the tax year required to be reported on the company's proxy statement. It also adopts a new once-a-covered-employee, always-a-covered-employee rule. Perhaps most notably, the act eliminates the exception for commissions and performance-based compensation.

20 Percent Deduction for Combined Qualified Business Income. The TCJA provides for a deduction, under new code section 199A, of up to 20 percent of certain pass-through income. The deduction is designed to provide relief to owners of pass-through businesses, which include partnerships, S corporations and sole proprietorships. Notably, the deduction phases out after 2025, a consideration that may factor into the choice-of-entity calculus.

The deduction is generally equal to the taxpayer's "combined qualified business income." (Technically, there is fine print and for some taxpayers the calculation is slightly more complicated.) The deduction, however, cannot exceed the taxpayer's taxable income (reduced by net capital gain) for the year. It is not taken into account to compute adjusted gross income, and is available to both itemizing and non-itemizing taxpayers.

"Combined qualified business income" is generally equal to 20 percent of the taxpayer's qualified business income (QBI) with respect to each qualified trade or business. QBI is defined as the net amount of qualified items of income, gain, deduction and loss with respect to any qualified trade or business of the taxpayer.

The amount of QBI for each qualified trade or business that is taken into account, however, is limited to the greater of (a) 50 percent of the W-2 wages paid with respect to the qualified trade or business or (b) the sum of 25 percent of the W-2 wages paid with respect to the qualified trade or business plus 2.5 percent of the unadjusted basis, immediately after acquisition, of all qualified property. (These limitations do not apply for taxpayers with taxable income below certain thresholds – $157,500 for single taxpayers and $315,000 for married filing joint taxpayers – and are "phased-in" for taxpayers with taxable income exceeding such thresholds.) The allowable amount must be calculated and added together for each qualified trade or business to determine the taxpayer's "combined qualified business income."

The section 199A deduction is not available with respect to income from a "specified service trade or business" for taxpayers with taxable income over certain thresholds ($207,500 for single and $415,000 for married filing joint taxpayers). A specified service trade or business generally includes any trade or business involving the performance of services in the fields of health, law, accounting, actuarial science, performing arts, consulting, athletics, financial services, brokerage services, or any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees.

The deduction for such income – income from a "specified service trade or business" – begins to be phased out for single taxpayers with taxable income over $157,500 and married filing joint taxpayers with taxable income over $315,000; it is completely phased out (i.e., unavailable) when such taxpayers reach the thresholds mentioned above ($207,500 for single and $415,000 for married filing joint taxpayers).

Loss Limit. The new law disallows "excess business losses" for non-corporate taxpayers. An "excess business loss" is defined as the amount by which the taxpayer's total deductions attributable to the taxpayer's trades or businesses exceed the total gross income from those trades or businesses plus $250,000 (or $500,000 for married filing joint taxpayers).

Section 1031. The new law scales back the scope of like-kind exchanges under section 1031. It eliminates 1031 deferral for exchanges of tangible personal property and intangible property. Thus, like-kind deferral is limited to exchanges of real property and is not allowed for exchanges of real property held primarily for sale.

Carried Interest. The new law provides for an extended, three-year holding period in order to qualify for long-term capital gain treatment on the sale of certain partnership interests. More particularly, it provides that the sale of certain profits interests in a partnership that were received in exchange for the performance of services constitutes short-term capital gain unless held for three years or longer. The rule applies to interests in partnerships engaged in raising or returning capital and (1) either investing in (or disposing of) certain assets (or identifying certain assets for investing or disposition) or (2) developing certain assets.

> "TAXPAYERS WILL BE REQUIRED TO SEPARATELY TRACK NOLS FROM PRIOR PERIODS."

International Tax Provisions. The new law fundamentally changes the international tax landscape, marking a shift toward a quasi-territorial system of taxation. The new rules feature a deemed repatriation, which treats "United States shareholders" (as defined in section 951) of specified foreign corporations as receiving a dividend (taxed at special effective rates) equal to their pro rata share of certain unrepatriated and untaxed existing earnings and profits of the foreign corporation, whether they actually receive such funds or not.

The TCJA provides domestic corporations with a new 100 percent deduction for the foreign-source portion of dividends received from specified 10 percent owned foreign corporations when the domestic corporation is a United States shareholder of such foreign corporation. The deemed repatriation and dividends received deduction are designed to remove the "lockout" effect that inhibits the investment of foreign subsidiary earnings back into the United States.

The new law retains the current subpart F regime with some tweaks. It also provides for a new class of income known as global intangible low taxed income (GILTI), requiring United States shareholders of controlled foreign corporations (CFCs) to include their share of the CFC's GILTI in current income in a manner similar to subpart F income. Corporate shareholders, however, are allowed to deduct 50 percent of such income (37.5 percent beginning in 2026).

The new law provides domestic corporations with a reduced effective tax rate (13.125 percent) on foreign derived intangible income, which is defined as a portion of the statutorily defined "intangible" income earned directly by U.S. corporations from serving foreign markets. In addition, the new law contains a number of base erosion and anti-hybrid measures. As a result, taxpayers with international operations will be required to navigate a new and complex array of tax provisions and, for some, to rethink existing structures. ■

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An Economic Reckoning?

By Mano Mahadeva, CPA, MBA | Column Editor

Nobody runs a balanced budget all the time. There are times when our incomes exceed our expenditures – when this happens, our net worth improves. When our expenditures exceed our income, the converse happens and our net worth worsens. It is no different for the government. When tax revenue is higher than its expenditures, a surplus is created, which reduces its accumulated liability; when tax revenue is lower than its expenditures, a deficit occurs. To maintain equilibrium, it must borrow funds to finance this deficit and this borrowing is added to its accumulated liability – the federal debt.

Very few topics generate as much public frustration, confusion and controversy as the budget deficit and national debt. The recently achieved budget agreement, hailed as ambitious and bipartisan, further heightens these conversations and concerns, as the new budget and the recent tax cut plan projects an increase in our national debt by $1.2 trillion over the next two years.

Historically, debt helped to expand businesses, improve returns and enhance lifestyles. Social attitudes continued to change as we moved past the Great Depression and toward savings in the 1930s, to the advent of plastics in the 60s and to metals in the 90s, with a “buy now, pay later” mentality. The 1980s and 1990s produced steady growth with low unemployment and inflation, which helped mask the steady rise in debt levels. By early 2000, we were paying for imports with deficits financed by the same countries selling us services, oil and other commodities.

Low interest rates in the early 2000s fueled more borrowing. Hedge funds and private equity operators used debt aggressively around the globe. Homeowners consolidated debt via home equity lines of credit, further mortgaging their futures. Highly leveraged investment banks had record low levels of equity on their balance sheets. Bankruptcy was easy and a socially acceptable norm.

Then came the Lehman Brothers failure. This set in motion the dismantling of an overheated economic engine. The spigot of credit closed. Global growth became snail paced. Unemployment grew and as a result, there was more borrowing to finance basic needs. Private debt reshaped itself to public debt, leading to major bailouts.

The federal debt stood at $10 trillion in 2008; today, it is double that amount. Most blame this increase on the 2008 crisis. We had the economic stimulus package of $787 billion and an ongoing recession, which led to lower revenue and taxes, the funding of two wars in Iraq and Afghanistan that increased military spending to just nearly a trillion dollars, and rising mandatory spending for health care and pensions, costing more than half the intake in revenues.

Concern about the budget deficits and the national debt has fluctuated over time, with the ebb and flow of surpluses and deficits. As our debt tripled from what it was to today, the topic has once again taken center stage. Economists are split on their views of future capital formation – the traditionalists suggest that budget deficits will retard the growth rate of capital formation, reduce national income and our future living standards. The classical theorists suggest no impacts to either capital formation or the welfare of future generations. Past data tends to support the views of the traditionalists in that budget deficit size increases were accompanied by net positive inflows of foreign investment.

These foreign inflows account for a third of our national debt. They pay relatively lower rates as compared to historical levels. Most are our trading partners. They could influence what our policymakers do. Projected federal spending for health care costs and retirement costs continue to rise, chewing up more of our total spending, saddling us with commitment for years. If our ratings get affected, would investors stop buying our debt, when we have traditionally been the haven of safety in times of uncertainty?

Such is the quandary. We have never had a debt as large relative to the economy as it is now and is projected to be over the coming decades. This is an area of unchartered waters and no one seems to offer what might happen. Financial booms and busts have occurred throughout our history because of policy mistakes, irrational human behavior, greed and a lack of sacrifice to name a few. And it seems to be politically easier to “kick the can” down the road and argue claims of improper methodology, smoke and mirror accounting and flawed data.

The basic economic problem is that our economy’s finite resources are insufficient to satisfy the needs and wants of our citizenry. As such, our economy needs a drastic makeover in policy. Policy makers will have to make crucial decisions quickly to restore order to public finances. The capital market gyrations recently suggest that awareness of this inevitable reckoning is beginning to dawn. Let us hope that the crater already dug by some is not too deep. ■

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


YOU'VE GOT THE DESIRE. NOW GET THE DESIGNATION.

Becoming a Clinical Accounting Professor: Lessons Learned

By Don Carpenter, CPA, Guest Columnist

The role of a clinical professor offers the opportunity to teach and mentor students without the requirements inherent in tenure-track positions. Increasingly, higher education is valuing the contribution individuals with professional credentials bring to the educational experience of students pursuing degrees in professions such as accounting, engineering or nursing.

Likewise, professionals value the opportunity to extend their careers and use their experience to invest in students who will soon be on career paths very similar to their own. By maintaining awareness of the inherent challenges in transitioning from the corporate to the academic world, clinical accounting professors can increase their likelihood of success.

A Day in the Life …

The transition from boardroom to classroom may not be as seamless as one might assume. If you have been dreaming of this as an easy way to "retire," beware: it's more work than you might have imagined, different from practice, but certainly nonetheless enjoyable. The roles of C-suite executive and clinical professor are worlds apart in some ways. Yet, there are similarities. Whether measured in financial quarters or academic semesters, there is a periodic nature to each. Each also serves multiple customers who may have competing priorities.

However, there are distinct differences that require adjustments and adaptation. These distinctions are often subtle, but nonetheless important.

As a professor, the client-driven demands and relationships of the profession are superseded by the cadence of each semester's teaching assignments with a fresh group of students replacing those from the previous term. Research is generally not a requirement as it is with tenure-track positions nor is there an expectation to publish, although it is typically encouraged.

In exchange, clinical professors are expected to carry a more robust course load. While tenure-track positions may teach two classes a semester with periodic sabbaticals to allow time for research and publication, the clinical professor might be required to teach four classes. A balanced faculty of tenure-track and clinical professors allows a university to produce research necessary for a respected academic reputation while at the same time offering a breadth of classes with manageable student-teacher ratios.

The heavier course load will generally also require longer office hours for availability to students. When combined with the time needed to adequately prepare for lectures, the week can quickly become fairly structured. This might surprise some potential clinical professors who may have previously experienced the flexibility of an adjunct position or enjoyed the stimulation of interacting with students as a guest speaker.

Although a clinical professor will generally retire from full-time practice, his/her industry experience and relationships are critical in securing a faculty position. To avoid becoming dated, there is an expectation that clinical professors will remain engaged in practice to at least a minimal degree. This might entail periodic consulting projects or advisory roles. It is also common to see such positions tapped as expert witnesses in controversies where accounting knowledge is relevant.

Relating to Students

To transition successfully to the new role, a clinical professor must first and foremost have an interest in engaging students who are considering accounting as a profession. Students see accounting as a promising career path, but often approach the curriculum with a level of trepidation due to the demanding workload. They welcome relationships with professors who have demonstrated the ability to translate the academic requirements into successful careers. Concurrently, clinical professors are able to give practical career advice in a profession that offers a myriad of alternatives: public accounting, industry or government and specializations: audit, tax or advisory services.

Building on years of experience, the clinical professor has the opportunity to convey technical subject matter in the context of examples and circumstances that offer practical applications. The following paragraphs are just a few recommendations that might be helpful in the transition from the corporate world to the classroom. They are described in terms of "do's and don'ts" that should help capitalize on professional experience in practice, yet avoid missteps that might make the transition more difficult than it need be.

Do: Use your 'Real World' Experience

Most accounting students come to university with minimal exposure to accounting beyond maybe a high school bookkeeping course. The world of "debits and credits," cash flow statements and internal controls is as foreign to them as early English texts or microbiology. In addition, the accounting curriculum is designed to prepare students for entry into a profession. Very few students will remain in academia. Their goal is a career in either public accounting or industry. From this perspective, the average student is seeking to relate what seems to be a series of rigid rules and arcane terminology to a career that is just beyond the horizon called "graduation." It is the role of the professor to present the material in such a way as to answer the question "why study accounting?"

A clinical professor brings years of experience that if presented appropriately can answer just that question. For example, describing the development of a threatened lawsuit can bring to life the judgment that accountants are required to exercise when gauging whether a potential liability meets the standards for accruing a contingency. Or, the narrative of an acquisition that fails to meet projections can bring clarity to the very technical requirements regarding impairments of goodwill. Such practical experiences put flesh on the bones of regulations and procedures for which students lack personal experiential context.

Bringing such experiences into the classroom adds a dimension to the discussion that allows students to match the material with practical application. The examples need not be limited to an individual's personal experience. Drawing from current newspaper articles and then placing the information within one's framework of experience can be just as effective and avoids the potential that all discussion eventually comes back to, "At Company X, we …. "

Don't: Abuse Your 'Real World' Experience

As is often the case, a strength can also be a weakness. Although drawing on career experience can be very helpful in the classroom, several potential pitfalls require self-governance:

- Referring to the "real world" can give the impression that the university and classroom are in some way not the real world and, therefore, the experience and effort are to be discounted. The classroom is just as "real" as the work environment only with different priorities and goals.
- Teaching the technical application of accounting theory should never be compromised by the practicalities of the workplace. It is common for accounting theory to be modified in practice due to materiality and the cost/benefits of compliance. Implementation of accounting standards within specific industries may also alter application in an effort to better inform the user of the information. It is the goal of the clinical professor to produce technically proficient students who are prepared to later adapt to the work environment.
- Finally, storytelling should never be a substitute for instruction. Although students may find the clinical professor who regales the class with a series of adventures to be entertaining, they receive a great disservice if they leave the classroom without the technical knowledge intended.

Do: Rely on Colleagues

The adjustment to teaching in the university environment can be quite daunting. Preparation is essential and it is almost certain that a motivated instructor will improve as semesters pass. This, however, is little compensation to students in the initial semesters who are relying on their course content and experience to prepare them for later courses and ultimate technical proficiency.

New professors coming out of professional careers have a priceless resource in the form of experienced colleagues. Clinical professors may feel intimidated by those on the faculty who have years of classroom experience, particularly those who have achieved tenure with a weight of research and publications to boost their credentials. Don't be afraid to ask. These experienced colleagues can be very helpful and are generally quite willing to share course materials. These resources can significantly reduce the preparation time for a course and provide a baseline for a new professor to assess what is expected of an instructor in a particular course. Access to previous homework and testing material can also provide insight into what are reasonable expectations of students as far as workload and comprehension.

In addition, colleagues can provide counsel into such uncertainties as:

- What is the appropriate pacing for a particular course?
- What are the faculties' expectations regarding classroom attendance and behavior?
- What is the policy for administering tests and grades?

Since accounting is a field of study that consistently builds upon foundational courses, it is essential that new professors be made aware of the overall expectations and goals for a particular course within the context of the overall curriculum. Although one of the attractions of teaching at the university level is the freedom allotted to faculty members, this must be balanced with a need to work as a team to assure consistency of content and continuity of the learning experience for the student.

In summary, when in doubt, ask. Someone who "knows the ropes" will generally be there to help.

Don't: Rely Too Much on Colleagues

Although colleagues can be a great resource, a clinical professor should keep in mind that he/she was offered a position on the faculty to address a need. Although a new faculty member lacks the years of classroom experience that seasoned colleagues possess, there is a value to the knowledge and experience in current business practice and the issues facing the profession. This experience is beneficial to the classroom experience and to other faculty members, as well. Colleagues should be actively engaged on issues of common interest from their unique perspective. In addition, clinical professors often bring with them new business relationships and contacts that can enhance the resources available to a department.

Finally, some professionals are attracted to the academic environment under the assumption that this new career offers a semblance of semi-retirement. Although the nature and cadence of the work is different, the opportunity for engagement and intellectual challenge is every bit as demanding as executive-level positions in the profession. To rely on colleagues to reduce the effort required or alleviate the workload would be an abuse of these relationships, as well as a disservice to the students under one's instruction.

A Win-Win Opportunity

As universities look to the experience of practitioners as an asset to complement the more traditional tenured positions on accounting faculties, clinical roles offer win-win opportunities for professionals and students alike. Practitioners are able to capitalize on their careers to re-invest in a profession that has given so much in intellectual and material rewards. Students are able to benefit from their professors' experiences and receive mentoring in a stage of their development when they are making major decisions regarding their careers. ■

Don Carpenter, CPA accepted the position of assistant clinical professor of accounting at his alma mater after a 35-year career managing tax and accounting responsibilities (most recently as chief accounting officer for Houston-based Waste Management Inc.). He received his BBA in accounting at Baylor University and his Master of Science in accountancy at the University of Houston.

Reducing Outsourcing Cyber Risks

By Paul A. Ashcroft, Ph.D., CPA

The scope of cyber risks is significantly expanding. Many firms utilize outsourced services to improve productivity and/or to reduce costs. Significant recent technological developments in the methods for delivering outsourced services have improved the capability and efficiency of the companies that provide such services.

However, the benefits from an increased use of outsourced services may be hampered by the correlating greater potential cyber risk vulnerabilities created for firms acquiring these services. Entities that acquire outsourcing services may be less than fully protected against these risks or perhaps unaware that they exist. The increase in outsourcing cyber risks provides CPAs with opportunities to develop and offer additional cyber risk advisory services.

Stan Lepeak, research director of KPMG's Shared Services and Outsourcing Advisory group, highlights items that significantly increase the risk of significant cyber-attacks for entities that extensively outsource their processes. Lepeak states that outsourcing creates opaqueness and uncertainty between the client and the outsource provider. He suggests avoiding the problems of the client not sufficiently understanding or having control over the provider's cyber protection procedures, and the provider not timely notifying the client when a breach does occur.

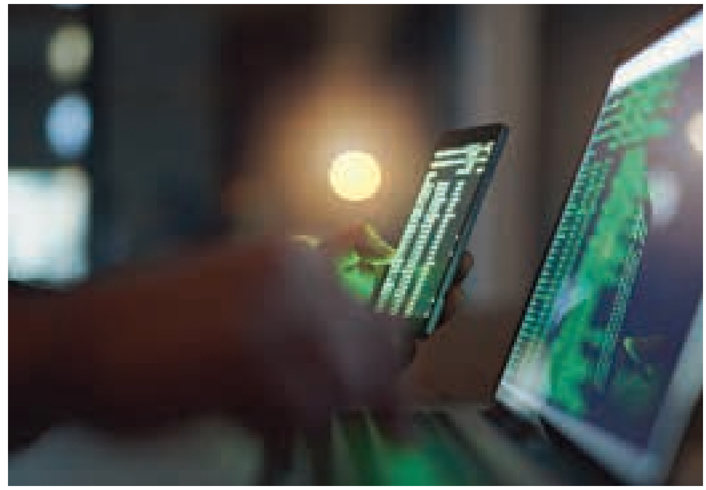
Indications of Significant Outsourcing Cyber Risks

Deloitte stated in their 2016 Global Outsourcing Survey that many companies today view outsource providers as key business innovators and enablers of transformation and not merely a cost-reducing option. This expansion of the outsourcer's role requires that companies allow outsourcers access to significantly more of a company's sensitive data, which increases the potential cyber risk exposure of data breach losses. Deloitte's survey reports that 73 percent of respondents consider cyber risks during the outsourcing process and that 23 percent expect to reduce their use of outsourcing in response to the related cyber risks.

Further indication of how outsourcing presents significant cyber risks to every organization is that Soha Systems reports that 63 percent of all data breaches result either directly or indirectly from access by third parties, such as outsourcing contractors and suppliers. Additional key results presented by Soha Systems in their 2016 Survey on Third Party Risk are:

- Organizations are providing third parties with increased access to their application infrastructure: 87 percent of IT professionals report that their organization's use of outsourcing contractors increased 49 percent since 2013 and 40 percent of the professionals expect it to continue increasing in the next three years.
- 56 percent of respondents were very concerned about their organization's ability to control and/or secure third-party access to their data.

Ponemon Institute conducts research on privacy, data protection and information security policy. Ponemon's 2016 survey of professionals



knowledgeable about proper governance of third party risks reports that responding organizations paid an average of $10 million over the previous 12 months to repair a data breach caused by negligent or malicious third parties. Regarding the extent of third party data risks, 21 percent of respondents replied they are significantly increasing, 20 percent said they are increasing and 29 percent stated the risks are not changing. Only 19 percent of respondents stated that their organization's third-party risk is decreasing and 11 percent said they could not determine the level of third party risks. Ponemon adds that 78 percent of their survey respondents expect the overall increasing trend in cyber-attacks to significantly impact their organization's third-party risk. In summary, the results of Ponemon's research provide additional indications of significant cyber risks from outsourcing.

The remainder of this article focuses on how entities can protect themselves against the cyber risks from outsourcing.

Initial Steps to Assess and Defend Against the Risks

Understanding the cyber risks a company may encounter from using outsourced services begins with asking clarifying questions. Business executives evaluating whether to increase their use of outsourced services would be wise to thoroughly answer these important cyber security questions:

- How is our company more vulnerable to cyber risk due to the technological changes in service delivery?
- How do we obtain the greater efficiency that results from an increased use of outsourced services and simultaneously reduce the correlating cyber risks to an acceptable level?

A major part of answering the above questions involves creating cyber security goals. Dan Kinsella and Steven Darroch of Deloitte & Touche recommend that firms develop and operate systems having the following three characteristics to effectively manage their service delivery cyber risks from outsourcing:

- Be secure: Protect critical assets against known and emerging threats;

Exhibit 1. Initial Defenses Against Outsourcing Cyber Risks

Defense	Key Actions
Be Secure	• Evaluate which data would cause the greatest disruption if it becomes unavailable and which data may be valuable to outsiders.
Be Vigilant and Resilient	• Fully include cyber security into the outsourcing procurement considerations. • Evaluate the effect of all outsourcing cyber security risks and issues on the overall business value chain. • Identify the specific controls and policies that should be implemented by the outsourcing supplier and require that each supplier fully and consistently follow them.

- Be vigilant: Reduce detection time and develop the ability to detect the unknown; and
- Be resilient: Strengthen your organization's ability to recover when an attacker makes it through your defenses.

Be Secure. Securing critical information to reduce cyber risks from outsourcing starts with identifying which types of data are the most critical and most valuable. Kinsella and Darroch state that executives should not think that their company's data is not valuable or not important merely because they have not experienced one of the high-profile data breaches that made national news. Rather, executives should thoroughly evaluate which data would cause the greatest disruption if it becomes unavailable, as well as which data may be valuable to outsiders. Cash flow and supply chain disruptions may result from important data becoming unavailable on a hosted or outsourced system.

Be Vigilant and Resilient. In the last few years, outsourcing has become a key strategy since one benefit of the increased use of a variety of supply chains is that it often eases entry into new markets. Whether outsourcing is for current markets or new ones, becoming more vigilant and resilient largely depends on implementing strong security controls.

In the majority of cases in which he has been directly involved, the controls required of outsourcing suppliers are "sadly lacking compared with those imposed on internal capabilities. And that is the soft underbelly that can expose a business to often difficult-to-manage cyber risk," states Mark Brown of Ernst and Young. Brown strongly advises the outsourcing buyer to:

- Fully include cyber security into their procurement considerations. Do not make financial savings the only goal of outsourcing.
- Evaluate the effect of all cyber security risks and issues on the overall business value chain. Do not merely assess cyber security from a technical perspective.

Security controls are critical, because a company's outsourcing of IT operations, supply and other business processes can create greater risks if cyber security standards are not equally and regularly followed by their contractors. Businesses can significantly reduce their risks by identifying the specific cyber security controls and policies that their suppliers should implement. In addition, the buyer should require each supplier to fully and consistently adhere to the specific controls and policies.

Exhibit 1 summarizes the key actions in developing important initial defenses against outsourcing cyber risks.

The High Cost of Cybercrime

According to Microsoft, the information security market totaled $170 billion in 2015, largely because 71 percent of companies reported having a 2014 cyber-attack and subsequently increased their security investments. Microsoft further stated that 556 million people are cybercrime victims annually. The World Economic Forum estimates the worldwide cost of cybercrime at $3 trillion.

Opportunity for CPAs

Companies acquiring outsourcing services should perform regular internal and/or external assessments to test the cyber security effectiveness of the vendor's systems. CPAs can provide needed assistance by conducting a Service Organization Controls 2 (SOC 2) review of the outsourcing vendor's system. A SOC 2 review is an attest engagement under the American Institute of CPAs' (AICPA's) Attestation Standards (AT) Section 101. AICPA's publication titled "Reports on Controls at a Service Organization over Security, Availability, Processing Integrity, Confidentiality or Privacy" provides specific guidance about performing a SOC 2 review.

AICPA states that a SOC 2 review report is intended to provide a broad variety of users with "information and assurance about the controls at a service organization that affect the security, availability and processing integrity of the systems the service organization uses to process users' data, and the confidentiality and privacy of the information processed by these systems." NDB LLP, Accountants and Consultants, explain that a SOC 2 review will examine and report on one or more of the "Trust Service Principles," which include the following:

- The security of a service organization's system.
- The availability of a service organization's system.
- The processing integrity of a service organization's system.
- The confidentiality of the information that the service organization's system processes or maintains for user entities.
- The privacy of personal information that the service organization collects, uses, retains, discloses and disposes of for user entities.

Due to the potentially high cyber risks of outsourcing, SOC 2 engagements provide CPAs with a valuable opportunity for adding services to current clients, as well as gaining new clients.

Reducing the Cyber Risks of Outsourcing

Cyber risks are continually present and cannot be totally eliminated. As such, it is very important to plan and implement effective procedures that reduce the risks associated with each outsourcing option considered. Buyers should perform each of the following procedures to reduce their outsourcing cyber risks, which are summarized in Exhibit 2 and are modified from recommendations by Brown and Lepeak.

1. Self-assessment. The firm acquiring the outsourcing services should thoroughly evaluate and understand their own level of

continued on next page

Exhibit 2. Specific Procedures to Reduce Outsourcing Cyber Risk

Procedure	Basic Description
Self-assessment	The buyer of outsourcing services thoroughly evaluates their own level of expertise and capability to defend against a cyber-attack.
Prioritize risks	Perform a holistic assessment of each supplier's data security tools and skills to identify where the significant risks are likely to occur.
Be employee cautious	Understand how the service provider trains and supervises its employees to handle, process and protect confidential information.
Involve experts	Have all of the client's internal experts and selected third-party experts assess the outsource provider's security methods and abilities.
Learn from mistakes	Study prior cyber-attacks on the client's organization and its peers, and determine how the provider learns from prior data security breaches.
Specify boundaries	The provider must notify the client of where its data resides at all times and may not sub-contract any of the delivery to another party.
Clarify controls	Clearly state to each outsourcer the information security, business continuity and privacy controls necessary.
Do a test run	Provide the supplier with a limited set of the company's data. Then test if the supplier has the desire and the ability to meet its obligations.
Be braced	Prepare for a cyber-attack by clearly predefining emergency and remedial response procedures for a variety of data breach scenarios.
Create a monitoring strategy	Monitor the supplier with continuous right-to-audit activities and the use of third-party testing beyond that of the outsourcing provider.
Observe intently	Observe in-depth the provider's response to early stage threats and attacks. Evaluate the quality and breadth of the provider's approach.
Plan for the possible consequences	Create a cyber-attack contingency plan and coordinate it with the outsourcer's contingency plan to reduce surprises and confusion.

expertise and capability to defend against a cyber-attack. This is needed to assess the quality of an outsourcing provider's defenses and define best practices that the provider should have in place and identify how to enforce those best practices.

2. Prioritize risks. In the planning/procurement stage, perform a thorough, holistic due diligence assessment of each supplier's data security tools, skills and abilities to identify where the significant risks are likely to occur. Avoid the mistake of focusing on just one area, such as network security, and skimming quickly over other areas such as data privacy and application security. While it is important to first protect the crown jewel assets, it is also vital to evaluate risks across all assets, applications and systems.

3. Be employee cautious. The outsourcer's employees will be handling and processing the client's data. Because of that, it is critical that the client fully understand and critique how the service provider trains and supervises its employees to handle, process and protect confidential information both internally and externally. For example, discover if employees handle sensitive data from different clients or store such data all in the same location on a common system. Also determine if the provider's employees possess all relevant and/or required training and certifications.

4. Involve experts. To accomplish a quality assessment of an outsource provider's data security methods, abilities and procedures, the client entity should involve all of their internal experts in the review process. Doing so will typically include many people beyond those who are specifically part of the team to acquire the outsourcing services. If the client's personnel lack critical knowledge or skills to properly perform portions of the assessment, it is vital to contract with third-party experts to overcome those weaknesses. The outsourcing provider should also have skilled security experts already in place.

5. Learn from mistakes. Identify the types of attacks that may occur and possible controls to prevent them by studying actual cyber-attacks that the client's organization and its peers have experienced. In addition, determine if the provider is taking a similar approach to learn from prior data security breaches. From this entire process, the client and the outsource provider should then collaborate to clearly define and agree on leading practices to reduce the cyber risks appropriately.

6. Specify boundaries. The client organization should require that the outsource provider notify them of where its data resides at all times and that the client retains the right to not allow the data to be moved out of agreed-upon markets. In addition, impose on each supplier sufficient restrictions that prevent the outsourcer from sub-contracting any of the delivery to another party. This is vital in order to pinpoint responsibility.

7. Clarify controls. State clearly in the contract with each outsourcer the information security, business continuity and privacy controls necessary to comply with the company's internal policies, as well as laws and regulations.

8. Do a test run. Prior to transferring full responsibility to the supplier, provide the supplier with limited access to a set of the company's data. Then perform acceptance testing to assess if the supplier has both the desire and the ability to fulfill its contractual obligations.

9. Be braced. Prepare in advance that a significant cyber-attack will hit the firm and its provider at some future time. Right now, clearly predefine emergency and remedial response procedures for a variety of data breach scenarios.

10. Create a monitoring strategy. After fully transferring data responsibility to the supplier, do not become complacent that the outsourcing provider is maintaining adequate cyber-attack defenses. Reduce long-term cyber risk in the supply chain by closely monitoring the supplier with continuous right-to-audit activities, such as network penetration and applicable vulnerability testing. Consider the use of third-party testing beyond that of the outsourcing provider, for example via the use of "ethical" hackers. Thoroughly review the provider's data defense strategies, tools and risk environment on a frequent and regular basis. Pay very careful attention to the connection points between the systems and applications used by the outsource provider.

11. Observe intently. In a careful, focused, detailed manner, observe how the provider responds to threats and early stage attacks.

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Have the client’s executives and security experts evaluate how comfortable they are with the quality and comprehensiveness of the provider’s approach. Quality of the response is much more important than speed, because a rushed reaction to an attack can provide the perpetrator with additional vital information about the organization and its defenses. If the client considers the provider’s methods to be inadequate, insist that the provider install proper methods within a limited time, such as 10 to 15 days, or the client will find another provider.

12. Plan for the possible consequences. Since preventing all cyber-attacks is impossible, the client should create a cyber-attack contingency plan in advance and compare/coordinate their plan with the outsourcer’s contingency plan. In the event of an attack, it is essential to fully understand the consequences on the firm and its obligations as compared to those of the outsource provider. Having a clear contingency plan and an understanding of the provider’s contingency plan should significantly reduce the number of unexpected surprises and potential confusion about each entity’s responsibilities, which is very valuable in the already stressful event of a cyber-attack.

Make a Comprehensive Plan

Outsourcing typically provides significant cost reductions and efficiency improvements. However, companies acquiring such services are advised to thoroughly assess the cyber risks involved in acquiring these services.

Proper overall management of cyber risks requires selecting a reliable and diligent supplier of outsourcing services. Selecting outsourcers of lower quality may result in significant cyber-security breaches that could have been rather easily prevented.

This article presented several specific methods to reduce the cyber risks of outsourcing. The foundation of these methods are identifying which data is most valuable, holistically assessing the outsource provider’s ability to implement and adhere to proper controls over confidential information, learning from prior cyber-attacks, and performing regular and detailed monitoring of the provider by using continuous right-to-audit activities and third-party testing.

In particular, CPAs can perform a SOC 2 review that reports on the security and integrity of the vendor’s systems processing the client’s data. ■

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Working in Business and Industry

Chapter Presidents Share Their Experiences

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

Building upon the theme of this issue, we have spotlighted current chapter presidents who work in areas other than public practice. Their fields of employment are as varied as their geographic locations within Texas. In alphabetical order, they are:

Marylyn Byrd, CPA – Texas State University System–Lamar Components, Southeast Texas Chapter;

D'Anne McNaughton, CPA – Charger Shale Oil, Permian Basin Chapter and

Nancy Miller, CPA, CGMA – SPJST (a fraternal organization), Central Texas Chapter.

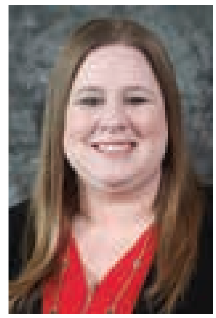
CPA Career Range, Job Experiences

As they gathered around the virtual campfire to share stories, it quickly emerged that the participants have held a variety of jobs during their CPA careers. Those include office manager for a water control and improvement district, public school district business services director, state sales tax auditor and accounting manager for a small medical practice. Two of the three started in public practice.

Their posts have been with employers of widely varied size, ranging from an oil and gas company with worldwide operations to a nine-person quasi-governmental entity to an audiology practice with eight on staff.

A rich collection of experiences has emerged. When Byrd worked at the water district, a major line burst one evening after the office closed. Water was shooting into the air; many customers lost service completely. The five repair employees were frantically working to shut off valves, only to find out that the valves were so old their locations couldn't be verified. Water had to be pumped out of the location where the pipe was broken quicker than it was spewing out. Byrd helped shine flashlights as it got dark and she handed off supplies to the workers who were swimming in the water trying to make repairs. She also served as an informal spokesperson, explaining the situation to residents who came to the office.

McNaughton has driven out to remote locations, walking around gas plants and leases with production personnel and staff from taxing authorities. She discussed the details of field operations: how the companies find the oil and gas, how they get it out of the ground, and their additions to equipment and properties. The conversations required that she know how the tasks were performed, how the equipment functioned (in order to qualify for certain tax exemptions) and how to speak the language of the operations people and the taxation representatives. She proudly said, "I even had my own hard hat with my name on it."



Marylyn Byrd, CPA

D'Anne McNaughton, CPA

Nancy Miller, CPA, CGMA

Being at SPJST has given Miller the satisfaction of serving members through a fraternal organization. That work is done in the 501(c)8 entity, which helps to provide financial security for members through life insurance products, annuities, IRAs and mortgage loans. She created an accounting program for a 501(c)3 foundation that offers a way to honor loved ones through memorials or gifts; it supports several independent organizations and funds charitable projects for individuals in need, such as those affected by Hurricane Harvey.

Concurrently, Miller worked with another 501(c)3 entity, a 182-acre camp program, managing the books, analyzing business line activities, and budgeting for marketing strategies and camp development. She explained, "I expanded into human resource areas, researching laws and regulations, creating job descriptions, helping hire personnel, handling payroll, meeting with the state workers compensation auditor and preparing federal tax payroll reports." She also assisted in the recent conversion of the camp facilities and programs to a new segment of SPJST where she continues her involvement with the camp fiscal activities.

When discussing busy season, it became apparent that some jobs involve more than one. McNaughton said, "Working with auditors is like two mini seasons." She explained, "My part happens once during the year while they do the interim work and then a second time the following spring while they finalize the audit." She adds, "During all of that, I'm also doing day-to-day accounting management and month-end close."

Miller referred to December and January for year-end closing, financial statements and sales tax returns. Projects in other months include February and May for preparation of various tax returns and May through August for increased financial support for camps, while June and October involve unclaimed funds escheatment.

In the internal auditor's office where Byrd works, during July and August risk assessment interviews are conducted and the audit plan for the next fiscal year is determined.

Work/Volunteer Skills and Chapter Involvement

Participants talked about the skills that are helping them as volunteer leaders. Byrd said that she has learned to multitask, as well as handle duties that are sometimes unexpected. "You often wear more hats than just performing accounting work – especially when you're with a small staff. You must be adaptable and willing to tackle pretty much anything," she commented.

McNaughton cited the ability to work with a team to reach long-term goals that span much longer than the time needed to complete an audit or a discrete client project, which is similar to leading a chapter during a multi-year activity. Miller stated, "The nonprofit activities in my job with SPJST have required more detailed knowledge and training related to board member functions, which directly correlates with the board, operational and membership needs of TSCPA."

As they touched upon chapter involvement, Byrd said she first learned about her chapter when she received one of its accounting scholarships. The meeting with students where those were presented was her introduction to the world of CPAs, having grown up in a tiny town with none.

McNaughton volunteered to speak at a chapter CPE program and was asked by the CPE chair to serve on the committee, then was recruited for the chapter board.

Miller was first asked by Annette Cole, a member of her chapter's CPE committee (also a previous coworker), to give topic suggestions. After a few years, Cole then asked if she would be interested in becoming a board member. Upon joining the board, Miller was mentored by Dora Jean Dyson, who encouraged her to become more deeply involved in the chapter and state levels of TSCPA.

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"OTHER CREDENTIALS ARE HELPFUL, BUT THE CPA STANDS ALONE AS A BENCHMARK OF EXCELLENCE."

Career Rewards and Challenges

The conversation shifted to the most rewarding aspects of their accounting careers. More than one person spoke about meeting new people and working with those from widely varied backgrounds to develop solutions. McNaughton enthused, "Oil and gas is the most interesting industry in the world to me!" Miller talked about being able to help others, whether by providing solid structured data analysis, technical or analytical problem resolution, accurate instructions and processing for operations or sound decisions based on complete and comprehensive financial statements.

There was mention of the challenge faced by young professionals thrust into a role supervising significantly older staff, with little training about managing distinct differences between work generations. CPAs at smaller employers can find themselves saddled with new responsibilities after identifying a process that needs fixing, running the gamut from human resource work, risk management and employee benefits to state regulatory filings and more.

There was also a comment about the challenge of balancing professional ambition and the desire to be successful with finding work/life balance, to be present and active with multiple generations of family.

The Next 10 Years for CPAs Working in Industry

Looking ahead, they talked about the big thing in the next 10 years that will be a game-changer for CPAs working in industry. Byrd said: "I see a big change taking place in what employees expect from their employer. Younger staffers have a different work ethic and a strong desire for work/life balance. I believe employers will have to develop ways to meet the changing needs of a new generation of workers coming in, to recruit and retain the best talent."

McNaughton expressed a need for more business and industry employers to recognize that the CPA accreditation is valuable. "Being a CPA means the employee has committed to a level of excellence that's crucial for any company's success."

Miller referred to innovative technological advances that improve processing and analytical capabilities while requiring fewer resources. She also foresees increasing international growth and opportunities in the fields of accounting for CPAs because of the continued development of common accounting practices and the expansion of worldwide organizations.

Advice to Students Considering a Career in Accounting

The final topic was the advice they would give to students who are considering a career in accounting.

Byrd suggested:

- "Research the many different career paths available to you and ask everyone you meet what they like and dislike most about their current career. Don't choose a path or employer solely based on income. From experience, I learned quickly that is not what will make you most successful and happy.
- "If you decide to become a CPA, get your certificate as soon as possible. The longer you're out of school, the busier you become and the less likely you are to complete it. You will thank yourself later if you forge ahead.
- "I highly encourage everyone to get some experience in auditing. This will help you look at things differently, no matter what CPA career path you eventually settle on. My background in that area has been a sought-after skill set that employers wanted."

McNaughton's advice:

- "Get the CPA certification. Other credentials are helpful, but the CPA stands alone as a benchmark of excellence that transcends public practice and multiple business types, all entities and sizes. In at least two of the positions I have held, I was hired over otherwise equally qualified candidates because the CPA certification set me above.
- "Always continue to learn and grow because things always change: business, processes, systems, how we get things done and who we do those things with. Maintain flexibility and curiosity."

Miller recommended:

- "Having your accounting degree – and especially your CPA certification – will enable you to enjoy a career that can fit any lifestyle you choose, whether fast-paced or slow to meet your family needs as they change over time. It allows you to live where you want. You can be involved in a smaller organization or a larger one, and meet your preference for an all-encompassing role or a specific project.
- "In addition to career options, your CPA certificate prepares you for personal choices and actions that will occur throughout your life, from the point where you finish college through your retirement activities and beyond. There are so many areas that are covered by the knowledge you gain while acquiring your certification and while continuing to meet your CPE requirements throughout your career. Enjoy the opportunity!"

Are you a business and industry member? Contact your chapter president or executive director to see how you can become involved in a committee or in community service projects.

Two-Part Harmony

San Antonio CPA Hits the High Notes as CFO and Half the Family Band

By Anne McDonald Davis

The tenor taking the stage with wife, Kathy, at Bending Branch Winery in Comfort, Texas, also happens to be the chief financial officer (CFO) of a San Antonio software company – because let's face it, nothing says "managerial accounting" quite like The Beatles.

Steve Feinstein chuckles: "I find my work at Conceptual MindWorks quite creative. It fits what I tell my kids, 'If you don't enjoy what you do at work, find something else to do. If you don't enjoy your job, it will affect your entire life.'"

So how exactly did a Brooklyn-born certified public accountant end up in south Texas helping to support a software company … and playing cover gigs in his spare time?

"You know, when I was nine, my mother told me I'd probably grow up to be an accountant," Feinstein muses. "Kind of makes me mad that she was right. I really don't remember ever wanting to be a fireman or anything. But even though our parents hadn't gone to college, somehow all the kids understood that we were expected to go. My brother is an MBA and a software engineer and my sister is an occupational therapist, so I guess whatever my parents did worked."

After starting as a math major at Brandeis University, ultimately, Feinstein would receive his BSBA in accounting from Babson College, well known in the Northeast as a leading entrepreneurial college, a bit of foreshadowing for what was to come once he and his wife grew weary of the Boston-area weather and lack of affordable housing in the early-1980s.

It started with a vacation to Puerto Vallarta and a side trip to San Antonio on the way back. "We visited Kathy's aunt, who happened to be a Realtor. We found out how much easier it was to find, and afford, a house in San Antonio."

Although neither Steve nor Kathy had a job when they left Boston, Steve quickly found a position. That's when he discovered he'd landed in quite a different culture. At his last job performance review in Boston, he'd been told he was "not aggressive enough." At his first review in San Antonio, he was told he was "too aggressive."

By the early 1990s, Steve was promoted to director of quality control; all financial statements passed through his hands. By the mid-1990s, he had added a master's certificate in governmental accounting to his professional arsenal, which in turn led to work with government contractors for the firm, which led him to Conceptual MindWorks, then starting out as a governmental contractor.

"I realized by that time that I wanted to try something new, something outside public accounting," he admits. "Our company was pretty small in the beginning, but evolved into an electronic health record software company and grew. It's exciting – something different every day, all the time."

Fein Tuned (that's the name of the band) evolved more serendipitously. Basically two pretty good singers/guitar players went out to dinner one night with their wives, who both happened to be singers, and the band at the restaurant turned out to be, well, not so good.

Guitar player and singer Steve Feinstein, CPA-San Antonio, CGMA, performs at various venues and private parties.

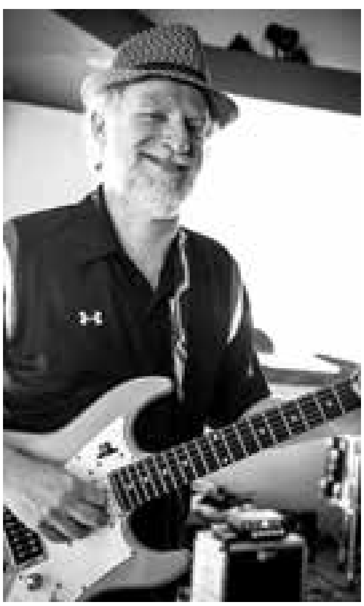
Steve recalls: "My friend and I looked at each other and said, 'Hey, we're better than that!' Kathy, an extrovert, went over to the manager and got us our first gig. The other couple has since retired from the band, but Kathy and I still perform at various venues and private parties, eight to 12 a month!"

Of his life and musical partner, Feinstein observes: "What the music does is give us a common purpose. My wife is really smart and has interesting ideas. Last year, she came up with the idea to do a two-hour Beatles concert and sold the idea to a winery. Voted best actress in San Antonio 20 years ago, this allows her to go out there again and perform. She has a headset mic and she walks around talking to the audience as she performs. She has no fear in front of people."

In the midst of all that, the couple managed to have twin girls who are 32 now. Bethany is director of events at Rooster Teeth, a media and entertainment company in Austin. Steve says: "She flies all over the world – Australia for 18 days next. She also has an online show … and people recognize her everywhere she goes!"

"Our daughter, Hillary Romero, and her husband, Marco are Realtors and investors here in San Antonio, with about 20

I FIND MY WORK AT CONCEPTUAL MINDWORKS QUITE CREATIVE. IT FITS WHAT I TELL MY KIDS, 'IF YOU DON'T ENJOY WHAT YOU DO AT WORK, FIND SOMETHING ELSE TO DO. IF YOU DON'T ENJOY YOUR JOB, IT WILL AFFECT YOUR ENTIRE LIFE.



properties. Their daughter – our granddaughter, Elia – is 18 months old. We spend as much time as we can with her."

Recently, Fein Tuned was one of a handful of bands selected to perform with the Youth Orchestra of San Antonio at their annual theme concert on March 12 at the Tobin Center. "This year, the theme is the Eagles and is titled 'Hotel California.' At more than 1,000 people, it will be the biggest audience we've ever performed for. We auditioned with 'Desperado,' because we had the voices for it and since the original recording is very heavily orchestrated, we hoped they were going to include it in the concert."

Some of the smallest audiences the Feinsteins play for are at retirement homes. "We perform songs from their era and they sing along! Stuff from the '30s, '40s and '50s. People often remember their lives through music. 'Best of My Love' – my wife remembers dancing to that at her high school prom."

What are some lyrics meaningful to him?

"We've never performed it … but 'Guitar Man' by Bread," he replies.

Then you listen to the music and you like to sing along.
You want to get the meaning out of each and every song.
Then you find yourself a message and some words to call your own and take 'em home.

2018 Spring and Summer TSCPA Conferences

Mark your calendar now for TSCPA's popular, live learning opportunities being held this spring and summer. Come for the sessions, benefit from networking with your colleagues and leave with the knowledge you need to advance your career.

Texas CPA Technology Conference
Addison, May 7-8

Texas CPA Technology Conference
Houston, May 10-11

Energy Conference
Austin, May 14-15

Nonprofit Organizations Conference
Dallas, May 21-22

Texas School Districts Accounting & Auditing Conference
San Antonio, June 4-5

CPE by the Sea
Galveston, June 13-15

South Padre CPE Cluster
June 18-20

Cowboy CPE Cluster
Grapevine, June 25-27

Audits of Employee Benefit Plans Conference
Addison, June 27

San Antonio CPE Cluster
July 9-11

Advanced Health Care Conference & Pre-Conference Workshop
San Antonio, July 22-24

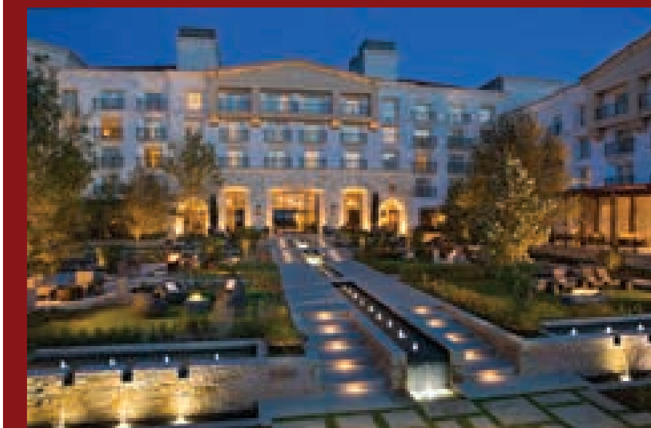
Galveston CPE Cluster
July 30-August 1

Texas State Taxation Conference
Webcast, August 7

Advanced Estate Planning Conference & Pre-Conference Workshop
San Antonio, August 15-17

To learn more and register, go to the CPE section of our website at tscpa.org.

Save the Date: TSCPA's Annual Meeting of Members and Board of Directors Meeting



June 29-30, 2018 | La Cantera Resort & Spa, San Antonio
Learn more on the website at tscpa.org

Simplify and Maximize Your Membership Renewal with the Group Billing Option

If you have more than one TSCPA member in your firm, company or organization, you are eligible for group billing benefits. TSCPA's Group Billing Program is tailored to meet your unique needs while ensuring that your membership dues investment returns the highest value available.

We asked prior participants why they would recommend TSCPA's Group Billing Program. This is what they had to say: "It's worth it for the reduction of my time from reimbursing individual staff for dues and to ensure that everyone in the firm are members to receive discounts."

"The group billing process makes the process go very smoothly. It's one bill to pay. It's one document rather than several, which can be time consuming and tedious."

"It's so much easier than having to hunt down each person's bill."

"It's the best way to be sure all memberships are current."

For more information, visit our website at https://www.tscpa.org/membership/payments/firm-billing or contact Stephanie King at sking@tscpa.net, 800-428-0272, ext. 233.

Today's CPA Magazine – CPE Quiz Available Online!

The self-study exam included in each *Today's CPA* magazine issue for readers to earn one hour of continuing professional education credit can now be taken online. Please see page 48 in this issue for more details.

CGMA® Designation: Next Testing Window for the Exam

The Chartered Global Management Accountant (CGMA®) designation was created by AICPA and the Chartered Institute of Management Accountants (CIMA) to recognize U.S. CPAs and CIMA members who work in management accounting roles. The designation is a respected complement to your CPA license.

Candidates for the CGMA designation must pass a strategic and comprehensive examination. The exam is available four times a year during five-day testing windows. Candidates must register before the registration deadline for each testing window.

The next testing window is May 22-26, 2018, with a registration deadline of May 8, 2018. To learn more about the program and register for the exam, go to the Become a CGMA section of their website at cgma.org. ■

TSCPA Awards Nominations Due April 30

If you know TSCPA members who are deserving of recognition, be sure to nominate them for an award! TSCPA's Awards Committee is seeking nominations for Meritorious Service to the Profession, Distinguished Public Service, Outstanding Chairman, Honorary Fellow, Honorary Member and Young CPA of the Year. All criteria details are available online.

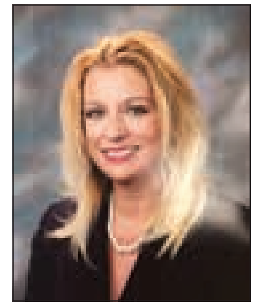
For more information, go to TSCPA's website at https://www.tscpa.org/about-tscpa/awards or contact Holly McCauley at hmccauley@tscpa.net; phone 800-428-0272, ext. 202 or 972-687-8502 in Dallas. Nominations are due April 30, 2018. ■

Accountants Confidential Assistance Network Seeks Volunteers

The Accountants Confidential Assistance Network (ACAN) program befriends a number of CPA candidates around the state as part of the ACAN peer assistance program. ACAN supports Texas CPAs, CPA candidates and/or accounting students who are addressing alcohol, chemical dependency and/or mental health issues.

Can you help? If so, please contact Craig Nauta at 800-428-0272, ext. 238; 972-687-8538 in Dallas; or at cnauta@tscpa.net. ■

Roxie Samaniego, CPA-El Paso, Receives 2018 B&I Award



TSCPA congratulates **Roxie Samaniego**, CPA-El Paso, on being named as the recipient of the 2018 B&I award. This award spotlights the professional accomplishments of CPAs who have spent their careers in business and industry and have made significant contributions through the recruitment of others to the accounting profession.

Samaniego worked in public accounting as an auditor for 18 years, where she had a concentration in governmental, nonprofit and healthcare. In 2007, she established herself as a co-founder and partner of White, Samaniego, and Campbell, LLP. During this time, she acquired a great amount of knowledge and experience in financial reporting of government, nonprofit and for-profit entities to include community healthcare centers, gaming companies and city and county governments.

In 2016, she joined Emergence Health Network, the El Paso Local Mental Health Authority, as the controller. She was quickly promoted to her current position of chief financial officer.

Throughout her 20 years in the industry, Samaniego has been committed to being a mentor to aspiring CPAs and introducing them to the TSCPA community and its member benefits. She has served on various committees and in leadership roles for her chapter and TSCPA. Many of her employees are currently involved in TSCPA because Samaniego has shown support for their involvement and encourages them to be active in the El Paso Chapter. ■

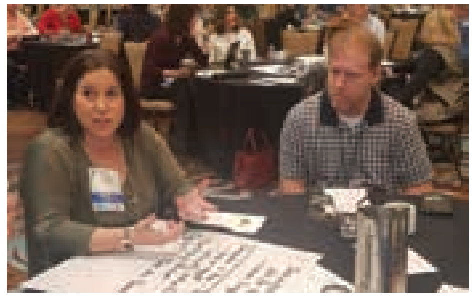
Submit an Article to *Today's CPA* Magazine

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

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

TSCPA Midyear Board of Directors and Members Meeting

Carol Warley, CPA-Houston; Sheila Enriquez, CPA-Houston; and Natalie Klostermann, CPA-Corpus Christi



San Antonio Chapter Members Melanie Geist, CPA, and Chuck Clark, CPA

TSCPA Chapter Presidents with 2017-2018 Chairman Jim Oliver (Center), CPA-San Antonio

By Rhonda Ledbetter, Chapter Relations Representative

Coming together to strengthen their connections around the state and gain powerful knowledge, members of TSCPA and those on its Board of Directors met in Corpus Christi Jan. 26-27. There was a sense of excitement in the air as the participants talked about being part of the vibrant future for the profession and its organization in Texas.

Chairman's and President's Report

TSCPA 2020

TSCPA Chairman **Jim Oliver**, CPA-San Antonio, CGMA, teamed with President and CEO **Jodi Ann Ray**, IOM, to delve into the dynamic new strategic plan, TSCPA 2020. They emphasized the Vision, which is to empower members to lead and succeed, and they spotlighted the pillars of success – Professional Excellence, Advocacy, and Community and Connection – that support the plan. (Check the November/December 2017 and January/February 2018 issues of this publication for an explanation of how the roadmap was developed and a snapshot of its key elements.)

True value comes from putting the plan into action. Within the Professional Excellence pillar, work is in progress on the CPE strategic plan, tax reform and peer review. Advocacy efforts include sunset review 2019, federal tax policy and the #CPApowered public awareness campaign. The Community and Connection pillar is being achieved through the Hurricane Harvey response, TSCPA Exchange online community and chapter connections. As unforeseen opportunities arise, they can be quickly captured and responses crafted.

Volunteers and staff will be working to move the strategic plan forward. The focus will be on:

- increasing member satisfaction,
- growing the membership, and
- measuring member success and engagement.

U.S. Tax Reform

Bringing some clarity to a complex matter, **Bret Oliver**, CPA-Houston, of PwC, provided a perspective on the 2017 Tax Cuts and Jobs Act. He covered aspects of domestic tax changes, such as the corporate tax rate reduction, interest deduction limitation, full expensing/bonus depreciation and net operating losses. International provisions include the deemed repatriation toll charge, shift to a territorial system, global intangible low-taxed income, foreign-derived intangible income, and base erosion and anti-abuse tax. There are individual tax changes and pass-throughs, and a 20 percent deduction for domestic qualified business income. Financial reporting considerations are a result of the act. Please see the article on page 38 and the Tax Topics column in this issue of *Today's CPA* for more details on the Tax Cuts and Jobs Act.

Economic Impact of Hurricane Harvey and Continuing Recovery

Texans across the state have felt the sense of devastation from Hurricane Harvey and have reached out to help those affected. **Jim Lee**, Ph.D., of the South Texas Economic Development Center, provided information about how the Coastal Bend area was shaken by the storm and how recovery is progressing. In assessing the hurricane's costs, he listed financial impacts from immediate to long-term. They include casualties and injuries, property damage, infrastructure impairment, disruption to business, permanent loss of businesses and residents, and the permanent increase in insurance costs.

Details included statistical profiles of Port Aransas, Aransas County and Refugio County. Lee stated that about half of local businesses remain closed today, leading to the loss of gross sales activity, including wage earnings. A portion of businesses and residents are displaced at least temporarily.

Recovery scenarios included simulations of direct impact and response over time with a regional economic model. There are three phases:

- Direct impact (immediate) – Loss of economic activity and capital.
- Recovery (transitory) – Rebuilding efforts take effect.
- New normal (equilibrium) – Long-run; occurs years later.

There is a race against time for communities with high-storm impacts and low rebuilding capacity, leading to a vicious cycle in the recovery process. The light at the end of the tunnel will be a period

Fort Worth Chapter Members Norm Robbins, CPA; Steve Newcom, CPA, CGMA; and Cliff Parker, CPA; CPA-PAC Breakfast Speaker Scott Braddock; Southeast Texas Chapter Member Wendi Christian, CPA, CGMA

How Members Can Lead and Succeed

- Participate in the Society's interactive and engaging educational opportunities
- Keep your member profile up-to-date and tell us what's important to you
- Leverage TSCPA Exchange and explore connections across the state
- Be informed about advocacy efforts and get involved
- Connect with your local chapter

TSCPA will continue to provide a wealth of tools and resources to keep Texas CPAs informed about the details emerging from federal tax reform legislation. Read *Today's CPA* magazine for curated content and check tscpa.org, as well as your chapter's website, for education.

of opportunity, with a reconstruction boom in addition to capital projects around port areas.

Challenging Texas Sales Tax Audits

Jimmy Martens, JD, CPA-Austin, of the law firm Martens Todd Leonard & Ahlrich, shared strategies for handling and challenging sales tax audits that are useful for CPAs in business and industry, as well as those in public practice.

He first explained the nature of such audits and incentives for comptroller staff and taxpayers. Audit selection includes priority one accounts (the state's largest in terms of sales tax reported), taxpayers with previous audit problems, Business Activity Research Team (BART) referrals and taxpayers identified in audit lead cards.

A crucial period of time is between the dates the letter is sent and the auditor is at the business's office. There is an opportunity to review records, reconcile accounts, and get exemption certificates and other documentation in hand.

Once the audit begins, one upper-level staff person should be the sole contact for the auditor. It is important to control the information given, provide the auditor a soundproof area in which to work, make and keep copies of every document utilized, ensure that the auditor tags documents of interest so that they can be copied rather than removed from the office and take detailed notes on all verbal communication.

Martens discussed the advantages and disadvantages of a post-audit independent audit review. He walked through decision trees identifying taxpayer choices after the notice of tax due has been issued.

Path to Innovation in 2018

Donny Shimamoto, CPA-Houston, CGMA, with Intraprise TechKnowlogies, energized the group by stating that the time for change is now and asking "Are you ready for exponential change?" After showing Change^2, a film by Gerd Leonhard, he raised bold, CPA-specific questions connected to the ones suggested by the film.

Other questions that got the audience buzzing were, "What do you do that's different from what machines can do?" and "Have you considered the 'why' of your department or firm?" He explained that harnessing technology and adding innovation frees up staff to provide services that are more meaningful.

> **"TRUE VALUE COMES FROM PUTTING THE PLAN INTO ACTION. WITHIN THE PROFESSIONAL EXCELLENCE PILLAR, WORK IS IN PROGRESS ON THE CPE STRATEGIC PLAN, TAX REFORM AND PEER REVIEW."**

Shimamoto provided sample initiatives for CPAs to stay ahead of change. He examined the future of audits and the evolution of the auditor, pointing out that nonfinancial information increasingly drives value. He explained that the "death" of bookkeeping will provide opportunities for the accountant's department or firm to evolve into value managers providing integrated functional excellence.

He then moved into the topic of developing an innovation strategy for sustainability and discussed a different kind of ROI: Run – Optimize – Innovate. Segmenting the business's expenditures into those three categories and analyzing the resulting percentages helps indicate whether it is a laggard, leader or early adopter and shows areas where change can be made in the portfolio of initiatives.

He issued a challenge to embrace technology, but not become it. He stated that the future is in technology, yet the bigger future lies in transcending it.

continued on next page

TSCPA Leaders for 2018-19

Chairman-elect: *Term beginning June 2018 and ending May 2019; Chairman in 2019-20*
Lei Testa *(Fort Worth)*

Treasurer-elect: *Term beginning June 2018 and ending May 2019; Treasurer in 2019-20*
Billy Kelley *(Permian Basin)*

Secretary: *Term beginning June 2018 and ending May 2019*
Bill Schneider *(Dallas)*

Executive Board: *Term beginning June 2018 and ending May 2021*
Julia Hayes *(Southeast Texas)*
Angela Ragan *(Central Texas)*

Director at Large: *Term beginning June 2018 and ending May 2021*
Edie Cogdell *(San Antonio)*
Trish Fritsche *(Central Texas)*
Christi Gibson *(East Texas)*
Jennifer Johnson *(Dallas)*
Mary Pat Jones *(Southeast Texas)*
Stephanie McCasland *(Houston)*
Jeremy Myers *(Austin)*
Martha Piekarski *(El Paso)*
Jeannette Smith *(Rio Grande Valley)*
Mary Stanford *(Fort Worth)*
Susie Sullivan *(Corpus Christi)*
Diane Terrell *(Abilene)*

Nominations Committee: *Term beginning June 2018 and ending May 2019*
Art Agulnek *(Dallas)*
Elaine Hoffman *(Corpus Christi)*
Kristy Holmes-Hetzel *(Austin)*
Elena Levario *(Permian Basin)*
Arturo Machado *(San Antonio)*
Amy Restivo *(Brazos Valley)*
Norm Robbins *(Fort Worth)*
Debra Seefeld *(Houston)*
Veronda Willis *(East Texas)*

As immediate past chairman of TSCPA, Jim Oliver *(San Antonio)* will automatically serve as the Nominations Committee chair. Dora Dyson *(Central Texas)* was named as vice chair.

Chairman-elect Appointees to the Executive Board *ratified by vote of the Board of Directors at this meeting*
(Term beginning June 2018 and ending May 2019)

Edie Cogdell *(San Antonio)*
Josh LeBlanc *(Southeast Texas)*
Priscilla Soto *(San Antonio)*

The following names will be submitted to the AICPA Nominating Committee as recommendations from Texas to serve on the **AICPA Council:**

One-Year Designee: *Term beginning 2019 and ending 2022*
Stephen Parker *(Houston)*

Three-Year Terms: Beginning 2019 and expiring 2022
Charlotte Jungen *(Houston)*
Toni McBee Joyner *(Brazos Valley)*
Jim Oliver *(San Antonio)*

Accounting Education Foundation

Trustees Elected - *Terms beginning June 2018 and ending May 2022*

Art Agulnek *(Dallas)*
Ricardo Colon *(Southeast Texas)*
Alyssa Martin *(Dallas)*
Marshall Pitman *(San Antonio)*

Member Roundtables

Was it personal? You bet! Members actively participated in roundtables where they talked with each other to share their thoughts about how TSCPA can leverage and lead with technology, attract and engage younger members, and improve the CPE experience.

Other Business

The members elected to lead TSCPA in the 2018-19 year were announced and there was a vote to ratify the appointees of Chairman-elect **Stephen Parker**, CPA-Houston.

President of the Accounting Education Foundation **Fred Timmons**, CPA-San Antonio, conducted the AEF's annual meeting, where trustees with terms beginning June 2018 were elected.

CPA-PAC Chair **Jesse Dominguez**, CPA-Austin, CGMA, gave an update on donations and presented awards to chapters for their work encouraging member participation.

Treasurer **Jerry Spence**, CPA-Corpus Christi, and **Ben Simiskey**, CPA-Houston, reported on the financial health of TSCPA and of the CPE Foundation. A $5.00 dues increase was approved for CPAs who do not hold a retired license with the Texas State Board of Public Accountancy and for International Affiliate members.

Upcoming Events

Members are invited to be part of the TSCPA community during the Annual Meeting of Members at San Antonio's La Cantera Resort, June 29-30, 2018. They are also encouraged to participate in the next Midyear Board of Directors and Members Meeting and Advocacy Day, Jan. 29-30, 2019, at the Sheraton Austin Hotel at the Capitol.

CPA-PAC Awards

The following awards were presented to chapters for their work encouraging members to donate to the CPA-PAC.

Highest Percentage of Fund-Raising Goal
Large Chapter – Fort Worth
Medium-sized Chapter – Central Texas
Small Chapter – Southeast Texas

Highest Percent Increase in Members Contributing
Large Chapter – San Antonio
Medium-sized Chapter – El Paso
Small Chapter – Victoria

Taxing Times

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

The Texas Legislature is not in session until next year, but that doesn't prevent political leaders from pushing issues now that they want to see on next year's agenda. Promoting agenda items now also gives politicians a chance to try and make hay on issues that will help them in the election coming up later this year.

Property Tax Reform

One item that is sure to make the list for the 2019 legislative session is the issue of property taxes and the effort to reduce, or at least try to control, the rate of increase of those taxes. There were bills introduced in both the House and Senate in 2017 aimed at curbing the rate of increase in property taxes by giving voters the authority to approve proposed increases above a threshold. While none of those bills passed the legislature, the idea has not gone away and recently Gov. Greg Abbott has added his voice to this movement.

In January, Abbott rolled out his proposed plan to limit local governments from raising property tax revenue growth above 2.5 percent per year. To go above that limit, two-thirds of the voters in the locality would have to approve the increase before it could go into effect.

At a news conference to announce his plan, Abbott said: "Enough is enough. Texans are fed up with property taxes being raised with impunity. They are tired of endless government spending while honest, hard-working people struggle just to keep up with paying their tax bills. We can no longer sit idly by while homeowners are reduced to tenants of their very own property with taxing authorities playing the role of landlord."

Those are strong words and ones that will likely resonate with a lot of voters. Who, after all, likes to pay taxes, property or otherwise? And making this push about property taxes doesn't carry with it much responsibility on the part of the governor or state legislators, since these taxes are established by local elected leaders. It's always easier to tell others what to do rather than control your own house by say, lowering sales taxes or other taxes you do control.

The governor's proposal has already ignited anger from some local leaders who say state officials in recent years have overstepped their bounds and tried to control how cities, counties and school districts operate. After all, property taxes are how local governments fund local services and most importantly, local schools.

Abbott's plan does offer local leaders something last year's proposed property tax overhauls didn't. The state would no longer be able to saddle local governments with providing new services without providing state funding to cover the costs, the governor said. And when it comes to funding public education, which makes up most of local property tax bills, Texas lawmakers would likely be required to put up more state funds under Abbott's proposal. That's important, because the state's share of funding public education has shrunk over the past decade. In 2008, the state and local governments split school funding 50/50, with each putting up around 45 percent and the federal government covering the other 10 percent. By 2017, the local portion of that split had grown to 52 percent and the state's share had dropped to 38 percent.

At his press conference, Abbott acknowledged that the legislature might need to pass a school finance reform package as a precursor to his tax proposal, pointing to his successful push last year for the creation of the Texas Commission on Public School Finance. That panel is expected to report its findings to the governor and the legislature by the end of this year.

While the governor's plan would slow increases in how much money local governments collectively take in, it wouldn't necessarily lower individual property tax bills. The amount of money a landowner must pay each year is not just tied to the tax rates that local governments set. It is also determined by the appraised value of the land and any buildings on it. So, a city could lower its tax rate and a homeowner could still pay more in property taxes than a previous year if the owner's assessed values have gone up.

The cap in Abbott's plan wouldn't apply to either the tax rate or the increase in appraised value – it would only pertain to the total amount of money a local government collects on existing land and buildings. Current law allows voters to weigh in on increased property tax revenues that cities, counties and special purpose districts collect. But that only happens if revenues increase 8 percent or more and voters can collect enough signatures to force an election on the issue.

What About the Franchise Tax?

Another tax people love to hate, besides property taxes, is the dreaded Texas franchise tax. Legislative and business leaders are nearly unanimous in their dislike of the tax. And in the 2017 legislative session, there were several bills designed to eliminate the tax completely or phase it out over time if revenue targets were met for the state. Again, none of these bills passed, but they did garner discussion and are likely to surface again in the 2019 legislature.

The overarching problem is the negative effect the elimination of the franchise tax would have on the state's coffers. Unless the state can find another way to replace that loss of revenue, it is not likely the franchise tax will go away anytime soon. Rather, my guess is we will continue to see a push for raising the exemption from the tax and other minor modifications, but no wholesale change or elimination of the tax.

Remember to Vote

By the time you are reading this, the primary elections will be over. Did you vote? I hope so. And don't forget to exercise your right in the upcoming general election in November. Remember, if you don't vote, you really can't complain about what your elected leaders do!

You can read the entire plan that Abbott is proposing by going to: https://www.gregabbott.com/propertytaxes/.

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

FEATURE ARTICLE

Do Accountants Need to Know About Integrated Reporting Framework?

By Dr. Kamala Raghavan, CPA, CFF, CGMA, CFP

Integrated reporting (IR) is based on the concept of "integrated thinking," defined by the International Integrated Reporting Council (IIRC) as "the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects. Integrated thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term."

The financial crisis of 2008-10 and the growing income disparities across societies have caused many observers to blame the short-term focus of businesses for the social, environmental and economic problems, and demand a fundamental change in the paradigm. Such a change will require management to combine innovation, competitiveness and sustainability by using integrated thinking to change the way in which businesses plan and run their operations to create value.

IR provides a holistic view of the business by looking at the financials, strategies, operations, risks and opportunities, future outlook and governance. It combines information about the organization's business model, strategy, governance, performance and prospects to enhance the information content hidden in traditional reporting and to encourage long-term strategic thinking by managers. It enhances corporate reporting and transparency of all types of "capitals," including financial, intellectual, human, manufacturing, natural resources, social responsibility and sustainability in a coherent, whole structure and shows the connectivity between the various capitals and value creation over time.

Increasingly, investors and other stakeholders are demanding more information on the social, environmental and governance issues that affect businesses. IR is a driver of sustainability strategies, leading to enhanced financial performance when they incorporate an innovative business model, as shown by the real-life case studies listed below. By promoting IR and its business benefits, CPAs can play a key role in the development of financially successful sustainability strategies.

Real-life Case Studies

Southwest Airlines renovated its aircraft lighting system to more energy efficient LED lighting expected to last 10 times longer than the previous lighting system and replaced the steel brakes on its aircraft with new, lighter-weight carbon brakes, resulting in reduced fuel consumption and greenhouse gas emissions (http://www.southwestonereport.com/2012/). Southwest's decision to replace older aircraft with new, more fuel efficient ones that have reduced greenhouse gas emissions required a cost-benefit analysis, and results are measured based on environmental benefits and increased margins.

Dow Chemical Company shifted its focus from waste reduction to waste elimination and undertook massive innovations in products and processes. It also developed a new market in consulting with customers on environmental issues.

Baxter International Inc., a global medical products and services organization, measures return on investment for its environmental initiatives and produces an annual environmental financial statement detailing environmental costs, as well as environmental income, savings and cost avoidance. The company's 2010 Sustainability Report stated that its environmental initiatives have shown an annual savings and cost avoidance of about $3 for every $1 invested. The company solicits information about sustainability from potential suppliers in its requests for proposals, incorporated 20 "green" criteria into its purchasing policies and identified its top 100 suppliers in terms of sustainability.

PepsiCo Inc. provides access to its suppliers to the energy-assessment tools it uses for its own operations and provides three-day training workshops to its suppliers with a support team. The results show that sharing its own energy assessment tools with suppliers has increased mutual return on investment (https://webadnmcdproject.net). In the company's 2015 Global Reporting Initiative Report and Performance with Purpose 2025 Agenda (www.pepsico.com/sustainability/Sustainability-Reporting), it centered performance with purpose work on products (human sustainability), planet (environmental sustainability) and people (talent sustainability) and used strong sustainability governance as a foundation for delivering on the performance with purpose vision. Sustainability topics are integrated into the core business and the board considers sustainability issues an integral part of its business oversight.

Kraft Foods Group collaborated with TerraCycle, a company that rewards consumers for returning non-recyclable packaging to help divert it from going to landfills. Kraft was able to raise its brands' profile and influence consumers to make better choices. In addition, the company has taken action to reduce C02 emissions, decrease needed water for processes, reduce waste, and reduce road miles from its transportation and distribution network.

Nike Inc. responded to customer concerns about product design and manufacturing processes. The company is aiming for a goal of zero waste as one of several long-term goals for 2020, and for production and design standards to reduce waste, cut energy use and slash the use of solvent.

Wal-Mart Inc. also responded to consumer pressure by developing a complex plan to measure the sustainability of every product it sells and a goal to provide consumers with a scorecard for over 100 product categories. The effort has resulted in collaboration with suppliers and supply chain partners to move toward zero waste initiatives.

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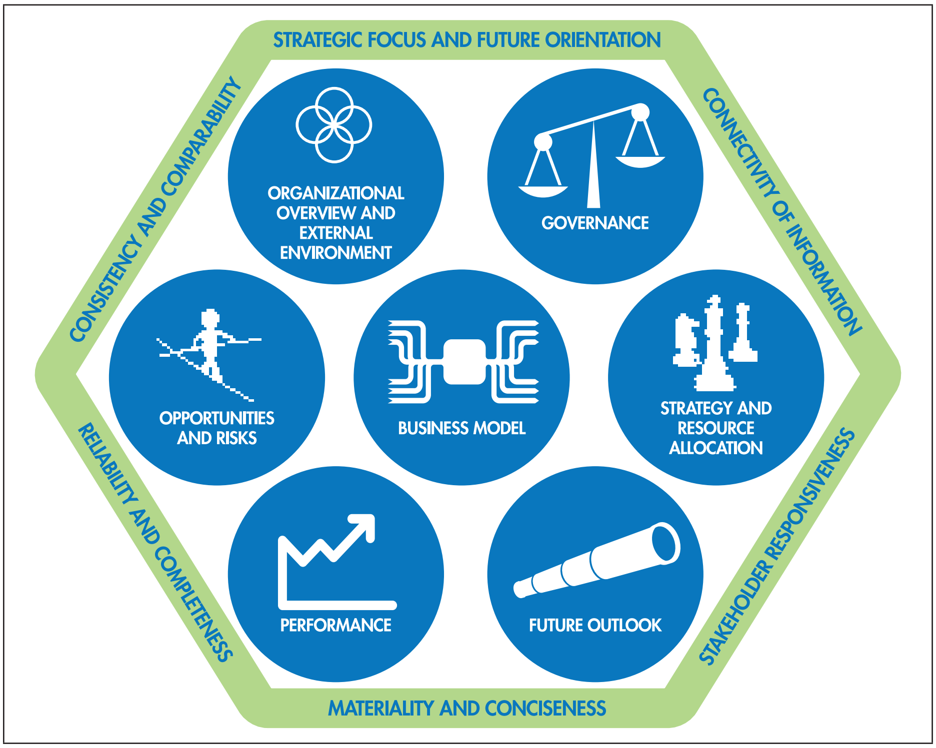
Figure 1: IR Guiding Principles and Content Elements



(Source: IIRC)

Tenets of IR

The six tenets of IR are:

1. Communication about the resources (capitals) used by businesses that are critical to long-term value creation;
2. Concise and clear communication;
3. Clear articulation of the business strategy, risk management and performance indicators to help investors understand the business;
4. Recognition of interconnectivity and dependency of information from different parts of the business and break down the traditional silos;
5. Use of historical and future-oriented information to provide a qualitative assessment of the risks and opportunities; and
6. Reflection on the impact of external environment on a business' ability to create value.

Hermes EOS, an investment firm, found that IR supports stewardship and ownership activities along with better investment decision-making and analysis. The IR business model is a description of the organization, and how longer-term factors fit into that description is the key to understanding the organization and its sustainability.

SAP, a global software provider, uses four key performance indicators to reflect its dependence on three capitals: financial, intellectual and human. The two financial performance indicators (revenue and margin) measure the historic performance and the two non-financial indicators (customer loyalty and employee engagement) look to the organization's future success and value creation. Producing an integrated report brought sustainability, investor relations, financial and communications department employees together. SAP's graphic showed the relationships between the financial and non-financial indicators and supported findings with external research. It reported that €220 million of costs were avoided since the beginning of 2008 by reducing its carbon footprint and that a 1 percent change in employee retention has an effect of €62 million on operating results.

IR Framework Structure

The framework tries to balance flexibility and prescription by providing the fundamental concepts, guiding principles and content elements to be included in an integrated report and encourages organizations to design reports outlining their strategy, governance, performance and prospects within the context of external environment. The framework's principles apply to corporate, nonprofit and governmental entities alike.

The fundamental assumption of the framework is that an organization creates value by using a business model that draws on various capitals as inputs and converts them to outputs (products, services, by-products and waste) through its business activities that lead to outcomes that affect the capitals. An integrated report reveals the challenges and uncertainties that the organization is likely to face in executing its strategy and the potential future implications.

The framework uses a principles-based approach to define the content and elements of the integrated report to satisfy the minimum requirements of "designated, identifiable communication," and focuses on the connectivity and interdependencies among internal and external factors in the business model and its value creation over time. It treats internally created and externally purchased capital similarly and defines the six types of capitals used by an organization to create value over time:

1) Financial capital includes funds generated by financial or internal operations available to the organization as it carries out its business activities.

2) Manufactured capital includes inventory, property, plant and equipment owned by the organization, as well as infrastructure (roads, bridges, etc.) that the organization has access to and uses in its business.

3) Intellectual capital includes traditional intellectual property and the organization's knowledge, systems and procedures that contribute to value.

4) Human capital includes employees' competencies, capabilities and experiences, as well as the skills of contractors and suppliers.

5) Social and relationship capital includes brand reputation developed by the organization and stakeholder relationships, such as banking, investors, suppliers and customer relationships.

Guiding Principles of IR

The seven guiding principles of IR are:

1. Strategic focus and future orientation – Reports should provide insight into the organization's strategy and the effect on its short, medium and long-term value creation.
2. Connectivity of information – Reports should take a holistic view of the business and show the inter-relatedness and dependencies between the organization's value-creating factors.
3. Stakeholder relationships – Reports should offer insight into the organization's relationships with stakeholders and its responsiveness to stakeholders' needs and interests.
4. Materiality – Reports should disclose information that materially affects the organization's value creation over short, medium and long-term horizons.
5. Conciseness – Reports should be concise and eliminate duplication.
6. Reliability and completeness – Reports should include "all material matters, both positive and negative, in a balanced way and without material error."
7. Consistency and comparability – Reports should be consistent over time and be comparable to industry.

6) **Natural** capital includes renewable and non-renewable environmental resources.

While the first three capitals are like those traditionally recorded as assets, the latter three are typically not shown on the balance sheet.

By enhancing the information relevance to financial capital providers, IR will enable better allocation of capital and provide concise communication about the organization's strategy, governance, performance and prospects, and shows how these can lead to value creation in the long run. It can also benefit all stakeholders, including employees, customers, suppliers, business partners, local communities, regulators and policy makers. The framework provides six tenets, seven guiding principles and nine key content elements for reporting. Figure 1 shows the seven guiding principles and nine content elements of the IR framework.

The framework is tested and driven by market forces and CPAs can benefit by understanding the framework and incorporating it into the business operations. The next sections describe the background and current state of the framework, regulatory standard-setting environment and implications for accountants

Background and Current State of Integrated Framework

The global coalition of accounting professionals, regulators, investors, organizations, standard setters and non-governmental

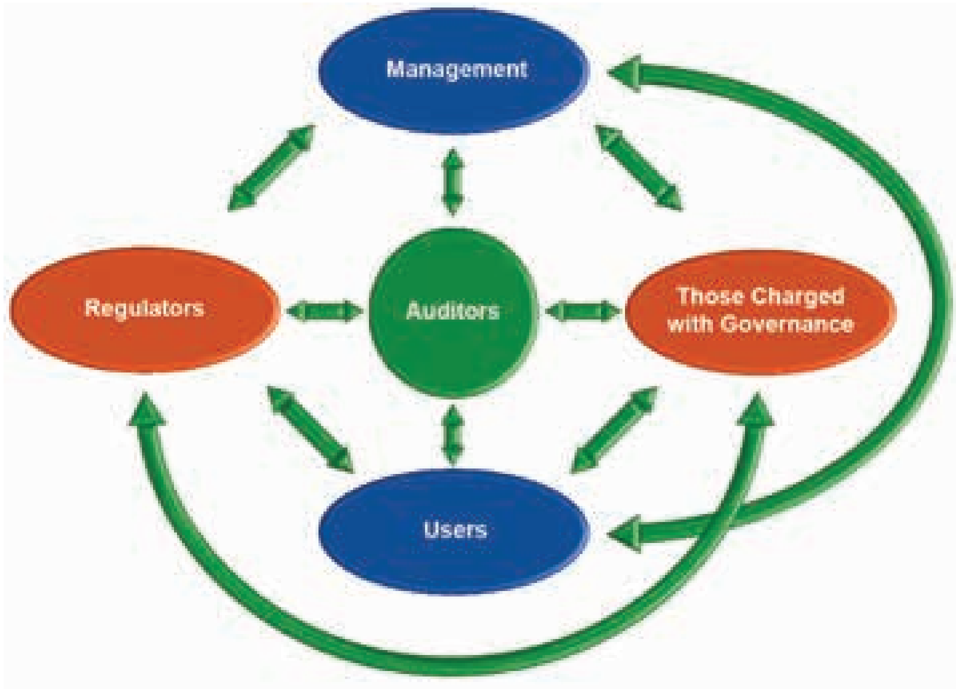
continued on next page

Content Elements for the Integrated Report

The nine content elements for the integrated report present a concise and holistic picture by including the business model, external factors impacting the business and management's strategy. They provide the basis for discussing the performance, prospects and governance of the business. The content elements include:

1. Organizational overview and external environment reports to address the organization's mission and vision, culture and values, ownership and operating structure, activities and markets, competitive landscape, revenue and staffing numbers, and external factors, such as legal, political and environmental aspects.
2. Governance reports to detail the organization's governance structure, including leadership, strategic direction, risk appetite and the impact of compensation structure of key personnel on value creation, plus the change in capitals over the short, medium and long term.
3. Business model reports to identify the organization's key inputs, business activities and outputs, and how they relate to the capitals. For example, the intellectual and human capitals are critical to the success of a service business while manufactured, financial and natural capitals are critical to a manufacturing organization.
4. Risks and opportunities reports to describe specific risks and opportunities from external sources and internal business activities, and the organization's risk responses.
5. Strategy and resource allocation reports should identify the organization's short, medium, and long-term strategies, and their impact on the organization's value creation.
6. Performance reports should outline the qualitative and quantitative overview of an organization's ability to achieve its strategic objectives, including the organization's key performance indicators.
7. Outlook reports should describe the organization's forward-looking information about the expected impact of current strategic objectives on future changes in capitals.
8. Preparation and presentation reports should summarize the organization's method for determination of materiality, and significant frameworks and methods used to determine material events.
9. General reporting guidance reports should include disclosures about material matters, capitals and policies for aggregation and disaggregation.

Figure 2: Key Interactions



(Source: IAASB Framework for Audit Quality)

organizations formed the International IR Council (IIRC) in 2009 to oversee the creation and implementation of an IR framework "to include long-term decision making, increased financial capital for investments and holistic picture of value creation over time." The American Institute of CPAs (AICPA) and the Chartered Institute of Management Accountants (CIMA) are members of the IIRC Council.

The mission of IIRC was to enable IR to be embedded into mainstream business practice in the public and private sectors (www.THEIIRC.Org). IIRC consists of a board with overall responsibility for the IR framework, council to provide guidance, working group to develop the framework, and support staff. A pilot program involving over 100 global businesses from various sectors and over 35 global institutional investors was conducted to enable businesses and investors to share experiences and create a framework of concepts and principles to be used for preparing integrated reports. Based on 350 responses from the participants, the IR framework was released on Dec. 8, 2013, as a key step to guide organizations on their reporting, and to enhance the relevance and usefulness of information to capital markets.

The participants in the pilot program found that using the capitals concept helped them to improve inter-departmental communications, enabled them to establish the causal relationship between their business model, strategy and performance, and led to increased non-financial communications to provide investors with potential leading indicators of financial performance.

They found that explaining their business models provided clarity and new insight to investors, as well as increasing their own understanding of inter-relationships of activities. Global organizations, including Microsoft, PepsiCo, Southwest Airlines and others, have voluntarily adopted IR and are recognizing the benefits of a cohesive, efficient and valuable reporting process.

Regulatory Accounting Standard-Setting Bodies

The Association of Chartered Certified Accountants (ACCA) has introduced IR within its qualification examinations. Together with the Institute of Management Accountants (IMA), they released a report in January 2016 on how accountants can play a key role in developing integrated reports to add value to their organizations. Integrated financial reporting is also addressed in the document titled *Framework for Audit Quality,* released by the International Auditing and Assurance Standards Board (IAASB) in February 2014.

Regulators like the UK's Financial Reporting Council and U.S. and Canadian professional organizations such as AICPA, ACCA and CAA, and stock exchanges are encouraging businesses to adopt and benefit from reporting innovations inherent to IR. Some of the key interactions within the financial reporting supply chain are reflected in Figure 2.

A New and Powerful International Practice

The development of the framework has been a collaborative, market-led activity involving extensive global consultation and market testing. The participants in the IIRC pilot program are acting as catalysts for IR by forming regional networks across the globe, refining the reporting by sharing their experiences, and engaging with policymakers, peers, standard setters and others in their geographical domain to drive the adoption.

As more businesses voluntarily adopt IR and get the benefits of a cohesive, efficient and valuable reporting process, changes in current reporting models will require CPAs to re-calibrate their thinking of financial and managerial reports, strategy and accounting information systems. IR combined with integrated thinking is morphing from a promising concept to powerful practice around the world.

The Governance & Accountability Institute surveyed the sustainability reporting practices – environmental, social and corporate governance (ESG) – of S&P 500 Index companies and found that 82 percent of the companies reported in 2016 vs. 20 percent in 2011. It observed that the companies are seeing dramatic benefits from their efforts and are engaging more with investors to make ESG data more strategically useful for decision making by management, stakeholders and investors. Global Reporting Initiative reports that 92 percent of the 250 world's largest corporations report on their sustainability performance, and large European companies are required by European Union directive to report on their performance regarding environmental, social, employee-related, human rights, anticorruption and bribery matters.

Since the framework was tested and driven by market forces, CPAs need to understand the framework and incorporate it into operations. Value creation for the organization will involve accountants in all areas of strategy, planning and implementation. Complex business transactions, globalization and technological developments continue to change the business environment making risk management, technological and managerial skills, and lifelong learning critical for accountants.

The innovative approach and flexibility of an integrated report offers opportunities for CPAs to leverage their existing skills. Accountants can play a critical role in the development and issuance of integrated reports, including financial statements and other financial information, as well as help in planning for the required disclosures about strategies, sustainability and corporate social responsibility.

Integration of knowledge, skills and ethical action has built the competency and professional responsibility of accountants. As expressed by the Pathways Commission report, a vibrant and strong accounting profession operates with a social contract encompassing a set of promises and commitments centering on the preparation of reliable accounting information. Roles and opportunities will exist for accountants to provide pragmatic balance between competitiveness and sustainable growth to guide their organizations towards enhanced value creation using integrated reporting. ■

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How to Deter Fraud in Not-for-Profit Organizations

By Jeanette Verrelli, CPA

Any organization can be a victim of fraud. According to the most recent *Report to the Nations on Occupational Fraud and Abuse*, issued March 30, 2016, by the Association of Certified Fraud Examiners (ACFE), organizations around the world lost an estimated 5 percent of their annual revenues to occupational fraud. More than 75 percent of the occupational fraud reported was committed by individuals working in seven key departments: accounting, operations, sales, executive and upper management, customer service, purchasing and finance.

So what is occupational fraud? Occupational fraud is the use of one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets. Occupational fraud schemes fall into three primary categories:

1. **Asset misappropriation** schemes, in which an employee steals or misuses the organization's resources; e.g., theft of company cash, false billing schemes or inflated expense reports.
2. **Corruption** schemes, in which an employee misuses his/her influence in a business transaction in a way that violates his/her duty to the employer to gain a direct or indirect benefit; e.g., schemes involving bribery or conflicts of interest.
3. **Financial statement fraud** schemes, in which an employee intentionally causes a misstatement or omission of material information in the organization's financial reports; e.g., recording fictitious revenues, understating reported expenses or artificially inflating reported assets.

Asset misappropriation is by far the most common form of occupational fraud and among the various forms of asset misappropriation, billing and check tampering schemes pose the greatest risk. Certain schemes tend to be particularly high-risk in specific industries. For example, skimming – when cash is stolen before funds are archived in the accounting records – is a scheme frequently seen in educational organizations, whereas check tampering schemes are often seen in charitable organizations.

Why are these schemes so common, specifically for not-for-profit (NFP) organizations? Unfortunately, most NFP organizations lack strong internal controls and proper segregation of duties. For example, NFPs often place a lot of control – sometimes excessive – in the founder or executive director. The executive director could submit expense reimbursements without the organization requiring someone to review his/her submission. Without that level of review, the executive director can easily take from the organization.

In addition, the NFP usually operates with limited resources that allow the organization to spend funds on its programs and not on overhead expenses. Therefore, some employees could have multiple responsibilities and wear multiple hats. NFPs may also receive a lot of charitable contributions through campaigns or special events; e.g., silent auctions. These transactions make it easier to steal from the organization, since no consideration is exchanged. The NFP might not do an inventory of the silent auction items donated and an employee could easily take various items not sold at the auction that are of substantial value. Strong internal controls and proper segregation of duties help reduce an organization's vulnerability to fraud.

We all may remember the fraud triangle from our Fraud 101 class in college. The fraud triangle is the model for explaining the factors that cause someone to commit occupational fraud. Factors include pressure, opportunity and rationalization. Unfortunately, organizations have no control regarding the rationalization component. The employee will rationalize inputting a fictitious vendor, falsifying a timesheet or using an organization-issued credit card for personal use for whatever reason. That being said, NFPs can help eliminate the pressure and opportunity components through strong internal controls.

Following are some examples[1] of government and NFP organizations that were victims of fraud, due to the organization lacking proper segregation of duties and internal controls to mitigate fraud risk.

Example One

The former treasurer of Healdton, Oklahoma, took advantage of three systematic flaws to steal $80,000 from the city. First flaw: Customers who paid their utility bills with cash at the city office received receipts that were not pre-numbered when recorded. This, along with the treasurer being the sole employee responsible for bank deposits and the bank reconciliation, made it easy to skim approximately $43,000 from utility payments.

Second flaw: The treasurer had access to an unsecured vault where the city clerk placed each day's cash. The treasurer then obtained the cash and reconciled the revenue account with the day's activity in preparation of the bank deposit. No controls were in place to verify that the cash amount deposited was the same as what the clerk left in the vault.

Third flaw: The treasurer had complete access to the city's billing system. An investigation discovered the treasurer had manipulated previously recorded activity to show lower amounts received to conceal the fraud. She had the ability to make changes within the system without approval or review.

Example Two

The president and executive director of Discovery Counseling Center, an NFP that provides counseling and other mental health services, was charged with four felony counts of embezzlement for stealing more than $150,000 in funds. The director used a company credit card linked to the organization's checking account for his own personal expenses.

Example Three

The finance director of Kids House of Seminole, an NFP that supports abused and neglected children, was accused of embezzling $48,000 from the organization by writing checks from the organization to himself and then depositing the money into his personal bank account.

> “ASSET MISAPPROPRIATION IS BY FAR THE MOST COMMON FORM OF OCCUPATIONAL FRAUD …”

Best Practices and Internal Control

NFPs should consider the following best practices and internal controls to help avoid situations similar to what the above organizations faced:

- Have a board member review and approve the expense reports and reimbursements of the executive director, CEO, etc.
- Have a board member receive the unopened bank statement, review the bank statement for unusual activities and complete the monthly bank reconciliation so one person is not handling an entire business transaction.
- For credit cards, require written approval from a person other than the user in advance for costs estimated to exceed a certain dollar amount.
- Require two signatures, even if the bank does not, for expenditures more than a predetermined amount.
- Regarding the executive director or board member who signs checks, make sure an invoice is attached to the check and an authorization is signed by a designated staff person. Initial the authorization to show that you have seen it, and occasionally pick out a large check and call the designated staff person to make sure the expense was authorized.
- Never pre-sign checks.
- Conduct background checks; they can reveal prior instances of fraud, which allows for the organization to avoid a bad hire.

Fraud Detection

So how do we detect fraud? The ACFE *2016 Report to the Nations* presents the top anti-fraud controls reported in fraud cases. The three most common methods of detecting occupational fraud include tips, internal audit and management review. Based on the findings of the study, barely half the entities used a hotline as an anti-fraud control, yet tips are cited as the most common way of preventing fraud.

Do you have a hotline? As most NFP organizations have fewer internal controls and probably have fewer resources dedicated to fraud prevention, a hotline can be a cost-effective method for managing fraud risk. A hotline is more than twice as common as

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the next most frequent detection method – internal audit. While your current reporting procedures may be effective, implementing an anonymous fraud hotline outside of your organization will supplement and enhance these practices. ACFE research indicates occupational fraud is more likely to be detected through a tip than by any other method.

However, fraud detection methods vary based on the organization's size. In place of tips, small organizations (those with fewer than 100 employees) tend to detect more fraud through management review, account reconciliation, accident, external audit and document examination. Whatever your organization's size, hotlines are becoming the most common method of initial fraud detection in the world and there are affordable options for even the smallest organizations.

Fraud detection methods, like hotlines, can be categorized as active or passive detection methods, as illustrated in the ACFE 2016 Report. An active detection method involves a deliberate search for someone within the organization's misconduct or an internal control or process that is instrumental in searching for fraud. In contrast, passive detection occurs when the organization learns of the fraud by accident, confession or unsolicited notification by another party.

Some detection methods could potentially be active or passive, depending on the circumstances. For example, tips might often be passive, but organizations that effectively promote reporting mechanisms can help with actively cultivating such tips. Additionally, while the typical external audit is not primarily designed to look for fraud, an organization might procure an external audit in response to suspected fraud; so external audits could be considered either active or passive depending on the circumstances.

Based on the data obtained in the 2016 ACFE study, frauds that are detected through active methods tend to be caught sooner and cause smaller losses than frauds that are passively detected. Of the victim organizations in the study, 36.7 percent said they were using proactive data monitoring and analysis techniques as part of their anti-fraud program. These organizations had 54 percent lower fraud and detected the fraud in half the time of other organizations that did not use these proactive techniques. Management review and the presence of a hotline were both similarly correlated with regard to lower losses (50 percent reduction) and decreased time to detect the scheme (50 percent reduction). Thus, organizations might be able to reduce the duration and cost of fraud by implementing controls or processes that will increase the likelihood of active detection, such as active management review, attentive account reconciliation and surveillance or monitoring techniques.

Data monitoring and analytics may sound complicated, but you would be amazed at what you can accomplish using Microsoft Excel. For example, you can potentially identify a fictitious vendor by putting your vendor master file and employee master file in an Excel worksheet, sorting the entries by many types – including addresses, phone numbers and tax ID numbers – and then looking for duplicate entries.

However, strong internal controls, hotlines and other methods aren't the only ways fraud can be detected. Watch for behavioral red flags among employees that are the most common traits associated with occupational fraud. These behaviors include:

- Living beyond financial means,
- Financial difficulties,
- Unusually close association with a vendor or customer,
- A general "wheeler-dealer" attitude that involves shrewd or unscrupulous behavior,
- Excessive control issues or unwillingness to share duties and
- Recent divorce or family problems.

Almost 80 percent of the fraudsters in the 2016 ACFE study displayed at least one of these six red flags during their schemes. So if you start seeing an employee drive an expensive new sports car, a bookkeeper refusing to take a vacation or other behaviors indicative of a potential fraudster, you should start a fraud investigation.

However, the most important control to have in your anti-fraud program is the tone at the top. The board of the NFP and management need a zero-tolerance policy to regularly hold everyone accountable for policies implemented and require all personnel to adhere to those policies. The NFP board has a fiduciary duty to ensure all financial decisions are soundly and legally made. Individual directors and management always put the organization's financial and business interests ahead of any personal interests and manage the organization's assets in furtherance of its exempt purpose. In addition, the board should ensure the organization has taken steps to identify fraud risks and protect itself against fraud through special reserves, and should oversee senior management's follow-up actions in response to audit findings.

What Next?

Take time to clearly define your policies and procedures and make sure you have controls in place for the proper checks and balances. While it is understandable small businesses do not have the resources necessary to invest in some of the more expensive internal controls noted, several controls – a code of conduct, management review procedure and fraud training for staff members – can be implemented with minimal investment. Get a hotline, or if you already have one, educate your employees on what occupational fraud might look like in their respective areas of responsibility. Your employees are your eyes and ears when it comes to fraud. Therefore, educate them, because the earlier they recognize a potential fraud, the more quickly it can become subject to investigation.

Finally, and most importantly, ensure the organization is maintaining respect from the general public – its donor base. Fraud not only hurts an NFP financially, but it hurts the people and community it serves. Even the best internal controls can't be expected to prevent fraud 100 percent of the time, but the slightest change can make a difference. Start revising your anti-fraud program today.

Footnotes

1. Sources: Venable, LLP and BKD Forensics

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Tax Reform Law

Major Changes in Store for Individual Taxpayers

By Don Carpenter and Tim Thomasson

On Dec. 22, 2017, President Donald Trump signed into law the most significant overhaul of the U.S. tax code in over 30 years. Congress passed the bill under special procedures known as budget reconciliation, which allowed the Republican majority to advance the bill without the threat of a filibuster. But the rules of reconciliation also required that the bill not increase the deficit by more than $1.5 trillion during the 10-year period of the budget.

With this restriction, almost all the provisions affecting individual taxes will expire at the end of 2025 and the law will revert to the provisions in effect in 2017. The Republican majority has stated its intention to make these provisions permanent, but with mid-term elections in 2018, it remains to be seen if they will have the ability to do so.

Interestingly, even the prior title of the bill, "The Tax Cuts and Jobs Act" violated the reconciliation rules and in the end the bill was titled "To provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018;" not a title that will be quoted as the various provisions are analyzed.

This article is intended to be the first in a series of articles examining the major changes to the tax code resulting from the bill. Here we will focus on the individual tax provisions, while later articles will examine the provisions that affect pass-through entities, corporate taxes and the taxation of nonprofit organizations, as well as trusts and estates.

Taxes Reduced – Plain, But Maybe Not So Simple

During the debate and run-up to the passage of the tax bill, there was considerable focus on the lower corporate and pass-through tax rates as a windfall to high income taxpayers and investors at the expense of the broader population of low- and middle-income wage earners. However, this latter group also stands to benefit, as is evident from the following chart.

		Tax Due	
		Prior Law	**New Law**
Wages Earned		2018	2018
Smiths	$50,000	$8*	($1,361)*
Jones	$100,000	$7,608	$4,739
Williams	$200,000	$34,335	$26,819

(*assumes $100 earned income tax credit)

Let's consider three "typical" American families: the Smiths, the Jones and the Williams. All three families have two healthy, relatively happy children. None of the families itemize deductions and all earnings are from salaries and wages. As the chart illustrates, all three families will benefit from the new tax law.

Next, let's consider what drives these reductions before considering the more specific changes in the tax provisions that affect individuals.

Taxable Income Increases! It may come as a surprise, but the taxable income of all three families increases in 2018 when compared to prior law. The increase is driven by the interplay between the standard deduction for non-itemizers and the personal exemption allowance. Previously, each family would have received a standard deduction of $13,000 and personal exemptions of $16,600 ($4,150 for each family member). Under the new provisions, the personal exemption is eliminated, but the standard deduction is increased to $24,000 for married filing jointly. Therefore, taxable income increased by $5,600 for each of these families!

Fortunately, that's not the end of the story. The increase in taxable income is more than offset by two additional changes.

Tax Rates Reduced. For all the emphasis on the reduction of the corporate tax rate, the individual tax rates saw similar reductions both in terms of the applicable rates and the expansion of the income bracket to which the rates apply. Although there was no modification to the 10 percent bracket, the previous 15 percent bracket remained unchanged in terms of the 2018 applicable income level, but the rate was reduced to 12 percent, resulting in a reduction in tax of $1,750 for joint filers with taxable income of $77,400 or more. All three families benefitted from this rate reduction.

As the high earners on the block, the Williams family, with earnings of $200,000, would see additional reductions on the portion of their income in excess of $77,400 as the rate for the third tax bracket was reduced from 25 percent to 22 percent and the income level expanded to $165,000 (previously $156,150). The Williams saw a savings of $2,893 on their income in this bracket. And the portion of the Williams' income that exceeded $165,000 will now be taxed at 24 percent rather than 28 percent.

Child Tax Credit Increased. In addition to benefitting from the revised tax brackets and rates, all three families would see their tax liability reduced by an increased child tax credit. The prior credit of $1,000 per child is doubled to $2,000. Additional features of the child tax credit benefit the Smiths and the Williams specifically.

Note that the Smiths receive a refund of $1,361. This refund is payable even if it exceeds taxes withheld on earnings throughout the year. In the reconciliation between the House and Senate versions of the act, not only was the credit increased to $2,000 per child, but $1,400 of the credit is now refundable.

And the Williams would not have enjoyed the benefit of the child tax credit prior to tax reform; now they receive the full $2,000 tax reduction for each of their children. This benefit is attributable to a provision that increases the phase-out of the credit for married taxpayers filing jointly from $110,000 to $400,000. Similar increases to the phase-out apply to other categories of filers.

Earned Income Credit Remains Unchanged. Since its enactment in 1975, the earned income credit has been a mechanism for reducing the tax burden for lower-income wage earners. The calculation of the credit was not modified as part of this act. At their income level, the Smith family received a small earned income credit in both years.

Maybe It's Not So Simple

Before considering the specific provisions that affect taxpayers who itemize deductions, let's consider what filers and practitioners should glean from the three examples above.

First, there will be fewer tax returns filed with itemized deductions. By raising the standard deduction to $24,000 ($12,000 for single filers), many taxpayers will lack the necessary expenses to qualify for itemized deductions. But the increased standard deduction comes with a price: the loss of personal exemptions. For a couple with no children, the effect of the trade-off may not be beneficial.

In this example, let's assume that the Dinks (who have no children) expect wage income of $75,000 and itemized deductions of $23,000 comprised of mortgage interest, real estate taxes and charitable contributions. Now let's compare their taxable income both before and after the new tax act:

	Prior Computation	New Computation
Gross Income	$75,000	$75,000
Itemized Deduction	-23,000	---
Standard Deduction	---	-24,000
Personal Exemption	-8,100	---
	_________	_________
Taxable Income	$43,900	$51,000
Tax	$5,632	$5,739

The loss of the personal exemptions is not fully offset by the reduced tax rates and higher standard deduction.

Generally, the loss of the dependent exemption deduction for children is offset by the additional $1,000 tax credit for children younger than 17. Arguably, the new $500 dependent credit will at least partially offset the loss of the exemption deduction for children between the ages of 17 and 24 and for other dependents. With a personal exemption of $4,150, a couple filing jointly would have to be at a taxable income level in excess of the 25 percent bracket ($165,000) before the loss of the exemption outweighs the benefit of the enhanced credit. And this is without considering that previously the credit began to phase out at $110,000 of taxable income.

> "BY RAISING THE STANDARD DEDUCTION, MANY TAXPAYERS WILL LACK THE NECESSARY EXPENSES TO QUALIFY FOR ITEMIZED DEDUCTIONS."

But I Have Always Itemized

With the higher standard deduction, this statement will no longer be true for many taxpayers. However, for those filers with itemized deductions in excess of the increased standard deduction, important changes to the specific categories of deductions are worth noting. The House version of the bill either eliminated or severely limited most categories of deductions. The Senate version took a gentler approach and the reconciliation saw a further softening as Republicans pushed their constituents' interests in exchange for their support of the bill. Let's take the individual deductions in the order they appear on Schedule A.

Medical and Dental Expenses. This category offers a classic example of how the reconciliation process had unexpected results in the development of the bill. The House version eliminated this category of deductions completely. But the final version of the bill not only retains this category, it offers additional benefits for 2018-2019. Prior to 2018, medical and dental expenses were only included as an itemized deduction to the extent that they exceed 10 percent of adjusted gross income. This floor is lowered to 7.5 percent for 2018-2019, before returning to the 10 percent level in 2020.

Taxes. The deduction for taxes paid likely generated more discussion and analysis than any other revision to the individual income tax provisions. The House version eliminated the deduction for state and local income taxes and sales/use taxes. It further limited the deduction for property taxes to $10,000 annually. Members of Congress from states that rely more heavily on income taxes objected to this approach and the final bill allows taxpayers to include all three categories of tax in the calculation of the $10,000 limit.

The bill includes a provision that will not allow cash basis taxpayers to prepay post-2017 state and local income taxes and thus include these amounts as a 2017 itemized deduction. This provision does not apply to shifting income taxes paid between years after 2017. The

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provision applies only to income-based taxes, so pre-paying property taxes was not prohibited. However, subsequent IRS guidance indicates that property taxes must be assessed by the tax jurisdiction if they are prepaid.

Mortgage Interest. The deduction for mortgage interest is retained, but limited to interest on $750,000 of mortgage indebtedness. The limit applies to debt incurred on or after Dec. 15, 2017. Debt in place by that date remains under the prior limit of $1 million even if subsequently refinanced. This provision is scheduled to expire in 2025 and interest would then be deductible on $1 million of mortgage debt even if financed after Dec. 15, 2027.

Interest on home equity debt is no longer deductible regardless of when the debt was incurred.

Charitable Donations. This category of deduction is not only retained, but expanded. Cash contributions are now limited to 60 percent of adjusted gross income rather than the prior limit of 50 percent.

Casualty and Theft Losses. Casualty and theft losses are now limited to only those losses incurred in a federally declared disaster.

Miscellaneous Deductions. Previously, other deductions, including unreimbursed employee business expenses, tax preparation fees, investment fees and safe deposit box rentals, were deductible to the extent they exceeded in the aggregate 2 percent of adjusted gross income. This category has now been eliminated.

Limitation on Itemized Deductions. For years prior to 2018, total itemized deductions were allowed only to the extent that they exceeded 3 percent of a threshold amount of adjusted gross income ($313,800 for married filing jointly in 2017). This limitation is no longer applicable.

All Is Not Lost

With the increased standard deduction and the limitations on certain categories of itemized deductions, it might appear that the ability to effectively utilize these expenses to reduce the personal income tax burden is severely restricted. This concern has been raised by nonprofit organizations that see the forfeited tax benefit to their donors as a disincentive to give. Homebuilders are also concerned that the limitation on mortgage interest coupled with the cap on taxes may weaken the demand for housing. But there is also some potential to maximize both the benefit of the higher standard deduction and itemized deductions with some planning and arguably some liquidity.

Let's take the Giver family as an example. They earn $150,000 annually and have the necessary two dependent children. In addition, they have $5,000 of mortgage interest, over $10,000 of combined taxes (state and local income, property, and sales) and give $15,000 in contributions. With $30,000 of qualified deductions, they should itemize. With some planning, they can structure their deductions to maximize the benefit. Without any adjustment, let's see what their tax liability would be in 2018 and 2019 (see above).

If the Givers family combined their charitable giving in one year (2018 in this case), their tax burden for the two years would be reduced by $1,980 as illustrated above. **Note:** once the $10,000 limit for taxes is met, there is no benefit to accelerating or deferring state income or property tax payments. Under the above fact pattern, it would also be to the benefit of the Givers to

	2018	2019
Adjusted gross income	$150,000	$150,000
Itemized deductions	-30,000	-30,000
Taxable Income	$120,000	$120,000
Tax Before Credits	$18,279	$18,279
Less Child Tax Credit	4,000	4,000
Tax	$14,279	$14,279

	2018	2019
Adjusted gross income	$150,000	$150,000
Standard Deduction	---	-24,000
Itemized deductions	-45,000	---
Taxable Income	$105,000	$126,000
Tax Before Credits	$14,979	$19,599
Less Child Tax Credit	4,000	4,000
Tax	$10,979	$14,599

incur optional medical expenses in 2018 to the extent these deductions will exceed 7.5 percent of their adjusted gross income.

This planning option existed with the pre-2018 standard and itemized deductions. However, the benefit was mitigated by the lower standard deduction amount. Either the filer consistently exceeded the lower standard deduction with expenses that could not be accelerated or deferred and if not, the tax savings from the standard deduction was less material.

What About Adjustments to Gross Income?

Although adjustments to gross income do not affect as many taxpayers, these items can be material to the determination of taxable income when they arise. The following two categories saw major revisions.

Moving Expenses. Historically, unreimbursed moving expenses were deductible from gross income and any reimbursement for such expenses was excluded from an employee's wages. With the exception of military relocations, any reimbursement will now be included in an employee's earnings and unreimbursed expenses are no longer deductible.

Arguably, this will increase the cost to employers for relocating their employees assuming the reimbursement will be grossed-up for the increased tax cost.

Alimony. The tax burden of alimony payments will shift from the recipient to the payor for any divorce settlements executed after 2018, as payments will no longer be deductible by the payor and are not included in gross income of the recipient. For divorce settlements prior to 2019, the payor continues to deduct the alimony and the recipient includes the payment in computing adjusted gross income. Any modifications to pre-2019 settlements can be included in the new provisions if the modification expressly elects to apply them.

This provision does not revert to prior law at the end of 2025 and its implementation is delayed one year until 2019. The alimony revisions have the effect of shifting the tax burden to the payor, who is typically viewed as more economically capable of bearing the burden. Arguably, the tax impact should also be considered by a judge or arbiter when determining the amount of alimony due. It is possible for an individual with more than one divorce to have alimony payments under both provisions if one divorce settlement is pre-2019 and another is post-2018.

Determining the Tax Liability

We considered the change in the tax rates and brackets earlier, but the following are other changes in determining tax liability that should be noted.

Healthcare Mandate. Although the requirement that individuals and families must have heath care remains, the penalty for non-compliance is reduced to zero. For a family of four, the minimum penalty would have been $2,085. This provision is not effective until 2019, but does not revert to prior law at the end of 2025.

Alternative Minimum Tax. Although repealed for corporations, the alternative minimum tax remains for individuals. However, the exemption amount increases from 84,500 to $109,400 for married filing jointly (54,300 to $70,300 for single filers). The phase-out thresholds increase to $1,000,000 for married filing jointly and $500,000 for single taxpayers.

Marriage Penalty/Head of Household. The new tax rates eliminate the "marriage penalty" in the lowest five tax brackets. The sixth bracket tops out at $500,000 for single taxpayers and all income in excess is taxed at 37 percent, while this bracket tops out at $600,000 married filing jointly taxpayers.

Taxpayers utilizing the head of household filing status do not fare as well. Beginning with the 24 percent rate bracket, the income thresholds for single taxpayers and head of household taxpayers will now be identical. Prior to 2018, the income thresholds were more generous for head of household filers at every rate bracket.

Kiddie Tax. Unearned income for dependent children will now be taxed at the rates applicable to equivalent income for trusts and estates. Previously, it was taxed at the higher of the child's or the parents' tax rate. Because the tax brackets for trusts and estates are much more compressed than individual tax rates, the tax burden on investment income of children could actually increase.

Tax on Investment Income. The tax rate on capital gains and dividends remains at 0 percent, 15 percent, or 20 percent, depending on the taxpayer(s) applicable tax bracket. The 3.8 percent tax on net investment income also remains in place. ■

What is Inflation? A Provision That Has Drawn Little Attention

Within the computations of individual income tax liability, items such as tax brackets and standard deductions are indexed for inflation. Annual inflation adjustments have historically been based on the Consumer Price Index (CPI).

However, beginning in 2018, the indexation will be based on chained CPI, which moderates CPI by considering purchasers' options to substitute cheaper goods in times of inflation. This will result in lower annual adjustments to items subject to indexation.

Unlike most of the individual tax changes in this new tax law, this provision does not sunset in 2025 and is the reason analysts often comment that taxpayers will experience a tax increase if the new provisions are not extended.

Review Withholding

After considering all the changes discussed in this article, a wholesale review of tax withholdings on earnings should be undertaken early in 2018. Married individuals should consider the effect of the new tax brackets on combined wages. In addition, the elimination of personal exemptions, higher standard deductions and child tax credits, as well as revisions to itemized deductions, can significantly change withholding obligations.

With the bill being enacted during the final weeks of 2017, payroll systems may not have the changes fully implemented until early February. Taxpayers should then look at withholdings and adjust accordingly.

Although not exhaustive, this article has focused on the most material provisions of the new tax bill that affect individual taxpayers, particularly when a significant portion of earnings is from salaries and wages. Later articles will consider the changes affecting pass-through entities, which also affect individual tax returns, particularly those of sole proprietors and partners.

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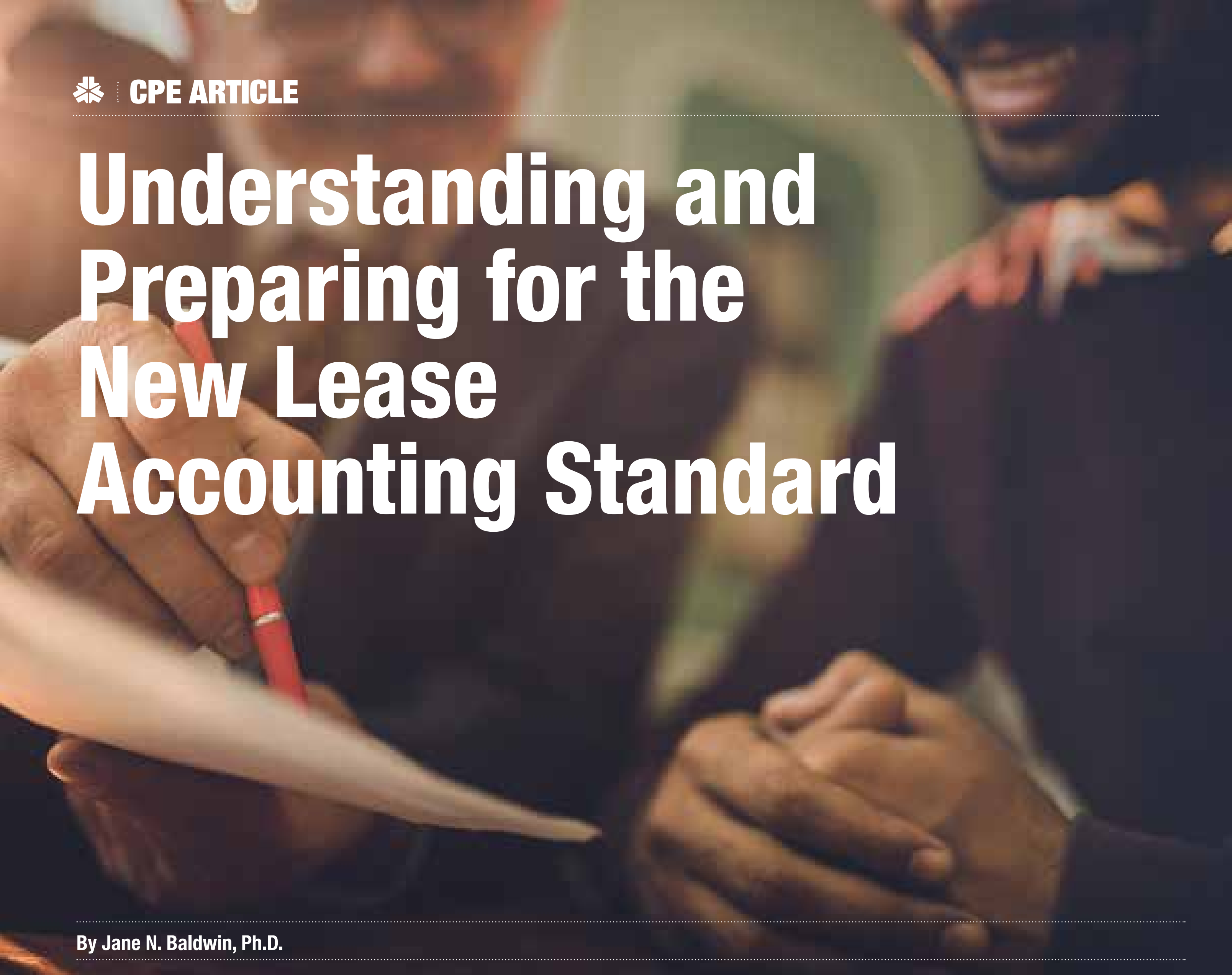

CPE ARTICLE

Understanding and Preparing for the New Lease Accounting Standard

By Jane N. Baldwin, Ph.D.

Curriculum:
Accounting and Auditing

Level: Intermediate

Designed For: CPAs in public corporations and other organizations and those engaged in public practice

Objectives: To provide an overview of the new standard, communicate the expected impact of the standard on financial statements and offer recommendations for implementation

Key Topics: Lease classification, finance and operating leases, transition period and impacts on accounting processes, the lessee balance sheet, comprehensive statement of income and statement of cash flows

Prerequisites: None

Advanced Preparation: None

After 10 years of research and deliberation, one discussion paper, two exposure drafts, more than 1700 comment letters and hundreds of meetings with financial statement preparers and users, the Financial Accounting Standards Board (FASB), in a joint project with the International Accounting Standards Board (IASB), issued an Accounting Standards Update on leasing transactions on Feb. 25, 2016 (Topic 842). The amendments become effective for public companies for fiscal years beginning after Dec. 18, 2018, and for other companies after Dec. 15, 2019.

The primary change in the new guidance is to bring right-of-use assets and lease liabilities for operating leases onto the lessee's balance sheet. The 40-year old treatment of operating leases under the old guidance had, based on an estimate from a 2005 SEC report on off-balance sheet activities, led to companies avoiding the recognition of over $1 trillion of lease liabilities (FASB, 2016). This article provides an overview of the new standard using relevant examples, discusses the expected impact of the standard on the financial statements and offers some implementation recommendations.

Definition of a Lease

FASB defines a lease as a contract that conveys the right to control the use of identified property, plant or equipment for a period of time in exchange for consideration. The emphasis in FASB's guidance is on the control of the use of the asset. This requirement for control is consistent with the revenue recognition principle, which specifies that the customer must have control of the goods or services in a contract in order for a performance obligation to be satisfied.

To determine whether a contract conveys the right to control the use of an asset, the company assesses whether the customer has both 1) the right to obtain substantially all of the economic benefits from use of the identified asset and 2) the right to direct the use of the identified asset.

Lease Classification

Classification Criteria

Under the new standard, nearly all lessees will record a lease asset and liability. The standard identifies two types of leases for the lessee, 1) operating and 2) finance, and three types of leases for the lessor, 1) operating, 2) sales-type and 3) direct financing. The distinctions among these leases are based on the criteria in Table 1.

In its implementation guidance for Topic 842, FASB indicates that one reasonable approach in assessing the criteria is to conclude, consistent with previous generally accepted accounting principles (GAAP), that 75 percent or greater is a "major part" of the remaining economic life of an underlying asset and that 90 percent or greater is "substantially all" the fair value of the underlying asset. In its Background Information and Basis for Conclusions (FASB, paragraph BC73), the Board acknowledges that (while) this largely retains some, but not all, of the "bright lines" in the lease classification test in previous GAAP, it does not mandate those bright lines. The Board also observed that, to some extent, criticism of the previous bright-line thresholds will likely be mitigated solely by the fact that all leases (other than short-term leases for which a lessee elects the recognition and measurement exemption) are required to be recognized on the balance sheet under Topic 842.

Table 1. Classification of Leases

1. General criteria for classifying leases

A. The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.

B. The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.

C. The lease term is for the major part of the remaining economic life of the underlying asset.

D. The present value of sum of the lease payments and any residual value guaranteed by the lessee that is not already reflected in the lease payments equals or exceeds substantially all of the fair value of the underlying asset.

E. The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.

2. Classification by the lessee

A. Finance lease: Lease that meets one or more of the five criteria.

B. Operating lease: Lease that does not meet any of the five criteria.

3. Classification by the lessor

A. Sales-type lease: Lease that meets these two criteria:

1) One or more of the five criteria.

2) The collectibility of the lease payments is probable.

B. Operating lease: Lease that does not meet any one of the five criteria.

C. Direct-financing lease.[1]

Measurement of Present Value of Lease Payments; Components of Lease Payments

The lease payments used in determining whether the present value of the sum of the lease payments equals or exceeds substantially all of the fair value of the underlying asset consist of:

1. Fixed payments, including in-substance fixed payments, less any lease incentives paid or payable to the lessee.
2. Variable lease payments that depend on an index or a rate (such as the Consumer Price Index or a market interest rate), initially measured using the index or rate at the commencement date.
3. The exercise price of an option to purchase the underlying asset if the lessee is reasonably certain to exercise that option.
4. Payments for penalties for terminating the lease if the lease term reflects the lessee exercising an option to terminate the lease.
5. Fees paid by the lessee to the owners of a special-purpose entity for structuring the transaction.
6. For a lessee only, amounts probable of being owed by the lessee under residual value guarantees.

Interest Rate

The interest rate implicit in the lease should be used in calculating the present value of the lease payments. If it is not practical for the lessee to determine the interest rate implicit in the lease, the lessee will use its incremental borrowing rate.

Finance/Sales-Type Leases

The lessee classifies a lease that meets one or more of the five criteria as a finance lease (formerly capital lease) and recognizes on the balance sheet a right-of-use asset and liability, initially measured at the present value of the lease payments and classified as current or noncurrent using the same considerations as for other assets and liabilities. On the income statement, the lessee recognizes interest on the lease liability separately from amortization of the right-of-use asset, which is generally calculated on a straight-line basis. The lessor classifies a lease that meets one or more of the five criteria and for which collectibility of payment is probable as a sales-type lease. While FASB made some changes to lessor accounting to conform

continued on next page

and align with new revenue recognition guidance, it is largely the same as the previous guidance. Consider the following example.

Example 1. Finance and Sales-Type Leases

Lease Terms

- The lease term is two years and requires equal rental payments of $2,561 on Jan. 1, 20X1, and Dec. 31, 20X1. The estimated residual value at the end of the lease term is zero.
- The cost and also fair value of the equipment to the lessor at the commencement of the lease is $5,000; the equipment has an estimated economic life of two years and has a zero estimated residual value at the end of its economic life.
- The equipment reverts to the lessor at the end of the two years; that is the lease contains no renewal options, no bargain purchase option and no agreement to transfer ownership at the end of the lease.
- The asset is not of a specialized nature.
- For the lessor, the interest rate implicit in the lease is 5 percent. The lessee knows, or can reasonably estimate, this rate.
- Collectibility of lease payments from the lessee is probable.

Application of Criteria for Determination of Lease Classification

Classification Criteria	Met?	Explanation
1. Transfer of ownership at end of lease	No	
2. Bargain purchase option	No	
3. Lease term is major part (≥75%) of economic life	Yes	Lease term is 100% of economic life*
4. Present value of lease payments is substantially all (≥) 90% of fair value	Yes	Present value is 100% of fair value**
5. Asset of specialized nature	No	

* 2 years / 2 years = 100%

** The present value of an annuity due of 2 payments of 2,561 each at 5% is 5,000 calculated as: 2,561 X 1.95238 = 5,000
5,000 / 5,000 = 100%

Conclusion: The lease is a finance lease for the lessee. It meets two of the five criteria. It is a sales-type lease for the lessor. It meets two of the five criteria and the probability of payment criterion.

Summary of Lease Payments and Interest Expense

Date	Lease Payment	5% Interest	Reduction of Lease Pay/Rec	Balance of Lease Pay/Rec
1/1/X1				5,000
1/1/X1	2,561	0	2,561	2,439
12/31/X1	2,561	122	2,439	0

Journal Entries for Finance/Sales-Type Leases

	Lessee			Lessor		
1/1/20X1	Right-of-Use Asset	5,000		Lease Receivable	5,000	
	Lease Payable		5,000	Equipment		5,000
	Lease Payable	2,561		Cash	2,561	
	Cash		2,561	Lease Receivable		2,561
12/31/20X1	Interest Expense	122		Cash	2,561	
	Lease Payable	2,439		Interest Revenue		122
	Cash		2,561	Lease Receivable		2,439
	Amortization Expense	2,500				
	Right-of-Use Asset		2,500			
	5,000/2 years = 2,500					
12/31/20X2	Amortization Expense	2,500				
	Right-of-Use Asset		2,500			

Operating Leases

The lessee classifies a lease that fails to meet one or more of the five criteria as an operating lease and recognizes on the balance sheet a right-of-use asset and liability, initially measured at the present value of the lease payments. On the income statement, the lessee records straight-line lease expense equal to the lease payments. The most significant change from previous guidance is the requirement that the lessee recognize on the balance sheet a right-of-use asset and liability.

Unlike the new IASB guidance that requires lessees to treat all leases as finance leases, FASB opted to keep a dual-lease (finance and operating) model, concluding that an operating lease is not equivalent to the purchase of the underlying asset because the rights obtained by, and the obligations imposed on, the lessee are different. In an operating lease, the lessee obtains a generally equal right to use the asset throughout the lease term and the Board concluded that straight-line lease expense is therefore appropriate.

In contrast, the finance lease recognizes a separate straight-line amortization expense of the right-of-use asset and a decreasing interest expense on the liability over the lease term. The Board also supported the dual-lease approach, because it maintains alignment between GAAP and U.S. tax reporting that exists under the previous GAAP. In addition, because of the existing volume of operating leases under the previous GAAP, significant costs would be incurred to implement IASB's single-lease approach.

To achieve a straight-line lease expense, the lessee determines interest expense and then plugs the amortization for the right-of-use asset in the amount necessary for interest plus amortization to equal the straight-line lease payment. The combined interest and amortization are reported as lease expense.

The lessor classifies a lease that fails to meet one or more of the five criteria as an operating lease. The accounting for the lessor is largely unchanged from the previous guidance. Consider the following example.

Example 2. Operating Leases

Lease Terms

- The lease term is two years and requires equal rental payments of $2,561 on Jan. 1, 20X1, and Dec. 31, 20X1. The estimated unguaranteed residual value at the end of the lease term is $1,102.
- The cost and also fair value of the equipment to the lessor at the commencement of the lease is $6,000; the equipment has an estimated economic life of four years and has a zero estimated residual value at the end of its economic life.
- The equipment reverts to the lessor at the end of the two years; that is the lease contains no renewal options, no bargain purchase option and no agreement to transfer ownership at the end of the lease.
- The asset is not of a specialized nature.
- For the lessor, the interest rate implicit in the lease is 5 percent. The lessee knows, or can reasonably estimate, this rate.
- Collectibility of lease payments from the lessee is probable.

Application of Criteria for Determination of Lease Classification

Classification Criteria	Met?	Explanation
1. Transfer of ownership at end of lease	No	
2. Bargain purchase option	No	
3. Lease term is major part (≥75%) of economic life	No	Lease term is 50% of economic life*
4. Present value of lease payments is substantially all (≥) 90% of fair value	No	Present value is 83% of fair value**
5. Asset of specialized nature	No	

* 2 years / 4 years = 50%

** The present value of an annuity due of 2 payments of 2,561 each at 5% is 5,000 calculated as: 2,561 X 1.95238 = 5,000
5,000 / 6,000 = 83%

Conclusion: The lease is an operating lease for both the lessee and the lessor. It meets none of the five criteria.

Summary of Lease Payments and Interest Expense

Date	Lease Payment	5% Interest	Reduction of Lease Pay/Rec	Balance of Lease Pay/Rec
1/1/X1				5,000
1/1/X1	2,561	0	2,561	2,439
12/31/X1	2,561	122	2,439	0

Journal Entries for Operating Leases

	Lessee			Lessor		
1/1/20X1	Right-of-Use Asset	5,000		Cash	2,561	
	Lease Payable		5,000	Unearned Revenue		2,561
	Lease Payable	2,561				
	Cash		2,561			
12/31/20X1	Lease Expense (Interest)	122		Unearned Revenue	2,561	
	Lease Payable	2,439		Lease Revenue		2,561
	Cash		2,561			
	Lease Expense (Amortization)	2,439		Depreciation Exp.	1,500	
	Right-of-Use Asset		2,439	Acc. Depreciation		1,500
	Interest and Amortization are combined and reported on the income statement as (straight-line) Lease Expense of $2,561 (122 + 2,439 = 2,561)			6,000/4 years = 1,500		
				Cash	2,561	
				Unearned Revenue		2,561
12/31/20X2	Lease Expense (Amortization)	2,561		Unearned Revenue	2,561	
	Right-of-Use Asset		2,561	Lease Revenue		2,561
	Interest and Amortization are combined and reported on the income statement as (straight-line) Lease Expense of $2,561 (0 + 2,561 = 2,561)			Depreciation Exp.	1,500	
				Acc. Depreciation		1,500

Comparison of Finance and Operating Leases

The lessee reports an asset and liability on the balance sheet for both finance and operating leases. The primary difference between the two types of leases is in the treatment of expenses. Consistent with previous guidance, operating leases result in an equal amount of lease expense each period. The result is that early in the lease term, the operating lease model reports a smaller amount of total expense compared to the finance lease. Lessees may prefer the operating lease classification, because it defers expense recognition.

Comparison of Lessee Expenses for Finance Lease and Operating Lease

(Example 1 Compared to Example 2)

	Finance Lease			Operating Lease		
	Interest Expense	Amortization Expense	Total Expense	Interest Expense	Amortization Expense	Total Expense
20X1	122	2,500	2,622	122	2,439	2,561
20X2	0	2,500	2,500	0	2,561	2,561
	122	5,000	5,122	122	5,000	5,122

Short-Term Leases

A short-term lease is one that, at the commencement date, has a lease term of 12 months or less and does not include an option to purchase the underlying asset that the lessee is reasonably certain to exercise. The lessee may elect to charge the lease payments to rent expense on a straight-line basis over the lease term.

Sale and Leaseback Transactions for Lessee

The new guidance prescribes two approaches for the lessee's recording of a sale and leaseback transaction. The treatment depends on whether the lease portion of the transaction is 1) an operating lease or 2) a finance lease.

Treat the Transaction as a Sale and Subsequent Lease if the Lease is an Operating Lease

Under the revenue recognition principle, a sale has occurred only if control has passed from the seller (lessee) to the buyer (lessor). In an operating lease, the control of the asset rests with the buyer/

continued on next page

Table 2. Companies Ranked by Total Operating Lease Obligation

Company	Lease Ranking	Operating Lease Obligations ($Million)
Walgreens	1	$33,721
AT&T	2	31,047
CVS Health	3	27,282
Wal-Mart Stores	4	17,910
FedEx Corporation	5	16,385
Bank of America Corp.	6	14,406
Verizon Communications	7	14,403
McDonald's	8	13,160
United Continental Holdings	9	13,000
Delta Air Lines	10	12,741
J.P. Morgan Chase & Co.	11	12,441
American Airlines	12	11,073
Citigroup	13	10,015
Whole Foods Market	14	8,902
Rite Aid	15	7,797
Home Depot	16	7,705
TJX	17	7,609
Aeropostale	18	7,446
Wells Fargo	19	7,055
Dollar General	20	6,627

lessor. Therefore, the seller/lessee (who has given up control) should record a sale of the asset along with any associated gain or loss on the sale and then record the operating lease in the normal manner. The seller/lessee removes the original asset account from the books and replaces it with a right-of-use asset and a lease liability. This approach can be used only if the lease portion of the transaction qualifies as an operating lease.

Treat the Transaction as a Loan (Failed Sale) if the Lease is a Finance Lease

If the lease portion of the sale and leaseback transaction is a finance lease, the seller/lessee retains control of the asset. If the seller/lessee "sells" the asset to the buyer/lessor who then "sells" it back, the seller/lessee effectively retains control over the use of the asset and there is really no sale at all under revenue recognition criteria. The "sale" portion of the transaction will not be treated as a sale and no gain or loss will be recorded.

Instead, the seller/lessee will treat the transaction as a loan from the buyer/lessor. The original asset remains on the books of the seller/lessee and the leaseback is accounted for as a loan. The lease payments are considered a repayment of the loan.

Transition

For public companies, the amendments in this update are effective for fiscal years beginning after Dec. 15, 2018. For other companies, the amendments are effective for fiscal years beginning after Dec. 15, 2019.

During the transition period, lessees and lessors are required to recognize and measure leases at the beginning of the earliest period of financial statements presented using a modified retrospective approach. FASB allows entities to elect a number of practical expedients. An entity that elects to apply the practical expedients will continue to account for leases that commence before the effective date in accordance with previous GAAP, except that lessees are required to recognize a right-of-use asset and a lease liability for all operating leases based on the present value of the remaining minimum rental payments under the previous GAAP.

This requirement to recognize the right-of-use asset and lease liability is expected to have a large impact on the balance sheets of companies with extensive operating lease commitments.

Impact

Impact on Accounting Systems and Processes

FASB relied heavily on feedback from its stakeholders in making the decision to retain a dual-lease model that uses a lease classification approach similar to previous GAAP. As a result, lessor accounting for sales-type and operating leases and lessee accounting for finance leases are substantially unchanged from previous GAAP. Lessors and lessees with these types of leases will likely not need to make substantial changes to existing accounting systems and processes.

For lessees with operating leases, however, the impact will be significant and companies should begin implementation efforts now (Tysiac, 2017). For example, lessees with operating leases may need to refine internal controls and other business processes, update information technology systems, determine whether the addition of lease liabilities to the balance sheet impacts debt covenants and assess the impact on income taxes.

Impact on Comprehensive Statement of Income and Statement of Cash Flows

The effect of the new lease guidance in the statement of comprehensive income and the statement of cash flows will be substantially the same as in previous GAAP for both the lessor and lessee. The lessor will classify lease payments received on all leases as operating activities, because leasing is generally part of a lessor's revenue-generating activities. The lessee will classify cash repayments of the principal portion of the lease liability for finance leases as financing activities and cash paid for interest as operating activities. Lessee cash flows from operating leases will be classified as operating activities.

Impact on Lessee Balance Sheet

The primary improvement and the primary impact of the new lease guidance is the recognition of lease assets and lease liabilities for operating leases. According to FASB Vice Chairman James Kroeker, the total future cash obligations, undiscounted, from off-balance sheet operating leases are somewhere "north of $1 trillion" (Burkholder, 2016). According to IASB, listed companies around

"THE PRIMARY IMPROVEMENT AND THE PRIMARY IMPACT OF THE NEW LEASE GUIDANCE IS THE RECOGNITION OF LEASE ASSETS AND LEASE LIABILITIES FOR OPERATING LEASES."

the world have around $3.3 trillion of leasing commitments, over 85 percent of which do not appear on their balance sheet (IASB, 2016). Table 2 contains a list of the top 20 companies, ranked by their total operating lease obligations (Burkholder, 2016).

Implementation Tips

There is a wealth of advice on implementing the new standard (Deloitte, 2016; Lease Accelerator, 2016; PricewaterhouseCoopers, 2017; Tysiac, 2017; Vollmer, 2017). For example, these tips are offered by Ernst & Young (2016):

1. Enhance understanding of the new standards and raise internal awareness. Set up training sessions and share insights.
2. Establish a cross-functional project team. Include all business functions that can contribute to the project or be impacted by the changes required to adopt the new standards.
3. Inventory lease types across the business.
4. Assess the current accounting and reporting policies, processes, technology and internal controls.
5. Develop an initial implementation plan, and evaluate synergies and interdependencies.
6. Make accounting policy elections. Define and adopt updated accounting policies to comply with the new standards.
7. Determine transition date. Evaluate whether there are any benefits of early adoption and confirm date of adoption.
8. Perform an impact assessment. Evaluate the magnitude of impact the changes will have from a financial statement and business perspective. Advise the board and audit committee on how the new standards will impact financial metrics.
9. Finalize the transition plan and budget. Confirm commitment of the required resources to meet the required timeline.
10. Communicate to key stakeholders. Identify key stakeholders, including the board, analysts, regulators and other capital providers, and communicate the effects of the new standard.

While the effective date for the new lease standard is still several months away, companies should begin planning now to ensure a smooth transition to the new lease guidance. ■

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Footnotes

1. A direct-financing lease involves a leasing arrangement that includes a residual value guaranteed by a third party. The direct-financing lease will not be examined in this article.

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By Jane N. Baldwin, Ph.D.

Understanding and Preparing for the New Lease Accounting Standard

1 What is the most significant change in the new lease accounting guidance?

- **A.** The requirement for the lessee to recognize on the balance sheet a right-of-use asset and liability for operating leases.
- **B.** The new criteria for distinguishing operating and finance leases.
- **C.** The new reporting requirements for the lessor.
- **D.** There are no significant changes.

2 What is the emphasis of FASB's guidance on lease accounting?

- **A.** The amount of the consideration given in the leasing arrangement.
- **B.** The presence of a contract.
- **C.** The type of asset involved in the leasing arrangement.
- **D.** The right to control the use of the asset.

3 What types of leases are possible for the lessee?

- **A.** Operating and finance.
- **B.** Operating and direct financing.
- **C.** Operating, finance and sales-type.
- **D.** Operating, sales-type and direct financing.

4 Which of the following is not a criterion for classifying leases?

- **A.** The lease transfers ownership of the underlying asset to the lessee by the end of the lease term.
- **B.** The lease grants the lessee an option to purchase the underlying asset that the lessee is reasonably certain to exercise.
- **C.** The underlying asset is of such a specialized nature that it is expected to have no alternative use to the lessor at the end of the lease term.
- **D.** The lease term is for a period that exceeds 10 years.

5 One of the criterion for classifying leases is that the lease term is for the "major part" of the remaining economic life of the underlying asset. In its implementation guidance, FASB indicates that a reasonable measure of "major part" is:

- **A.** 50% or greater of the remaining economic life of an underlying asset.
- **B.** 60% or greater of the remaining economic life of an underlying asset.
- **C.** 75% or greater of the remaining economic life of an underlying asset.
- **D.** 90% or greater of the remaining economic life of an underlying asset.

6 Which of the following is not true for finance leases?

- **A.** The lease meets one or more of the five criteria for classifying a lease.
- **B.** The right-of-use asset and liability are initially measured at the present value of the lease payments.
- **C.** The lessee recognizes interest on the lease liability separately from amortization of the right-of-use asset.
- **D.** All of the above are true.

7 A primary distinction between an operating lease and a finance lease is the treatment of the interest expense and amortization expense. Which of the following is not true regarding the interest expense and amortization expense?

- **A.** For the operating lease, the combination of interest expense and amortization expense results in a straight-line lease expense.
- **B.** For the finance lease, the interest expense decreases over the lease term and the amortization expense is straight-line.
- **C.** The treatment of lease expense for the operating lease under the new GAAP is consistent with its treatment under the previous GAAP.
- **D.** Early in the lease term, the operating lease model reports a larger amount of total expense compared to the finance lease.

8 For which type of lease is the lessee allowed to elect to charge the lease payments to rent expense over the lease term?

- **A.** Operating
- **B.** Finance
- **C.** Short-term
- **D.** Sales-type

9 For public companies, when are the amendments in the lease update effective?

- **A.** Fiscal years beginning after Dec. 15, 2018
- **B.** Fiscal years beginning after Dec. 15, 2019
- **C.** Fiscal years beginning after Dec. 15, 2020
- **D.** Fiscal years beginning after Dec. 15, 2021

10 For which type of lease is the impact on accounting systems and processes most significant and implementation efforts most urgent?

- **A.** Sales-type lease
- **B.** Finance lease
- **C.** Operating lease for the lessee
- **D.** Operating lease for the lessor

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