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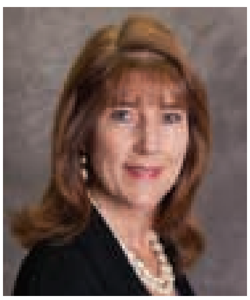
Business and Industry CPAs: Maintaining Your Competitive Edge

By **Allyson Baumeister**, CPA | 2015-2016 TSCPA Chairman and **John Sharbaugh**, CAE | TSCPA Executive Director/CEO

TSCPA is committed to delivering high-quality programs and services to meet the ever-evolving professional demands of our members. CPAs who work in business, industry, government and education have unique needs, and members can turn to TSCPA for resources to assist them in career advancement and getting the job done. We would like to highlight some of the activities and programs that have focused on business and industry members over the past year.



The month of April 2015 was designated as business and industry (B&I) month, with a theme of "Be a Part of Something Bigger Than Yourself." TSCPA promoted that every member makes the organization and the profession stronger. Members help TSCPA build a first-rate professional organization, and TSCPA helps members build a career. Efforts supporting B&I month included sending a brochure to all B&I members promoting member value, resources and upcoming education; launching a recruitment campaign; profiling members on the B&I LinkedIn page; a video focusing on membership value and benefits; and more.

In conjunction with B&I month, TSCPA hosted CFO panels in the five large chapters of Austin, Dallas, Fort Worth, Houston, and San Antonio. The events featured one hour of CPE, followed by an hour of networking. AICPA's **Barry Payne**, CA, and **Ash Noah**, CPA, CGMA, facilitated the panels on business partnering.

The upcoming B&I month this April will feature a theme that recognizes TSCPA's 100th anniversary. Activities are planned for the month, including 100 profiles of B&I members throughout the state.

TSCPA member **Bill Schneider**, CPA-Dallas, continued authoring the *Industry Issues* blog. Schneider is the chairman of TSCPA's Business & Industry Committee, and he shares his thoughts on critical issues and opportunities facing the profession. Over the past year, the blog featured guest bloggers from TSCPA chapters who shared their unique perspectives concerning industry issues.

The Society continued working with AICPA to encourage members to acquire and maintain the Chartered Global Management Accountant (CGMA) designation. AICPA and the Chartered Institute of Management Accountants (CIMA) created the CGMA designation for CPAs who work in business, industry and government. Designation holders have access to an exclusive suite of benefits.

AICPA Council recently voted to expand the availability of the CGMA designation in the U.S. to qualified non-CPAs who satisfy education, examination and experience requirements set by the AICPA Board. They will also be non-voting associate members of AICPA and subject to the AICPA Code of Conduct and applicable bylaws. AICPA will be establishing a new partnership model for state societies, to recruit this new non-CPA market for the CGMA. At the Midyear Board of Directors meeting in January, the TSCPA Board of Directors adopted a resolution of support for the expansion of the joint venture between AICPA and CIMA. To learn more about the joint venture and TSCPA's support, please see the article on page 17 of this *Today's CPA* issue.

AICPA also recently launched a new program called the CGMA Champions Program to build awareness of the CGMA designation and exam. Participants in this program will be given complimentary access to multiple learning and exam-prep resources, including CPE hours, the exam fee and member dues for the first year. In return, participants will give feedback about the process and share the value of the designation with other professionals. For additional information about the program, visit the website at www.cgma.org/champions or contact TSCPA's Rori Shaw at rshaw@tscpa.net.

The Business & Industry Center on TSCPA's website keeps members updated on professional news, relevant CPE, research information and more, as well as providing a connection with other B&I members. TSCPA also keeps members informed through the B&I E-ssentials newsletter, the Viewpoint e-newsletter, *Today's CPA* magazine, and various social media channels. A series of member profiles titled "A Day in the Life" is posted on the B&I LinkedIn page and in the B&I Center, and is featured in the B&I E-ssentials newsletter. Each profile explores a "normal" day of one of TSCPA's B&I members.

Opportunities to network and learn are offered through the Society's behind-the-scenes events. Fort Worth B&I members participated in Behind the Scenes with BNSF Railway Network Operating Center last April and Central Texas B&I members participated in Behind the Scenes with McLane Stadium last May. TSCPA is working to set up similar events in the Houston, Austin and Permian Basin chapters.

CPAs in business and industry work for a myriad of companies and organizations. Members in business and industry can look to TSCPA to give them access to the people, education and resources to grow in all the aspects of their role as a trusted strategic business partner. Take advantage of all that TSCPA has to offer by visiting the website at tscpa.org or contacting your chapter.

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The Evolution of Partnerships and Partnership Audits

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

Major changes are on the way for the partnership tax audit rules. The recently enacted Bipartisan Budget Act of 2015 (BBA), which will apply "to returns filed for partnership taxable years beginning after Dec. 31, 2017," is replacing the existing partnership audit framework with a new "streamlined" audit regime that is designed to allow the Internal Revenue Service (IRS) to more easily audit partnerships. Much like its predecessor, the new regime marks an evolution in the approach to partnership audits that has been driven by changes in the use, structure and prevalence of partnerships, as well as the difficulties of auditing them.

The Evolution of Partnerships and the Struggle to Audit Them

The IRS has long struggled to efficiently audit partnerships – especially large partnerships – and there are many reasons why. The complexities of Subchapter K are one obvious factor, as is the increase in the number of sophisticated, multi-tiered partnership structures. The current Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) partnership audit rules have also played a major role in the struggle to effectively audit partnerships.

Partnership audits are extremely resource intensive and complicated. Statistically speaking, they do not provide the IRS with a particularly good return on investment. As a result, the IRS does not conduct many of them. In fact, TEFRA partnership audits account for only about one percent of the audits completed by the IRS's LB&I and SB/SE divisions (although they use up a substantially greater percentage of their resources).

Large partnerships, it turns out, are particularly unlikely to be audited, especially when compared to their corporate counterparts. For instance, in fiscal year 2012, the IRS audited only .08 percent of large partnerships while it audited 27.1 percent of large C corporations. In other words, while nearly one third of large corporations get audited, less than one out of 100 large partnerships does – and when one does, more than half the time it does not result in a change to the partnership's net income.

Perhaps it should come as no surprise, then, that taxpayers have increasingly shifted away from the C corporation form in favor of pass-through entities, such as partnerships. Between 2002 and 2012, for example, the number of businesses organized as partnerships increased from about 2.2 million to 3.4 million – a 55 percent jump. At the same time, the number of C corporations decreased from 1.9 million to 1.6 million. This shift has been prompted by a number of factors, including the rise of the limited liability company form, the check-the-box regulations and the repeal of the *General Utilities* doctrine.

The growth in the number of partnerships has been coupled with an even sharper increase in the number of large partnerships. Over roughly the same period, the number of large partnerships grew by more than 300 percent. According to government data, as of 2011, there were more than 10,000 partnerships with 100 or more direct and indirect partners and $100 million or more in assets. This increase was reinforced by an eye-popping jump in the number of partnerships with more than a million partners, which increased from 17 to 1,809 in just one year (between 2011 and 2012) largely due to the investment decisions of a small number of investment funds.

As this data indicates, partnerships are at the center of an increasing amount of economic activity and income. To that point, there are currently over $24 trillion of assets held in U.S. partnerships, and those partnerships are generating over $765 billion of net income annually. This economic reality has made the difficulty of auditing partnerships a very pressing policy issue, particularly in light of the growing number of large partnerships, which historically have posed the most significant challenges.

The Evolution of the Partnership Audit Rules

The current partnership audit framework was largely enacted as part of TEFRA, which was designed to combat the rise in the use of syndicated partnerships (primarily limited partnerships) that were being marketed to large numbers of taxpayers in the 1970s and 1980s as tax shelters.

Prior to TEFRA, the IRS was particularly ill-equipped to combat these syndicated partnerships. At that time, it was required to individually audit each partner of a partnership separately, rather than simply auditing the partnership directly and then passing the audit results on to its partners. This led to enormous inefficiencies, duplications of effort and inequities among partners. With the growth in the number and types of partnerships that took place in the years before TEFRA's enactment, one can easily see how this proved to be an unwieldy system.

The TEFRA partnership procedures were introduced to address those challenges by allowing the IRS to largely audit partners and partnerships at the entity level through a "unified" audit proceeding. Under TEFRA, adjustments made at the entity level then "flow through" to each partner. Where the adjustments result in an assessment, each partner is then assessed individually. It turns out, however, that while this system works well in theory, it often turns into a quagmire in practice, particularly where the IRS has to manually make "flow through" assessments to large numbers of partners. Indeed, in many instances where the IRS has actually made partnership adjustments through TEFRA, it has left millions of dollars on the table, because it failed to make the "flow through" assessments to the partners in a timely manner.

Enter the BBA, which brings a new audit philosophy that will replace the TEFRA framework. The BBA is designed to make it much easier for the IRS to audit partnerships, especially large partnerships, and to assess any resulting tax. As a general rule, under the BBA, the IRS will audit partnerships at the partnership level. But rather than being required to then track down individual partners and assess them, under the BBA the IRS will be able to simply assess the partnership itself. In other words, the BBA generally imposes entity-level liability, a concept that is somewhat at odds with the conduit treatment traditionally envisioned under Subchapter K.

What is more, this entity-level assessment is made to the partnership in the year of the adjustment, regardless of whether the partners are the same partners who existed during the audited year. In effect, generally those who are partners of the partnership when such an assessment is made will bear the economic burden of the assessment even though they may not have been partners during the year under audit. (The act does, however, provide an election that allows the partnership to pass down the liability to the former partners, but it must be affirmatively made.)

While the BBA generally imposes the new rules on all partnerships, certain partnerships may qualify to elect out of the new regime. A partnership may qualify to elect out of the regime if it has 100 or fewer partners, but only if those partners are individuals, C corporations, a foreign entity that would be treated as a C corporation if it were domestic, S corporations or estates of deceased partners. So, for example, if a partnership has another partnership as a partner, it will not be eligible to elect out. But where an eligible partnership does properly elect out of the new regime, the IRS will be required to audit at the partner level. In a sense, this will bring the rules applicable to many such entities full circle to where they were before TEFRA and will create two distinct audit regimes. In many ways, this will exacerbate current challenges, not solve them.

The Evolution to Come

The BBA marks an evolution in the partnership audit rules. It is designed to meet head-on the challenges posed by the marked growth in the use of partnerships and, in particular, large partnerships. However, while the new rules provide procedural simplifications that will make it easier for the IRS to audit large partnerships, they also leave many unanswered questions and much room for improvement. In that sense, the new rules, like their predecessor, will likely prove just another step in the evolution of partnership audits. ■

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The Leadership Continuum of Finance

By Mano Mahadeva, CPA, MBA | Column Editor

"Will lead all financial strategy and drive P&L" … "Partner with senior management" … "Scale the business" … "Drive significant growth" … "Develop the highest caliber talent" … "Drive accountability throughout the organization" … "Work collaboratively with external constituents to optimize capital structure, liquidity options and explore acquisitions" … "Instill a mindset across the company to deliver results" … "Drive improvement initiatives" … "Be a trusted partner" … "Create a self-motivated culture" … "Confidant" … "Communicator."

These words help describe the Wonder Woman or Superman in business, but they are true excerpts from position specifications describing what is being required of leaders in finance today. This is *quite* the change from finance executives who began their careers as bean counters, crunching numbers, preparing financial statements and managing budgets! These roles are becoming harder, more difficult to prepare for, with more responsibility, carrying a highly visible profile and a greater level of risk.

> "THE COMPLEXITY AND RAPIDLY EVOLVING NATURE OF THE GLOBAL ECONOMY HAVE CREATED ENORMOUS DEMAND FOR NEW LEADERSHIP MINDSETS, CAPABILITIES AND SKILLS."

Global economic challenges, financial crises and technological innovations over many years have been instrumental in reshaping these roles. As examples, during the 1990s, companies recruited finance leaders who excelled in strategic vision. This thinking lasted until the Enron situation in 2001, which then added a premium of integrity. The collapse of global financial markets in 2008 caused another shift, keying on specific qualities of restructuring, turnarounds and cost cutting. This resulted in divestitures of non-core assets, reductions of debt burdens and improved efficiencies, leading to lean companies with cash-rich balance sheets paving the way toward improving top-line growth. And traditional finance work that was transactional in nature became automated, outsourced or moved offshore, creating opportunities for professionals in finance to change focus to newer, critical areas of the business. The transformational success resulted in influential roles that are here to stay.

It is clear that the complexity and rapidly evolving nature of the global economy have created enormous demand for new leadership mindsets, capabilities and skills. But finding those motivated individuals who can operate at these levels has been a challenge for many. Poor choices of leadership have led to casualties. Those who have been successful in these roles are well compensated and difficult to pry away, as these individuals are also in jobs that challenge and satisfy them. They feel they are making meaningful contributions and working in tandem with the CEO to keep their organizations moving forward.

A robust pipeline of leaders is critical to driving strategy and growth so that companies may achieve their goals. However, few are ready to take on greater responsibilities and challenges, as there is a stark gap between the current states of reality versus the future state of aspirations toward driving performance. Plenty of resources have been allocated for developing leaders of the future, but many have fallen short due to "cookie cutter," one-size-fits-all programs or because those curriculums are not keeping pace with present-day business complexities.

Today, many have found that the traditional path of starting individuals in a transactional role with the goal of progressing them through the ranks is not an optimal strategy. It is no longer enough to be able to account for wealth; it is important to also have skills to create it. As a result, companies have taken radical approaches to developing their leadership pipeline. Many have invested in technology and automated time-consuming manual tasks to help free finance teams to play a more forward-looking role in the company by gathering and analyzing vital information for executives sooner. Some have future leaders moving in and out of the finance function and into line operations and different geographies, "walking in others' shoes" and exposing them to the stark realities of the front lines. Others are developing talent by training, encouraging and challenging their young superstars by giving them critical projects and the opportunity to learn by successes and failures. There are those working with executives on a one-on-one basis in areas such as information technology, human resources or in leadership, which typically fall outside of academic and professional training.

This pent-up demand provides a leadership opportunity for those who seek experiences beyond their technical finance duties. The horizon is unlimited for those who have the innate desire to learn, love challenges, and have the passion and energy to succeed. It also provides us with abilities to influence others for the greater good. Instead of waiting for others to help shape our way forward, we need to step forward and lead the way! ■

Mano Mahadeva, CPA is chief financial officer with Solis Health in Addison, Texas. He serves on the editorial board for TSCPA. Mahadeva can be reached at mmahadeva@solishealth.com.

FASB Amends Accounting and Reporting for Financial Instruments

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

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) have been working to improve the reporting for financial instruments since 2005. The main objective has been to provide financial statement users with a more timely and representative depiction of a company, institution or nonprofit organization's involvement in financial instruments, while reducing the complexity in accounting for these instruments.

FASB and IASB have taken different approaches, with IASB issuing IFRS 9, *Financial Instruments*, in 2013. However, the feedback received in 2010 on the exposure draft caused FASB to rethink its original proposals on impairment, recognition and measurement, and hedging.

Amendments of the New Recognition and Measurement Standard

On Nov. 11, 2015, FASB voted to go ahead with a final Accounting Standards Update (ASU), intended to improve and simplify the recognition and measurement of financial instruments. The new standard, ASU No. 2016-01 *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*, was issued Jan. 5, 2016. The main objective of this ASU is to provide users of financial statements with more decision-useful information by enhancing the reporting of financial instruments. Following are the highlights.

The first amendment to GAAP is to require equity investments, except those accounted for under the equity method, to be measured at fair value with changes in fair value to be recognized in net income. The ASU also requires enhanced disclosures about these investments.

The second amendment is to simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. This qualitative assessment is similar to the assessment for long-lived assets, goodwill and indefinite-lived intangible assets. When an assessment indicates impairment exists, an entity is required to measure the investment at fair value. This impairment assessment reduces the complexity of the guidance entities were supposed to follow before this ASU, reducing cost for the preparers of the financial statements.

The third amendment eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public entities.

The fourth amendment to U.S. Generally Accepted Accounting Principles (GAAP) eliminates the requirement for public entities to disclose the method and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. These eliminations reduce cost for the preparers while still providing adequate information to the users of the financial statements.

The fifth amendment to GAAP requires public entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. This is consistent with Topic 820, *Fair Value Measurement*. This change eliminates the entry price method previously used by some entities for disclosure purposes. This elimination increases comparability between fair values of financial instruments held by different entities and provides users more comparable information.

The sixth amendment requires all entities to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments.

The seventh amendment is to require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.

The last amendment clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

When the Amendments Will Be Effective

For public entities, the amendments in this ASU are effective for fiscal years beginning after Dec. 15, 2017, including the interim periods within those years. For all other entities, including nonprofit entities and employee benefit plans, the amendments in this ASU are effective for fiscal years beginning after Dec. 15, 2018, and the interim periods within fiscal years beginning after Dec. 15, 2019. All entities that are not public entities may elect to adopt the amendments along with the public entities on its requirement date.

Early application is permitted for the credit provision and the amendment that eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for not-public entities. All other early adoption is not permitted. For more information on this topic, visit fasb.org.

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Cybersecurity in Small Businesses and Nonprofit Organizations

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

Most small businesses are becoming painfully aware that their small size does not provide them immunity from the risk of a cyberattack. Today's sophisticated hackers can and will attack any target. A survey by the National Cyber Security Alliance (NCSA) found that 71 percent of security breaches target small businesses, and about 50 percent of small businesses have suffered from cyberattacks. The credit data provider Experian reported that 60 percent of small businesses go out of business six months after suffering a security breach. The Department of Commerce's National Institute of Standards and Technology study also found a sharp increase in hackers and adversaries targeting small businesses in the past two years.

Small businesses and nonprofit organizations are attractive to hackers, because they tend to have lax online security. While they understand the need for cybersecurity, many have not taken sufficient measures to protect against cyberattacks. Typically, they do not take the time to develop a contingency plan or response plan to cyberattacks, and do not have the resources to recover from an incident when it happens. A cybersecurity incident could shut down an entire network for many days until the problem is researched and fixed. A small business may not be able to withstand the loss of income, or have insurance that helps to defray those costs or any liabilities that might occur as a result of the breach. A highly public breach could also damage the business's brand and lead to long-term loss of income.

NCSA's research identified three major reasons hackers target small businesses:

- they are not well equipped to handle an attack due to lack of resources;
- their partnerships with larger businesses provide back-door access to a hacker's true targets;
- they do not effectively guard the information that hackers desire such as credit card credentials, intellectual property, personal information, etc.

Small businesses and nonprofit organizations are increasingly doing business online using cloud services for expense savings, but they do not always ensure that the services use strong encryption technology. This combination provides the hacker the opportunity to easily access sensitive data. Cloud computing enables today's small businesses and their employees to work from anywhere using multiple devices. They are able to transfer files using Dropbox, videoconference globally with Skype and other sites, and remotely access work from their smartphones and tablets. But some of them have learned painfully that the price for these collaborative benefits is the potential for a serious data security breach. If the small business or nonprofit organization has *Fortune 500* companies as customers, they provide an easy entry point to a much larger treasure trove of data.

Examples of such breaches are the incidents at Target and Home Depot where the hackers used the access of a relatively small vendor in the supply chain as the entry point to a major credit card data theft. As businesses turn to digital technologies for business solutions, the risk of a security breach continues to rise. For the last 11 years, the security of information technology (IT) and data has been rated as a top technology initiative in surveys conducted and published by the American Institute of CPAs (AICPA). In addition to concerns about the loss of data and sensitive information, the AICPA surveys identify controls for mobile devices and cloud computing as ongoing concerns.

Recommendations

Businesses of all sizes need to assume a state of compromise today so that they can avoid considerable costs from loss of data or stolen intellectual property, interruption to business operations and damage to the business's reputation. Studies have shown that a breach can increase customer churn by nearly 4 percent. All businesses need to assess their cybersecurity weaknesses so that they can develop a strategy to safeguard sensitive data. A basic question to ask: what is the most sensitive data for the business? A pharmaceutical company might have the formula for a new drug in a document that is securely stored on its hard drive, but the data has also been shared by the researchers via email without encryption. Similarly, government and nonprofit agencies have large troves of sensitive taxpayer data in their files that are loaded onto employees' laptops or flash drives for work reasons without encryption.

It is important to ask specific questions about how data is handled and transported, what media are used for data storage, where did the data originate, and who has been granted access to the networks. The data most valuable to a hacker may not reside in a business's own database, but it can provide access to their customers. Effective management of the risks requires businesses to understand these vulnerabilities.

Most small businesses do not invest in cybersecurity, due to their erroneous perception of such investment as a discretionary spending item and not as an essential defensive strategy for sustainability. Studies have shown that 89 percent of consumers avoid businesses that do not protect their online privacy, as evidenced by the sales decline at companies like Target and Home Depot. Business partners also require proof that their interests and privacy are protected. Adequate security has become a requirement for companies to collaborate or outsource work. Sixty percent of U.S. businesses have baseline standards that they expect their external partners, suppliers and vendors to meet.

While small businesses and nonprofit organizations may not have the resources and time to research the most appropriate cybersecurity tools, a "one-size-fits-all" approach to cybersecurity by installing the bestselling package is not the answer. They need to focus more on the consequences of a wide range of potential risk events and adopt new risk management strategies, and focus less on the probability of the events. The new threats from trends of globalization, rapid technological changes and re-alignment of economies are increasing volatility in the markets, and disrupting ideas about "black swan events;" i.e., low probability, high-impact events. Small businesses that view security breach events as "black swans" and do not change their risk management practices may face big risks to their desired future state and growth strategy. They will need to view risk management as a dynamic business enabler to move the organization forward, rather than a static structure.

To understand any cyberbreach event, the motivation of the attackers needs to be understood. In today's interconnected global marketplace, individuals have to entrust businesses with sensitive personal details on email, Facebook, text messages, etc., as well as financial details. Increasingly, businesses and individuals use cloud services for storage and transaction processing, which has helped commerce to grow exponentially, but has also provided increased gateways to launch cyberattacks. The majority of these attacks are low skill and low focus, with hackers sending spam mails out to millions of email addresses hoping that someone will click on the link. The low-skill, low-focus hackers who penetrate the networks of businesses do not care much about the individual entity, and they will move on to the next weaker prey if the business' security protocols are strong. By having strong protection of systems, businesses can defend themselves against most of the low-skill, low-focus attacks.

However, the high-skill, low-focus attacks such as the ones suffered by Target, Home Depot, Michaels, Neiman Marcus, JP Morgan Chase and other commercial networks are more serious. These were sophisticated attacks using newly discovered "zero-day" vulnerabilities in software, systems and networks. In these attacks, the opportunist attacker got access to a large database of credit card numbers by exploiting the cybersecurity weaknesses. All networks are vulnerable to attacks by a sufficiently skilled, funded and motivated attacker, but good security can make the attacks harder, costlier and riskier. Security is a combination of prevention (protection), detection and correction (response). Prevention can defend against low-focus attacks and make targeted attacks harder, and detection can spot the attackers. Having a planned response strategy will minimize the damage and manage the fallout.

Creating a culture of cybersecurity, having current security software and creating an emergency response plan for a data breach are good first steps toward long-term protection of a business's interests. Powerful new tools used by small businesses to reach new markets and increasing productivity and efficiency, such as broadband and cloud storage, also create a critical need for them to develop a cybersecurity framework to protect their business, customers and data from growing cybersecurity threats. Some specific steps to take are include the following.

Set the tone at the top and ensure that it is communicated across the organization. Assign a top executive to lead the charge, rally company employees, regularly update other managers, oversee IT activities, and ensure that all cybersecurity threats are reviewed and protective measures are implemented.

Define cybersecurity goals and outcomes. The security team should keep the cybersecurity goals and expected outcomes updated, and show metrics on the tangible impact on risk reduction in the key areas. Such metrics are important for demonstrating how information security aligns with the business goals.

Raise employee awareness. Employees must understand the importance of cybersecurity in protecting their customers, colleagues, intellectual property and valuable business relationships, and stay vigilant about the risks. The main reason for security breaches is lax security awareness among employees and basic problems, such as negligence in following procedures; e.g., leaving their passwords visible or not turning off their computers before going home. Raising security awareness can be done by simple measures like using office bulletin boards and weekly emails to remind employees of basic security precautions.

Establish security policies to protect sensitive business data and practices rules for handling and protecting sensitive customer information and other vital data. Communicate them to employees on a regular basis along with the penalties for violating the business policies. Ensure that human resources and audit personnel implement legally acceptable procedures to monitor for any abnormal patterns in the Internet usage and email habits of key employees who are leaving the firm involuntarily.

Plan disaster recovery procedures. Establish cross-functional security teams, including leaders from the IT, human resources, finance, risk and legal departments who meet regularly to discuss and coordinate information security issues. The team should develop a crisis response plan detailing immediate action in the event of a security breach and run simulation exercises. The plan should outline actions to identify and mitigate the damage, such as using a call tree for contacting law enforcement, stakeholders and the media. Scenario planning exercises for crises must be tested periodically for effectiveness. Since technology touches all areas of a business, recovery from cybersecurity incidents should be treated as both a technology and a business issue.

Make regular backup copies of important business data, including word processing documents, spreadsheets, databases, financial reports, human resources files and accounts receivable/payable files residing on all equipment used in the business.

Implement barriers like a cloud-based security application and teach employees to think critically about the potential impact of their online actions.

Install and maintain strong firewalls between the business's internal network and the Internet to prevent outsiders from accessing data on the business's private network. Ensure that all remote access from employees' home computers and laptops are protected by firewalls.

Establish policies and practices on Internet security in the workplace around issues like use of USB devices, social media and personal devices in the workplace.

Install software updates for all operating systems and applications automatically. Most vendors regularly provide patches and updates to their products to correct security problems and improve functionality.

Secure the Wi-Fi networks and use encryption so that passwords are required for access. Change the administrative passwords on all devices after purchase. Mask the Wi-Fi network by setting up the wireless access point or router to hide the network name (SSID).

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> **INTERNAL CONTROLS CAN STRENGTHEN COMPANIES' RESILIENCE AGAINST GAME-CHANGING RISKS.**

Perform due diligence on third-party security providers. Establish the standards up front, spell out the desired security level, ensure that it is included in the provider's performance contract, and test them periodically.

Control physical access to computers and network components. Prevent access or use of business computers by unauthorized individuals. Laptops and flash drives need to be "locked" when unattended.

Set up a separate account for each individual and require that strong passwords be used for each account. Administrative privileges should only be given to trusted IT staff and key personnel.

Establish rules about password practices, including regular change of passwords and acceptable websites to access from a business network. The FCC's Cybersecurity Hub at www.fcc.gov/cyberforsmallbiz has more information.

Limit employee access to data and information while considering best practices in internal control, such as segregation of duties. Employees should only be given access to the specific data systems that they need for their jobs. Limit authority to install software to specific employees with proper authorizations.

Install, use and regularly update antivirus and antispyware software on all computers used in the business to protect information, computers and networks from viruses, spyware and other malicious code. Set the antivirus software to automatically check and install updates at a scheduled time of low computer usage and do a scan. Use the latest versions of anti-spam software that can screen for vulnerable or malicious URLs and install patches as soon as they are available.

Be alert to new, affordable technologies and cybersecurity innovations that can deter attackers by quicker detection of intruders. Many vendors are developing tools to identify and circumvent zero-day threats (unknown and unpatched code flaws) before the hackers can exploit them. Such prevention and detection tools can make cybercrime less lucrative for criminals by forcing them to spend more in technology and attack capabilities.

Risk Management

Internal controls can strengthen companies' resilience against game-changing risks. However, many businesses do not have formal processes in place to assess and prepare for circumstances that can increase their reputational, competitive, legal or operational risks. Many cyberbreaches result from weak spots in the technology and lead to faulty decision-making processes that ignore potential business consequences of technology issues. The long-term viability of any business depends on timely, uninterrupted access to vital information and IT resources, and adopting a consequences-based approach to risk management brings more focus on resilience and less on expectations.

By conducting scenario tests, managers can test the business's reaction to crises. The scenario plans should review the entire value chain, including key vendors. More businesses are beginning to establish systems that monitor and alert when the probability of a particular scenario increases, setting up cross-functional crisis management teams and identify processes to quickly react to risks when they occur. Effective internal controls can help a business maintain and test the IT contingency and disaster recovery plans. Successful risk strategies must embed risk awareness throughout the business's culture.

SEC Disclosure Guidance and Internal Control

In the fall of 2011, the Securities and Exchange Commission's (SEC) Division of Corporation Finance issued enhanced financial statement disclosure guidance for public companies, which can serve as a blueprint for small businesses and nonprofit organizations. The guidance has led to a higher level of cybersecurity awareness, monitoring and scrutiny by SEC registrants (CF Disclosure Guidance: Topic 2, Oct. 13, 2011). It was issued in response to the increase in number and severity of cybersecurity incidents experienced by SEC registrants, and the new disclosure obligations focus on both potential cybersecurity risks and actual incidents. It recognized that cyberattacks can be caused by deliberate actions by outside hackers or unintended events by internal agents like employees, contractors and vendors. It provided examples of specific attacks, including unauthorized access to sensitive data, industrial espionage, sabotage of hardware and software, infection of hardware and software with malicious software, theft of computer time and other denial of service attacks, and theft of mobile devices.

The guidance is consistent with other disclosure requirements mandated by federal securities laws and suggests that disclosures should identify specific material cybersecurity risk factors, such as risks and costs associated with a registrant's operations, outsourcing activities, undetected risks for an extended period, risks that lead to increased insurance protection, as well as past years' material cybersecurity incidents. Additional information on actual cyberattack incidents must be disclosed with details on the nature, occurrence, potential cost and related consequences so that stakeholders can understand the risks faced by the registrant and its remediation efforts. The guidance acknowledged that registrants have provided additional resources by hiring and training internal security personnel, upgrading IT systems and hiring IT security consultants.

Recognizing the reluctance of businesses to disclose the details of security breaches that can harm their reputation, lead to litigation and expose vulnerabilities to competitors, and the difficulty in estimating costs of potential breaches, the SEC offered guidance on costs that should be considered, such as remedial costs, cybersecurity costs, regulatory fines, litigation costs, loss of customers and loss of investor confidence.

Auditors' Roles

Internal control audits are governed by Auditing Standard (AS) 5, *An Audit of Internal Control over Financial Reporting that is integrated with an Audit of Financial Statements*, which requires auditors to use a "top-down approach" beginning at the financial statement level to identify controls that present a "reasonable possibility" of material financial statement misstatement. The SEC guidance can be viewed as an expansion of the scope of the integrated audit of internal control over financial reporting and the financial statements that include IT controls.

The SEC disclosure guidance requires management to identify the costs and consequences of past and potential material cybersecurity incidents and risks in the management's discussion and analysis (MD&A) section of financial reports, including costs of litigation, prevention of cyberattacks, maintaining business relationships, loss of business and future cash flows, and impairment of goodwill and long-lived assets. Disclosures about the impact of cybersecurity risks on the business's information systems and integrity of financial reporting should be an essential part of management's assessment of internal controls and potential internal control deficiencies.

Internal and external auditors need to evaluate the adequacy of existing cybersecurity controls using complex, specialized models and sophisticated IT skills. Internal auditors need technical expertise to be able to analyze the data security risks, participate in selection of security systems, conduct security and disaster recovery audits to evaluate gaps, and monitor compliance with security procedures. External auditors need the skills necessary to understand and identify the client's computer security environment and critical controls, conduct security review, identify strengths and weaknesses in a client's security system, determine if financial statements are fairly and accurately presented, and report the audit findings, including recommendations for mitigating material weaknesses in the client's security environment to management.

Auditors cannot assume that cyberattacks are limited to large or high-tech companies, because businesses of all sizes and in all sectors are at risk of having customer credit card numbers and other personal information stolen. The auditors should consider the SEC's disclosure guidelines for registrants as a guide for small businesses and nonprofit organizations as well, and seek assistance from an external specialist, if needed. Information system auditors and security experts can be valuable sources of information on security risks and remedial modifications to internal control systems to bolster them and help businesses to provide expanded cybersecurity disclosures.

Beyond Protection

Many small businesses are realizing that in the increasingly sophisticated and interconnected global marketplace, investing in information security goes beyond protecting the business. Strong cybersecurity can position organizations for competitive advantage with their business partners and customers, as well as to allow them to take advantage of newer, affordable technologies to help their growth. Such technologies are offering stronger protections to detect intruders sooner and help businesses to implement preventive and corrective measures.

Internal and external auditors have significant roles to help and guide the small businesses and nonprofit organizations in their cybersecurity risk management. The progressive ones understand that volatility is inevitable and are rethinking their approach so that shocks to the system will not disrupt their strategy and future growth.

A culture of risk awareness throughout the business is a necessary platform for effective risk management. By adopting some of the recommended steps, small businesses and nonprofit organizations can be resilient and able to take calculated risks to pursue growth in the global marketplace. ■

Dr. Kamala Raghavan, CPA, CFF, CGMA, CFP is a graduate faculty member at Texas Southern University in Houston, Texas.

Chapter Presidents Discuss Business, Industry and Education Careers

By Rhonda Ledbetter | TSCPA Chapter Relations Representative

In this issue, we spotlight the current chapter presidents who work in areas other than public practice. They are in widely varied fields: one is in the finance department of a privately held company providing industrial construction services, one owns an accountant recruiting firm and one is a faculty member in the school of business at a large public university.

Those participating are, in alphabetical order by last name:
Art Agulnek, CPA-Dallas;
Mark Goldman, CPA-San Antonio; and
Jeff Smith, CPA-Corpus Christi.

Art Agulnek
CPA-Dallas

Mark Goldman
CPA-San Antonio

Jeff Smith
CPA-Corpus Christi

CPA Career, Job Responsibilities

Along the way, they have gathered a wealth of knowledge through:

- public accounting at a very small firm;
- contract work for the Resolution Trust Corporation after the savings and loan crisis of the 1980s;
- the accounting department at a company that operates convenience stores; and
- a Big Four firm, with extensive international travel.

In addition to developing their work skills, they had other experiences that shaped their careers. One person stated that his first accounting job was working for his father's CPA firm, starting in high school. By the time he was in college, he was working directly with clients. He left his principles of accounting II class early one day to accompany one to the bank and help complete an application for a line of credit. He felt odd being 20 years old, working with the banker as an equal professional. But the visit was a success.

There was also the shirt-and-tie lesson. Early in his career, one of our story participants had to personally deliver some financial information back to a client's office. Because it was a quick trip, the CPA hadn't dressed for the occasion and was still wearing a t-shirt and jeans. The client didn't say a word, but the young accountant could feel the awkwardness of the moment. He resolved that would be the last time he wouldn't dress professionally for work, no matter how short the day was going to be for him.

One adventure involved a staff member's trip to an African nation that started smoothly enough. However, while he was there, a revolution erupted and the airport was closed, leaving him stuck for a week. Another adventure, in a developing nation, resulted from taking a cab (despite repeated warnings not to do so) when the prearranged driver didn't show up to go to the airport. They careened down dark, narrow streets, with the CPA terrified it was his last ride on this Earth. He was so happy to get to the airport that he gave the driver an extra $50 ... not knowing that giving the U.S. money violated the country's currency exchange rules and could have subjected him to spending time in jail.

Discussion included variations upon a busy season. At the company in industry, it's the beginning of January for calendar year-end processing. The end of the fiscal year brings a crunch for the financial reporting. For accounting recruiting, the busiest seasons are January-April for hiring in industry and October-December for public accounting. Work compression comes during December and May at universities. Final papers are due, and exams must be prepared and graded.

Work/Volunteer Skills and Chapter Involvement

The conversation turned to the skills that have helped in the volunteer arena. Learning to think like a leader rather than simply a member was cited. Another explained that being involved in a small company provides an opportunity to be involved in all aspects of corporate accounting. Having those different perspectives enables leaders to look at issues from several angles rather than having only one perspective.

Chapter involvement came in a variety of ways. One person started by volunteering for the committee promoting involvement in education. That led to chairing the committee, then service on the chapter board, then positions at the state level of TSCPA before being tapped as president. Another began by attending member involvement committee meetings, a springboard for participation in the chapter. He took on additional responsibility in holiday season toy collection efforts and moved up to co-chairing the committee. That led to the chairmanship of another committee and then election to the chapter board.

Career Rewards and Challenges

Participants talked about the most rewarding part of their career. Smith enjoys being able to work with both entry- and upper-level

accountants, which in turn adds to his own knowledge. He also enjoys facing new challenges in an evolving business environment. Goldman feels that recruiting is a combination of human resources consulting and business development activity. He helps employers accomplish more by filling positions and helps professionals find fulfilling jobs in the process. Agulnek explains that, at a multinational firm, he traveled around the globe. He finds satisfaction in leveraging that during classroom discussions about opportunities in the CPA world. He also relishes mentoring students and providing career guidance through the internship program.

Like other professionals, those in the group face career challenges. There is never a perfect balance to supply and demand in accounting. At times, there aren't enough people to fill the jobs and at others there aren't enough jobs for the qualified candidates. Another hurdle is keeping up with changes brought about by advances in the technologies that provide easy access to a global market. It requires frequently updating software and hardware to improve efficiency and dealing in a global marketplace rather than a small-scale market.

The Next 10 Years for CPAs Working in Industry

Looking ahead, data analytics was specified as the big thing in the next 10 years that will be a game-changer for CPAs working in industry. So much work on developing trends and consumer preferences is in progress, and so much can be done with the data that business has never had the opportunity to do before. It will be a big hill for CPAs to climb.

Another said that the biggest challenge will be the same for CPAs working in industry and those working in public accounting: the difference in work expectations between those nearing retirement and those who have recently entered the workforce. Most in the millennial generation have a different view of what a successful career and a successful life look like, as compared to older generations. Flourishing businesses must adapt their work culture. Those that do will be in a better position to compete for talent and, therefore, will have a better chance of thriving in the marketplace.

The third challenge is the turbulent environment arising from uncertainty regarding reporting standards. What will they be in 10 years? What information will no longer be necessary or will not be as important as it is today, and what will explode out of nowhere? What outside influences will change the focus of tomorrow's CPAs in business and industry?

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. Agulnek explained: "We start with the fact that the CPA certificate makes them more valuable in the marketplace. Then, when I talk to my classes about what employers look for during the hiring process, I tell them it's about more than grades – it's 'what have you done to become a leader.' I urge them to choose the company they're most comfortable with, not just the one with the highest pay. Find one where you can connect with the people in your interviews." He added: "Then give yourself a two-year period and get some experience. See what you enjoy doing and focus on that."

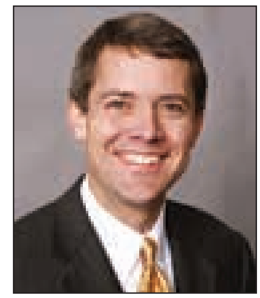
Goldman's advice was: "Decide very early that you are going to become a CPA. Don't look at your bachelor's or master's degree as the finish line. Instead, decide that it's when you complete your CPA certification. The cruel irony about the CPA certificate and your career is that the time when it is easiest to pass the exam, right after you have graduated, is also the time when it might seem to mean the least in terms of your career advancement." He continued: "As you proceed a few years into your career, then being a CPA has much more impact on your potential to advance; yet this is when it becomes much harder to pass the exam, because the information is not quite as fresh in our minds and we have developed a niche in one field or another. Make a conscious choice very early that passing the exam is the only option."

Smith suggested: "Make an effort to network with your peers in school, your professors and CPAs in several fields. Ask questions and talk with the 'veterans' about their experiences. Have an open mind and consider a variety of paths for an accounting career rather than focusing on only one. Participating in internships with CPAs, at different types of employers, is a great way to get a close-up look at what it would be like to focus in those areas down the road. Be prepared to work hard … but be sure to enjoy what you do." He closed with: "Be involved in your TSCPA chapter! Look at the activities and find a way to expand your network by participating."

Reel Life

Past Society Chairman Combines National Volunteerism With Family Sport

"TOOK TWO HOURS TO REEL IT IN. THE WHOLE FAMILY ENDED UP HAVING TO HELP, BUT THE GIRLS DID THE MOST. I ADMIT, I WAS SO EXCITED..."



By Anne McDonald Davis

There's a rather fun story behind how AICPA's Fall Council meeting last October opened with a photo of an 11-foot blue marlin on the meeting screen. But first, we'll need to catch up with **Willie Hornberger**, CPA-Dallas, and TSCPA's 2013-14 chairman. What's he been up to since his big service year with TSCPA?

"Time has just flown, hasn't it?" smiles Hornberger, who balances a busy tax law practice at Jackson Walker with his passionate involvement at *Avance* Dallas, an organization that offers crucial educational opportunities to disadvantaged parents and children. However, first on his list of priorities is his own family: wife, Gigi, and their three kids – Claire, now 17; Allie, now a sophomore at Baylor; and Jake, now a senior at A&M.

He reports that the Hornbergers remain a "Texas hunting and fishing family," which has included expeditions to Port Aransas several times a year. "These have been my father-son or father-daughter trips," he explains. "I started each of them out when they were about three, fishing for perch in the little park near our house. Gigi's not much for fishing, but she loves that this is my time with 'just them.'"

Hornberger highly recommends getting one's offspring off somewhere like a boat where there is not much to do for hours but open up and talk. "There's also nothing more fun than watching your kid catch their first fish," he enthuses, adding "and sports like this foster confidence. It's a memorable experience ... getting up in the early hours, spending that time together."

The family fishing zeal resulted in Jake becoming Texas Parks and Wildlife's first Junior Elite Fisherman, which involved the youngster catching five designated species within a specified time frame.

The Hornberger girls were not about to be outdone, as they proved last fall in conjunction with that AICPA gathering we were discussing earlier. As it turns out, the meeting destination was Maui, Hawaii, and there just happened to be a deep sea fishing boat available one afternoon. Hornberger agreed to take the family out, but warned his ambitious daughters that there were many serious sports fishermen who routinely invested thousands of dollars and many long days trying to catch the big one – with zero results.

"An hour before the trip was to be over, they hooked it," Hornberger grins ruefully. "Took two hours to reel it in. The whole family ended up having to help, but the girls did the most. I admit, I was so excited ... I could hardly stand it. I think we used 400 yards of line. Kind of a great illustration of a family pulling together!"

Thus it was that this particular AICPA meeting encompassed what is traditionally referred to as "a big fish story." This one happens to be true.

P.S. For the present, the blue marlin trophy will reside in Hornberger's office. Someday, Claire and/or Allie may claim their rights ... but Gigi says whoever gets it, it's not coming in the house.

AICPA Proposes Expanding Joint Venture with CIMA

The American Institute of CPAs (AICPA) and TSCPA are working on a variety of programs and initiatives to enhance the relevancy of the CPA profession far into the future. In response to the needs of CPAs working in management accounting, AICPA formed a joint venture with the Chartered Institute of Management Accountants (CIMA). Founded in 1919, CIMA is the world's leading and largest professional body of management accountants.

AICPA and CIMA created the Chartered Global Management Accountant (CGMA) designation in January 2012. This international designation recognizes management accountants worldwide and provides them with a suite of valuable resources and benefits.

Last October, AICPA Council voted to expand the availability of the CGMA credential in the U.S. to qualified non-CPAs who satisfy education, examination and experience requirements set by the AICPA Board. Under the proposal, AICPA and CIMA would join forces to create a new accounting association, while continuing to operate with their current membership bodies. The non-CPA CGMAs would be non-voting associate members of AICPA and subject to the AICPA Code of Conduct and applicable bylaws.

Why form the new association? As part of its strategic planning process, AICPA has assessed current trends and future challenges. There is a growing worldwide talent shortage and associated demand for high levels of specialized knowledge and services. Despite a decade of success in increasing the number of accounting majors, the number of accounting graduates bypassing the exam has increased. Only about one in three accounting graduates becomes a CPA. Many accounting graduates are going directly to work in business and industry. In addition, significant demographic and generational shifts are taking place, as well as an overall trend toward more international connectedness and interdependencies.

Impact on TSCPA

As part of the joint venture, AICPA will be establishing a new partnership model for state societies to recruit this new non-CPA market for the CGMA. States will have an opportunity to work on a 50/50 basis to recruit these individuals, and a national dues rate will be established that will be equally shared between AICPA and participating state societies. Recruitment of these new CGMA members will begin in 2017.

At the TSCPA Midyear Board of Directors meeting in January, the Board members discussed whether TSCPA should participate with AICPA in the effort to recruit non-CPA CGMAs with AICPA. Following the discussion, the Board adopted a resolution of support for the expansion of the joint venture between AICPA and CIMA. As of press time, 49 other state CPA societies had adopted resolutions of support.

"TSCPA IS SUPPORTIVE OF THE DIRECTION THE AICPA BOARD IS RECOMMENDING."

The TSCPA Board of Directors also approved a new affiliate member category – the Non-CPA CGMA Affiliate, which is defined as a non-CPA who holds the CGMA designation in good standing. The affiliate membership would terminate if the individual no longer holds the CGMA designation. This category will complement other current non-CPA affiliate membership categories at TSCPA for non-CPA employees and non-CPA academics. TSCPA affiliate members are prohibited by state law and TSCPA policy from implying or representing themselves as CPAs. The dues for a non-CPA CGMA affiliate will be established on a uniform, national basis by AICPA, and TSCPA will receive 50 percent of the established national dues rate.

TSCPA's 2015-2016 Chairman **Allyson Baumeister**, CPA-Fort Worth, said: "TSCPA is supportive of the direction the AICPA Board is recommending. The changes the profession faces are greater than ever. To preserve our relevance and stature, we need to consider innovative ways to better anticipate, reflect and lead. The proposal would bring together the entire accounting profession and extend the influence of CPAs in the United States."

What's Next

AICPA is seeking insight and feedback from members regarding their support of the proposal. Moving forward would require a vote by members, and a super-majority of those voting would need to approve it. AICPA's Council will be asked to authorize a member ballot in March, with a vote of members following tax season. The ballot would be open for voting by AICPA members for a 90-day period. CIMA has a similar requirement and timeline.

Members are encouraged to visit aicpa.org/horizons to learn more about the proposal and provide feedback. AICPA and TSCPA will continue to provide updates throughout the process.

TSCPA Midyear Board of Directors Meeting

TSCPA's 2015-2016 Chairman Allyson Baumeister, CPA-Fort Worth.

Larry Edgerton, CPA-Permian Basin; TSCPA's Executive Director/CEO John Sharbaugh, CAE; Gary McIntosh, CPA-Austin; and AICPA's Senior Vice President Arleen Thomas, CPA.

By Rhonda Ledbetter, Chapter Relations Representative

Members of the TSCPA Board of Directors met in El Paso Jan. 29-30 to conduct Society business and obtain profession information.

Chairman's Report

Chairman **Allyson Baumeister**, CPA-Fort Worth, summarized progress on the organization's projects during the 2015-2016 fiscal year to date. She said that membership statistics represent a big success. There was growth of almost 4 percent at the beginning of the fiscal year, for a total of almost 28,000 members. It was due in large part to the new automatic free membership program. Chapters have been doing an excellent job of engaging these new CPAs locally, and TSCPA is closely watching the renewal rates for these new members.

As part of a continuing focus on increasing diversity and inclusiveness in the profession, the Executive Board met with representatives from the National Association of Black Accountants, the Association of Latino Professionals in Finance and Accounting, and Ascend, the organization for Pan Asian business professionals.

TSCPA uses several social media channels to increase brand awareness and connect with members, as well as to connect members with each other.

The CPE Foundation has been taking a fresh look at how to provide timely, quality and convenient education. Six CPE conferences were webcast in 2015, giving members the option of attending live or watching from virtually anywhere. In response to a report from the Department of Labor regarding audits of employee benefit plans, a task force was formed to plan a new conference. The CPE Advisory Board sent a comment letter to the National Association of State Boards of Accountancy and American Institute of CPAs (AICPA) regarding an exposure draft of recommended changes to CPE standards.

In November, AICPA's Peer Review Board released an exposure draft, *Improving Transparency and Effectiveness of Peer Review*. It includes several proposed changes. An AICPA resolution hotline has been established to help resolve disagreements between reviewed firms and reviewers.

The Young CPAs and Emerging Professionals (YEP) Committee created TSCPA's first CPA Day of Service in 2015. With the support of chapters and members' employers, hundreds of volunteers helped their communities. To grow the project, the committee is expanding it into a month of service and moving it to November.

CPA 100th Anniversary

The anniversary of TSCPA's founding was observed in Fort Worth at the end of October. The celebration included a YEP Conference, where all CPA members could obtain eight hours of free CPE live or via webcast. There was also a special reception at a downtown rooftop terrace.

Read the "Year in Review" article in the upcoming May/June issue of *Today's CPA* for details about TSCPA's achievements on behalf of members.

AICPA Update and New Joint Venture with CIMA

Senior Vice President **Arleen Thomas**, CPA, discussed the CPA pipeline and the evolving accounting profession. She highlighted AICPA initiatives to grow, promote and protect the CPA and core of the profession.

She then provided an overview of AICPA's proposal to expand its joint venture with the Chartered Institute of Management Accountants (CIMA). AICPA and CIMA created the Chartered Global Management Accountant (CGMA) designation in 2012 for CPAs who work in management accounting. Last October, AICPA Council voted to expand the availability of the CGMA credential in the U.S. to qualified non-CPAs and under the proposal, AICPA and CIMA would join forces to create a new accounting association. At the TSCPA Midyear Board of Directors meeting, the Board adopted a resolution of support for the expansion of this joint venture. The Board also approved a new affiliate member category, the Non-CPA CGMA Affiliate, which is defined as a non-CPA who holds the CGMA designation in good standing.

The Non-CPA CGMA category will complement other current non-CPA affiliate membership categories at TSCPA for non-CPA employees and non-CPA academics. Please see page 17 of this *Today's CPA* issue for more information on the new joint venture.

Janelle Jones, CPA-Houston, and Kathy Kapka, CPA-East Texas.

Larry Folwell, CPA-Abilene; Julie Folwell, CPA-Abilene; and Olivia Riley, CPA-Austin.

Dallas Chapter members Lisa Ong, CPA, and Jose Luna, CPA.

CEO Report

TSCPA's Executive Director/CEO, **John Sharbaugh**, CAE, shared a glimpse into the future and how it will affect the accounting profession. He explained that we live in "exponential times," a difficult concept for many to grasp, because we were taught to think in a linear way. He offered perspective on populations around the globe, job holders, number of Internet devices, disintermediation and the explosion in human knowledge. Four major trends affecting the future are: demographic, social, economic and technology.

We are living in the Shift Age, the successor to the Information Age. The three key forces are: the flow to global, the flow to individual and accelerating electronic connectedness. In our broadband world, the number of mobile computing devices sold is far outpacing non-mobile ones. The CPA Horizons Project looked to the future of accounting. CPAs rated the top three trend domains as a high priority to be ready: the changing workforce, change management and innovation.

Few CPA firms are prepared to take advantage of the emerging trends, such as increased focus on client services and talent management. Small businesses want CPAs who collaborate, are a strategic partner, specialize in their industry and can work anywhere via technology.

Birth trends will affect CPAs, as well as every other profession. The college class of 2025 could be the largest ever. And the individuals in it will represent more diversity.

Tomorrow's digital finance organization was examined. Finance will be an insight engine for companies and will be composed of three key elements: analytics competency centers, integrated business services, and communications and control centers. To thrive, CPAs must be open to change. They must be nimble, collaborative and forward-thinking. Skills needed for the future are:

- Being tech savvy – able to utilize and leverage technology in ways that add value to clients, customers and employers;
- Leadership – able to influence, inspire and motivate others to achieve results;
- Communications – able to give and exchange information within meaningful context and with appropriate delivery and interpersonal skills;
- Strategic/Critical Thinking and Anticipation – able to link data, knowledge and insight together to provide quality advice for strategic decision making;
- Integration and collaboration and synthesis – able to engage others and work across boundaries to turn challenges into opportunities, including the ability to consider the whole picture (past, present and future context) and create alternatives and options for the future.

Engaging the Next Generation of CPAs

Dan Griffiths, director of strategic planning at Tanner LLC, led an interactive session on strategies for getting young workers engaged and productive. As with every generation entering the workforce, the Millennial generation brings a different set of expectations and challenges.

They look for meaning in their work and want to make a difference. They are drawn to companies that build philanthropy into their business model. Looking for authenticity and trustworthiness, they can quickly tell whether the truth is being told.

Innovation is a must. A static business model might be setting up tension between them and older work generations. CPA firms should move beyond tweaks to a wholesale revision of their value proposition.

Growth and development are important. Characteristics that differentiate great performers are:

- deep domain knowledge;
- willingness to retry difficult projects, even after initial failures;
- pushing themselves just beyond their current capabilities.

The best performers set goals that are not just about the outcome, but about the process of reaching the outcome.

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Figure 1. TSCPA Leaders for 2016-17

Terms begin June 1, 2016

Chairman-elect: *(Chairman in 2017-2018)*
Jim Oliver *(San Antonio)*

Treasurer-elect: *(Treasurer in 2017-2018)*
Jerry Spence *(Corpus Christi)*

Secretary: *(Beginning June 2016 and expiring May 2017)*
Janelle Jones *(Houston)*

Executive Board (Three-Year Term):
(Beginning June 2016 and expiring May 2019)
Tom DeGeorgio *(Houston)*
Jason Freeman *(Dallas)*

Director-at-Large (Three-Year Term):
(Beginning June 2016 and expiring May 2019)
Katy Avenson *(Austin)*
Leroy Bolt *(Abilene)*
David Colmenero *(Dallas)*
Travis Garmon *(San Angelo)*
Tram Le *(Fort Worth)*
Stephen Parker *(Houston)*
Ben Peña *(Rio Grande Valley)*
Priscilla Soto *(San Antonio)*
Shelly Spinks *(Central Texas)*
Jesse Vick *(Permian Basin)*
Laura Williams *(Southeast Texas)*
Veronda Willis *(East Texas)*

Donna Hugly *(Dallas)* was selected as a one-year replacement Director-at-Large (2016-17) for Jason Freeman *(Dallas)*.

Brad Brown *(Southeast Texas)* was selected as a replacement Director-at-Large to fill a one-year remaining term (2016-17) for Phil Davis *(Permian Basin).*

Committee on Nominations:
(Beginning June 2016 and expiring May 2017)
Chuck Clark *(San Antonio)*
Brad Elgin *(Houston)*
Olivia Riley *(Austin)*
Julia Hayes *(Southeast Texas)*
Kirby Jackson *(Dallas)*
Amanda Johnson *(Fort Worth)*
Ben Peña *(Rio Grande Valley)*
Shelly Spinks *(Central Texas)*
Mike Thomas *(East Texas)*
Amy Twardowski *(Corpus Christi)*

As immediate past chairman of TSCPA, Allyson Baumeister *(Fort Worth)* will automatically serve as the Nominating Committee chair.

AICPA Council – Three-Year Term:
(Beginning October 2016 and expiring October 2019)
The following names will be submitted to the AICPA Nominating Committee as recommendations from Texas to serve on the AICPA Council:
Allyson Baumeister *(Fort Worth)*
Mitch Perry *(Dallas)*
Roxie Samaniego *(El Paso)*
Carol Warley *(Houston)*

AICPA Council – One-Year Designee:
(Beginning October 2016 and expiring October 2017)
Kathy Kapka *(East Texas)*

Chairman-elect Appointees:
Ratified by vote of the Board of Directors at this meeting

Executive Board (One-year term – 2016-2017)	Terri Hornberger *(Dallas)* Cory Joiner *(Panhandle)* Royce Read *(East Texas)*
Committee on Nominations	Donna Wesling *(Austin)*

Figure 2. 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 – Austin
Medium-sized Chapter – Central Texas
Small Chapter – Southeast Texas

Highest Percent Increase in Members Contributing
Large Chapter – Dallas
Medium-sized Chapter – East Texas
Small Chapter – Southeast Texas

Strategic Planning

Strategic Planning Committee Chairman **Michael Brown**, CPA-Central Texas, recapped the five objectives in the current plan:

- Professional Competency – Deliver knowledge and resources for best-in-class professional development;
- Career Success – Provide tools and resources to help members compete and thrive;
- Advocacy – Advocate for Texas CPAs by influencing decision-makers who affect our profession;
- Culture and Community – Inspire CPAs to advance the profession and serve their communities;
- Organizational Excellence – Maintain a world-class accounting association.

Details about projects achieving these objectives will be in the "Year in Review" article, May/June issue of *Today's CPA*.

Other Business

A report on the current financial status of TSCPA and the CPE Foundation was presented. A motion was passed to increase the $265 member dues rate to $285. All other dues rates will remain the same. This will be effective for TSCPA's 2016-17 fiscal year.

The Annual Meeting of the Accounting Education Foundation was conducted and trustees with terms beginning June 2016 were elected. A CPA-PAC report was given and 2015 chapter awards were presented.

The results of TSCPA's electronic election for officers, Executive Board members, directors-at-large and Nominating Committee positions were announced. Also, the Board of Directors voted to ratify the chairman-elect's appointees. See Figure 1 for the names of new 2016-17 leaders.

Upcoming Events

The 2016 Annual Meeting of Members will be held in Galveston at the Moody Gardens Hotel, July 1-2. The Sheraton Austin Hotel at the Capitol is the site for the next Midyear Board of Directors Meeting, Jan. 31-Feb. 1, 2017. ■

TSCPA Awards Nominations Due in April

Do you know a young CPA who deserves recognition, someone who is working to promote the accounting profession, or someone who is making a difference in your chapter or local community? 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 www.tscpa.org/eweb/DynamicPage.aspx?webcode=ABTawards or contact Melinda Bentley at mbentley@tscpa.net; phone 800-428-0272, ext. 279 or 972-687-8579 in Dallas. **Nominations are due April 29, 2016**. ■

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? Please contact Craig Nauta at 800-428-0272, ext. 238; 972-687-8538 in Dallas; or at cnauta@tscpa.net. ■

Update Your TSCPA Member Profile

TSCPA members can now update their information using a new online form. Now is a great time to check your member profile and be sure we have all of the most accurate contact information on record, as well as your interest areas that help us best serve you. To access the form, go to http://tscpamemberupdate.tscpa.net. Your login information will be the same username and password as your member login on TSCPA.org. If you do not remember your password, you can use the retrieval link provided on that page, or simply call our member service team to have a temporary password set. You can reach us Monday through Friday between 8 a.m. and 5 p.m. CST by calling 800-428-0272 and selecting option 1. ■

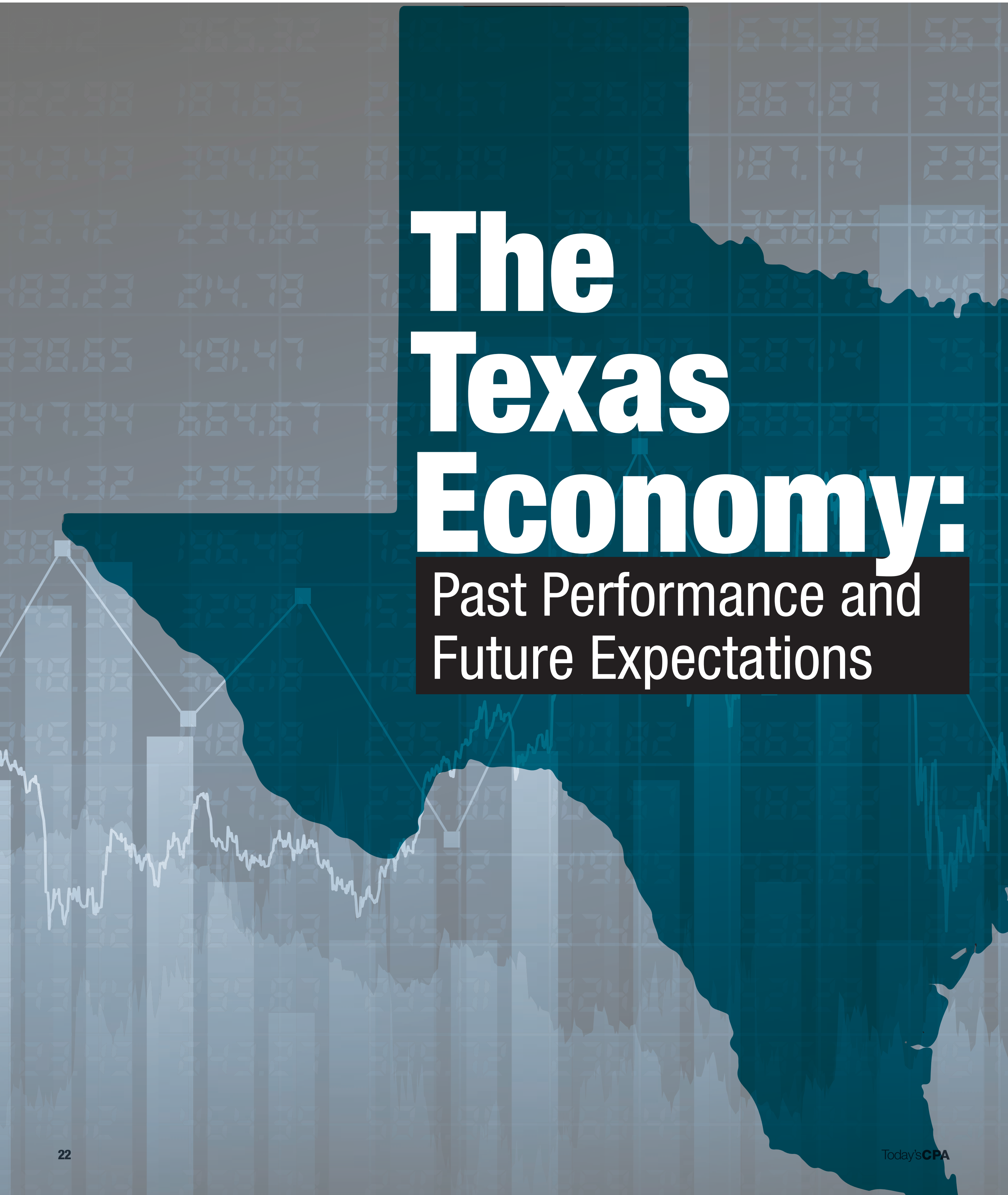
Succession Planning Resource for TSCPA Members

TSCPA offers the Practice Management Institute to assist members with their firm management and practice management issues and needs. Developed in partnership with the Succession Institute, LLC, the Practice Management Institute provides TSCPA members with free material and content on succession planning. There are also CPE self-study course offerings available at a discounted rate for those who would like to receive CPE credit. To learn more and utilize this members-only resource, please go to the CPE section of the TSCPA website at tscpa.org, scroll down and select Practice Management under Tools and Information. ■

Submit an Article to *Today's CPA* Magazine

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

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



The Texas Economy:

Past Performance and Future Expectations

By M. Ray Perryman, Ph.D.

For a number of years, the Texas economy has been outperforming the nation. In addition to lower rates of unemployment, the state entered the Great Recession later and exited it sooner, avoided the worst of the dramatic real estate market downturn experienced in many areas, and enjoyed better outcomes from economic development efforts. One reason for this strong performance was the substantial boost to business activity associated with the oil industry, which not only benefited from triple-digit crude oil prices, but also implemented new technologies allowing for the unlocking of oil and natural gas in shale formations that had previously been inaccessible. Energy was not the only source of growth, but it was certainly a major one.

Now that the oil surge has ended, at least for the time being, the Texas economy has definitely cooled, but nonetheless continues to expand. Looking ahead, The Perryman Group's latest forecasts indicate economic growth at a moderate pace, with gains across most industrial segments. Following a summary of recent trends and current status, we present The Perryman Group's expectations for the Texas economy.

2015 in Review

Over a period of months in late 2014, the price of crude oil fell from the $80-$100 per barrel range, where it had been trending for several years, to about $40. Through 2015, prices remained in the $40-$60 per barrel range and have fallen even further since that time. As I am writing this article, prices near $30 have been observed, and market forces suggest further downward movement.

As noted, the oil surge was a key reason for Texas' economic strength, with companies and communities across the state benefitting from the entire industry spectrum: drilling to headquarters operations to service companies and everything in between. With the sharp decline in oil prices and resulting scaling back in the industry, the pace of growth in the Texas economy has clearly demonstrated the effects.

Texas added 179,300 jobs during the previous 12 months (November 2014 to November 2015, the most recent data available as we go to press) to reach a total of 11.9 million nonfarm employees in the state. While the economy is creating jobs, the pace of hiring is well below the immediately prior years, when the economy was adding 300,000-400,000 net new jobs per year.

The great majority of the job growth in Texas and elsewhere comes from the services-providing industries, which comprise approximately 85 percent of total nonfarm employment in the state. Specifically, the education and health services sector added 57,600 through November 2015, 48,600 of which were in the health care and social assistance subsector alone. Moreover, the leisure and hospitality sector rose by 54,600 jobs, 92 percent of which were in the accommodation and food services subsector. Large gains were seen in the trade, transportation and utilities sector, with 33,200 additional jobs (mainly driven by a gain of 25,200 jobs in retail trade) and the professional and business services sector with 28,200 additional jobs. Public sector jobs also increased by 20,800 through November.

Where the mining and logging sector added 27,500 jobs in 2014, the sector lost 33,500 jobs in Texas during the first 11 months of 2015. It is estimated that American oil and gas companies have cut over 86,000 jobs since June 2014, and with the price of oil falling still further and low capital budgets among major drilling companies being reported, we may well see further job losses in the industry. However, while rig counts are reaching pre-oil boom levels, the industry has still not seen the level of job loss from the oil bust in the 1980s, when Texas alone lost 240,000 jobs.

The energy sector accounts for a relatively small proportion of jobs in the state (less than 3 percent in oil and gas extraction in related activity), but the positions are typically very high value-added jobs, generating substantial economic activity across a spectrum of industries and exhibiting high "multiplier" values.

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Along with the logging and mining sector, the manufacturing sector took a hit in 2015, with a loss of 35,800 jobs through November (although some strength has been observed of late in some of the technology segments). Employment in the information and construction sectors has remained relatively unchanged, though the number of building permits for single-family homes and multifamily buildings issued over the past year has increased from previous annual totals.

All in all, 2015 was a rocky road for the Texas economy. Even so, the state business complex has proven to be resilient. Despite the losses in the goods-producing sectors, the Texas economy is now much more diversified than in the past, as shown in the growth in services and other sectors. Growth was certainly not robust, but it was a far cry from the collapse that occurred when oil prices plummeted in the 1980s.

Outlook for Oil

Because oil prices (and the resulting level of activity in the energy sector) play a major role in determining the pace of Texas economic growth, the outlook for oil prices is of particular relevance. Currently, the price of oil is far below sustainable levels, but oversupply in the market continues to pressure the price down. This oversupply is largely due to increased U.S. shale production, as well as increased production from OPEC nations as part of a strategy to price out other oil competitors and restore the market share that has been lost in recent years. As OPEC and major U.S. companies have yet to cut production and global demand remains weak, it is likely that the price of oil could continue to fall, though the consensus view at this point (and the most likely outcome according to The Perryman Group's analysis) is that the price will begin to rebound sometime in the latter part of 2016.

Another factor influencing future oil prices is that it is now legal to export crude oil from the U.S. Although it seemed highly unlikely as recently as a few months ago, Congress and the administration have removed the ban on oil exports. For 40 years, it had been illegal to export crude except in certain very limited cases, primarily to Canada. While refined products (gasoline and other fuels, for the most part) were legal to sell into world markets, U.S. companies could not export crude oil without a special license, which was hard (or impossible) to obtain.

As a major oil producing region, Texas stands to benefit from the change, though the effect will likely be modest until global supply and demand shifts and worldwide prices begin to rise in earnest. The spread between oil prices in the U.S. and elsewhere has begun to narrow, and oil produced in Texas has already been sold into world markets.

In addition, removing the ban has had a stabilizing effect on crude oil prices. For example, the recent escalation of tensions between Iran and Saudi Arabia, which would historically have led to a spike in oil prices, had little, if any, effect. The reason for this unusual phenomenon was simply that the market recognizes that any interruptions in Middle Eastern supplies could now be made up by oil from the U.S., an option that had not been available prior to lifting the ban.

As more normal circumstances resume once global suppliers retrench and demand accelerates, domestic producers can expect prices $6-$7 per barrel higher than those that would have occurred with the export ban in place. With improving technology and lower costs, the increment will have a profound long-term impact on prosperity.

Economic Forecast

Many of the major indicators signal that Texas is continuing to outpace the rest of the nation in spite of retrenching in the energy sector. Even with the end of the oil surge, the state added jobs in nine of the 11 months of 2015 for which data is currently available. The Texas unemployment rate has been at or below the national rate for years, and it looks like that pattern will generally be maintained, despite slower hiring in the Lone Star State.

The Perryman Group's most recent short-term forecast indicates expansion in output (real gross product or RGP) at a 4.15 percent annual rate of growth through 2020, although most of the growth is anticipated near the end of the forecast horizon. Texas output is forecast to reach almost $1.9 trillion in 2020, representing an increase of $347.1 billion over current (2015) levels. The large services sector will contribute an estimated $95.1 billion of the total gain through 2020. Annual output in mining (mostly oil and gas) is projected to increase by $51.8 billion over the period, and wholesale and retail trade is likely to account for another $48.0 billion of the total gain. The state's manufacturing sector is also forecast to experience a notable increase in annual output of $47.3 billion.

More than 1.3 million net new jobs are forecast to be added over the next five years, a 2.12 percent compound annual rate of growth. This pace is below that observed during the recent surge, but represents a healthy pattern that is well in excess of that expected for the nation as a whole. About 821,000 of the net new jobs are projected to fall within the services sector, and all major industry segments are projected to experience job gains to some extent over the period.

Looking to other measures of economic activity, The Perryman Group projects that the population of Texas will increase by almost 2.2 million during the next five years to reach 29.2 million. Real personal income is expected to grow at a 4.81 percent annual rate over the period to reach almost $1.5 trillion in 2020. Real retail sales expansion is forecast to occur at a 2.12 percent annual pace, a gain of almost $111.6 billion by 2020. Housing permits are also forecast to increase.

Workforce Preparedness Challenges

One challenge the Texas economy is facing is in the area of workforce preparedness. The Texas Higher Education Coordinating Board (THECB) recently developed a new strategic plan with the overarching goal that at least 60 percent of Texans ages 25-34 will have a certificate or degree by 2030. The 60 percent goal is driven by expectations regarding what the economy and workplace of the future will require, and some well-informed people think that to fully meet the needs of the business complex, we will need to reach 60 percent even sooner.

The 25- to 34-year-old age group was chosen, because it is an indicator of the economic future of the state and its ability to remain globally competitive. The proportion is a large increase from the current level of around 34 percent of Texans in the 25-34 age range who hold associate's or higher degrees. It is important to note that this goal is not limited to individuals earning an associate or bachelor's degree (or higher) through traditional classes at two-year and four-year colleges and universities. For some students, a better path will be earning a certificate in a shorter or competency-based program. Associate degrees can also be earned through dual credit or early college high school programs. Online programs must also play a role.

Another bold aspect of the new strategic plan is that undergraduate student loan debt will not exceed 60 percent of first-year wages for graduates of Texas public institutions. Achieving this goal involves a spectrum of possibilities ranging from controlling tuition costs and promoting more scholarships to helping students make better choices as to how they spend their resources, which could involve anything from finding ways to reduce student costs of living to getting out of school faster by being very efficient with degree plans. It is also going to require increased funding and tangible support of higher education goals and the workforce of tomorrow.

Worst is Over

With the end of the oil surge, the state economy decelerated from its torrid expansion pace, but generally managed to sustain overall growth. Clearly, the current low oil price environment is dampening performance to a significant extent, but it appears that the worst of the adjustment process is over. Moreover, energy has not been the only source of growth in Texas; the state economy was growing nicely even before the energy surge and is unlikely to experience a prolonged setback despite the oil price decline.

A larger challenge to future prosperity is ensuring that young people in the state are obtaining the education and training they will need to succeed and meet the needs of business. Otherwise, long-term prosperity will not be attainable, irrespective of the price of oil and other favorable competitive factors.

The Perryman Group's current forecast indicates that Texas is well positioned for future growth. While the pace may not be up to that of the recent past now that the oil surge has ended, it will nonetheless likely exceed the growth rates observed in many parts of the U.S. ■

M. Ray Perryman, Ph.D. is president and CEO of The Perryman Group (www.perrymangroup.com), an economic research and analysis firm based in Waco, Texas. His firm has served the needs of more than 2,000 clients ranging from major corporations to small startups and from local communities to the federal government. Over the past 30 years, Dr. Perryman has helped recruit corporations providing tens of thousands of jobs through economic development work, resolved billion-dollar legal issues and revamped public policy through impact assessments and other studies.

FEATURE

The "Say-on-Pay" Advisory Vote

By Josef Rashty and John O'Shaughnessy

The corporate governance of U.S. public companies has evolved during the past decade. Two recent landmark legislations, the *Sarbanes-Oxley Act* (SOX) of 2002 and the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (Dodd-Frank) of 2010, have required public business entities (PBEs), among many other things, to provide more disclosures to shareholders regarding their executive pay. Specifically, Dodd-Frank has empowered shareholders to cast their non-binding votes on executives' pay. The 2015 proxy season was the fifth season that shareholders of PBEs cast their non-binding votes on the executive compensation subsequent to the Securities and Exchange Commission's (SEC's) promulgation on the "say-on-pay" law.

This article presents an overview of the say-on-pay law and provides guidance to investors for their non-binding votes on executive compensation. It deals with the information that is available to shareholders and the overall impact of shareholders' "no vote" on PBEs' corporate governance. Finally, it raises the question of whether this law has prompted a display of shareholders' discontent in recent years.

Background

Dodd-Frank requires that PBEs obtain a non-binding shareholder vote on executive compensation (say-on-pay) at least once every three years. Say-on-pay is a primary way for shareholders to express their satisfaction with the company's CEO and other executives' compensation. The say-on-pay law went into effect in 2011 for larger companies; the smaller companies had an additional two years to comply with the law. However, Section 102 of *The Jumpstart Our*

Business Startups Act (JOBS Act), which was signed into law on April 5, 2012, exempts the emerging growth companies from say-on-pay votes (including say-on-golden parachutes).

The say-on-pay law received a great deal of attention initially and has remained the most significant discussion item during each proxy season since then. The authors reviewed several corporate governance surveys conducted by accounting and law firms and reviewed the 2014 proxies of 30 large accelerated filers in preparation for writing this article.

The Advisory Vote

Say-on-pay allows shareholders to express their views on their satisfaction with the executive compensation program at least once every three years. However, the preference of most institutional shareholders and the two major institutional proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, is for execution of an annual say-on-pay vote.

Companies disclose the say-on-pay voting policy that they have adopted no later than 150 calendar days after their annual meetings, but at least 60 calendar days prior to the company's deadline for submission of shareholder proposals for the next annual meeting. An overwhelming number of companies that conduct say-on-pay votes have received a majority of shareholders' support.

PBEs do not take shareholder approval for granted. Companies that have not received a favorable vote or have low shareholder support for say-on-pay often devote a prodigious amount of time, resources and consideration to the administration and disclosure of their executive compensation programs. In summary, say-on-pay has impacted the PBEs in several fashions that will be discussed in the remaining sections of this article.

Corporate Governance

Even though say-on-pay is technically an advisory vote, in reality it has serious consequences for corporate governance, as well as the decision-making process of the boards of directors and their decision-making processes. A say-on-pay proposal that fails or receives significant opposition requires the attention of the proxy advisory firms. Morrow & Co.[1] has reported that ISS requires an explicit response from the board to any say-on-pay proposal that receives 30 percent or more opposing votes. Glass Lewis has a similar policy with a lower 25 percent threshold.

Negative recommendations from proxy advisors do not necessarily result in a failed say-on-pay vote. There are precedents for companies receiving majority approval on the say-on-pay proposal even though proxy advisors recommended voting against them. Nevertheless, it is most likely that a lack of support from proxy advisory firms would lower the shareholders' percentage of approval. Therefore, PBEs usually make an effort to obtain the support of the proxy advisory firms.

In June 2012, the SEC adopted the final rules to implement Dodd-Frank Act Section 952, requiring national securities exchanges to prohibit the initial or continued listing of any PBE's stock that does not satisfy compensation committee and compensation advisor independence criteria. Both the NYSE and NASDAQ have adopted rules regarding compensation committee and compensation advisor independence.

PBEs usually avoid the appearance of any interlocking relationship between any member of their compensation committees and any member of the compensation committee of another company. If such a relationship exists, they usually disclose it in their proxies.

PBEs pursuant to SEC rules select and disclose their peer companies in their proxies so that shareholders can compare and contrast their executive compensation with their peer companies. PBE compensation committees usually apply their intimate knowledge of their business to select their companies' peers for executive compensation analysis. When PBEs benchmark their executive compensation against other companies, they typically specify how the peer group was established and how the pay for named executive officers compared with the established benchmarks, and they also provide an explanation if actual compensation differs from the targeted percentiles.

Equity awards ordinarily represent the lion's share of executive compensation programs. Equity awards, for the most part, have replaced the traditional pension and retirement plans as an incentive to retain top-performing executives. PBEs, subsequent to enactment of say-on-pay, tend to grant more performance-based rather than time-based equity awards. Many PBEs have reduced CEOs' salaries while at the same time increasing the grant of equity awards. Of the 30 large accelerated filers the authors surveyed, 25 (83 percent) of the companies have changed their equity award programs to make them more performance-based. The rank of equity awards based on performance criteria is as follows:

- Performance-based stock awards
- Performance-based stock options
- Time-based stock options
- Time-based stock awards

The survey conducted by the authors confirmed that companies in general were compliant with the statutory requirements of executive compensation disclosures. Some PBEs have made changes to their corporate governance above and beyond the legal requirements to justify their executive pay to their investors and proxy advisors. The authors believe that say-on-pay generally has improved compensation practices among the PBEs. Under Dodd-Frank, directors pay more attention to executive compensation when they know that shareholders and proxy advisors will scrutinize executive pay packages.

Even though board members and management of PBEs in general have strong incentives to care about the result of a say-on-pay vote, there are instances where some PBEs have shrugged off the no-vote on pay. *The Wall Street Journal* on Aug. 26, 2014,[2] reported that about two dozen renegade companies have kept the compensation of top officers sky-high despite the no-vote by investors. These companies (including Oracle, RadioShack and Cogent Communications) have dug in their heels, paying high compensation to their top officers mostly due to the fact that their founders still run the companies.

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However, *The Wall Street Journal* reported on the same subject on July 8, 2015, that even though the top three executives of Oracle received the same number of share options this fiscal year compared to a year earlier, the company altered the terms of its grants in a way that the value of awards granted are lower[3].

Presentation and Disclosures

PBEs pursuant to SEC regulations have included extensive disclosures regarding the five highest paid executives' compensation in their proxies. Item 402 of Regulation S-K requires extensive disclosures on executive compensation for registration statements. Additionally, the SEC requires that companies disclose how this year's shareholders' vote has influenced the compensation program in the subsequent years.

SEC rules require companies to disclose a combination of grant date fair values for long-term equity-based awards and actual payments for annual and long-term cash awards. While the Summary Compensation Table (SCT) is the principal source of specific executive compensation disclosure, shareholders can also look at a variety of tables, in addition to the SCT in the proxy reports, to decide on their votes. These tables provide all the information related to executive pay in one place and make it easier for shareholders to obtain the information needed.

Compensation Tables

Summary Compensation Table (SCT) – This table provides a summary of cash compensation and equity grants to each executive. There has been an argument that there is a certain disconnect between the cash compensation and equity grants components of the pay in the SCT. Critics have argued that actual realized benefits (rather than grant information) is a more appropriate measure for equity-based awards. In response, a number of companies have presented alternative approaches to defining executive compensation in their proxy disclosures to better demonstrate pay and performance alignment.

Grants of Plan-Based Awards Table – This table follows the SCT and provides additional information about plan-based equity and non-equity compensation granted during the most recently completed fiscal year. Companies usually have narrative disclosures for any additional factors that help understand and give context to the information included in this table and the SCT.

Outstanding Equity Awards – This table reflects all outstanding option awards and unvested stock awards held by the executives as of the end of the most recently completed fiscal year.

Option Exercises and Stock Vested Table – This table reflects the number and value realized upon exercise and vesting of options and stock awards granted to executives.

Other Disclosures

There could be other disclosures in the proxies of PBEs that may help the shareholders determine their position on voting.

Golden Parachutes – Executive compensation usually includes retirement and other post-termination benefits. SEC rules pursuant to Section 951 of the Dodd-Frank Act require companies to provide disclosure regarding pension plans, nonqualified deferred compensation plans, and severance and termination benefits. Golden parachutes are subject to shareholders' advisory vote similar to other executive compensation. Of the 30 companies the authors surveyed, 25 companies (83 percent) disclosed their golden parachutes policies.

Nonfinancial Targets – PBEs have traditionally used quantitative financial measures (e.g., revenues, earnings per share, et al.) to measure the performance of their executives. Quantitative goals are usually easier to measure, and are less subjective and more transparent. However, use of qualitative measures (e.g., achievement of sustainability, customer satisfaction, et al.) is on the rise.

Of the 30 large accelerated filers the authors surveyed, six companies (20 percent) used only quantitative measures and 24 companies (80 percent) used a combination of quantitative and qualitative measures to measure the performance of their executives.

Peer Group – SEC rules require that companies disclose their peers in their proxies to enable the shareholders to compare and contrast the executives' compensation of their company with its peers.

Of the 30 large accelerated filers the authors surveyed, all have listed the peer group and all have provided rationale for the criteria that they have used in selection of the peer group. Fifteen companies (50 percent) have shown performance metrics and summary statistics for each peer group, but only one company (3 percent) has shown compensation data of their peers.

Pending Additional Disclosure

There are several Dodd-Frank mandates awaiting the SEC's proposal and finalization.

Hedging Policy Disclosures – In February 2015, the SEC proposed new rules required by Section 955 of the Dodd-Frank Act for PBEs to disclose hedging policies for directors and employees. The SEC's proposed new rules would require companies to disclose whether their directors, officers and other employees are allowed to hedge or offset any decline in the market value of shares that are granted to them by the company as compensation or held directly or indirectly by employees or directors. These new rules are expected to provide investors with additional disclosures regarding governance practices of PBEs.

Generally, companies are required to disclose their policies regarding hedging the economic risk of owning company securities pursuant to Item 402(b)(2)(xii) of Regulation S-K. Of the 30 large accelerated filers the authors surveyed, 29 companies (97 percent) disclosed their hedging policies.

Pay-for-Performance Disclosures – In April 2015, the SEC proposed new rules required by Section 953(a) of Dodd-Frank for PBEs to disclose the relationship between compensation actually paid to executives and the financial performance of the company. The disclosure is required for the last five years (the last three years for small companies, as defined in Rule 12b-2 under the Exchange Act). PBEs would also be required to tag the disclosure in an interactive data format using XBRL. This is the first time the SEC has required use of XBRL in proxy filings. The disclosure can be done in a narrative form, graphically or a combination of both.

Clawback Provisions – In July 2015, the SEC proposed new rules that would require executive officers of PBEs to pay back incentive-

> **THE SAY-ON-PAY LAW RECEIVED A GREAT DEAL OF ATTENTION INITIALLY AND HAS REMAINED THE MOST SIGNIFICANT DISCUSSION ITEM DURING EACH PROXY SEASON SINCE THEN.**

based compensation that they were awarded erroneously. Under this proposal, required by Section 954 of the Dodd-Frank Act, companies would clawback the unearned incentive compensation from current and former executive officers regardless of fault. PBEs would be required to disclose the recovery policies and their actions under these policies.

The clawback proposal would apply to incentive-based compensation that is tied to accounting-related metrics, stock price or total shareholder return. The clawback would apply to excess incentive-based compensation received by executive officers in the three fiscal years preceding the date a PBE is required to make restatements.

SOX includes clawback provisions for CEOs and CFOs of PBEs, but Section 954 of Dodd-Frank requires the SEC to issue expanded rules regarding clawback requirements for all current and former officers of PBEs in addition to CEOs and CFOs. It also requires national exchanges to bar the listing of any company that has not implemented a clawback policy that does not include recoupment of incentive-based compensation for current and former executives for a three-year period.

Although the SEC has not yet issued the final rules on this provision, a number of companies are already disclosing their clawback policies, likely because proxy advisory firms such as ISS and Glass Lewis take into account companies' clawback policies when making their say-on-pay voting recommendations. Of the 30 large accelerated filers the authors surveyed, 27 companies (90 percent) disclosed their clawback policies.

Pay Ratio Disclosures – In August 2015, the SEC adopted a final rule requiring PBEs to disclose the ratio of the compensation of their

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CEOs to the median compensation of their employees pursuant to Section 953(b) of the Dodd-Frank Act. Under this rule, PBEs would have to disclose the ratio of the annual total compensation of the median employee, other than the CEO, with that of the total CEO compensation.

PBEs will be required to provide disclosure of their pay ratios for their first fiscal year beginning on or after Jan. 1, 2017. The rule does not apply to smaller reporting companies, emerging growth companies, foreign private issuers, Multijurisdictional Disclosure System filers or registered investment companies.

Shareholders' Discontent

There is little evidence that the individual shareholders of PBEs have a robust understanding of executive compensation plans of their companies. Many shareholders probably cast their votes based on performance of the company and its stock price. On the other hand, most institutional shareholders outsource their say-on-pay vote to proxy advisors for a fee.

Ernst & Young in its *2016 Proxy Statements* publication stated that in the 2015 proxy season, investors continued to demonstrate support for most executive compensation packages. According to this publication, the average say-on-pay support for S&P 500, S&P 1500 and Russell 3000 companies in 2015 was approximately at 92 percent (consistent with 2014).[4]

Boardridge + PwC in its second edition of 2015 *ProxyPlus* also reported that support level had remained relatively unchanged in the 2015 proxy season (compared to the 2014 proxy season) with respect to say-on-pay vote.[5]

However, *The Wall Street Journal* on June 6, 2014, reported that the non-binding say-on-pay vote seeks to limit executives' equity awards subsequent to mergers and acquisitions. According to the article, the shareholders of several public companies voted to prevent executives from cashing in on certain equity awards in case of a merger transaction.[6]

There have been several waves of litigation arising out of say-on-pay and proxy compensation disclosures. The litigations alleged breaches of fiduciary duty by the board of directors for the companies that failed on their say-on-pay vote or suits alleging insufficient compensation disclosures. Even if plaintiffs are not successful in these litigations, the cost of defending such cases are high and may also negatively impact the reputation of the defending companies. Of the 30 large accelerated filers the authors surveyed, five companies (17 percent) have had outstanding litigations regarding their executive compensation.

It appears that shareholders have become more assertive in expressing their views regarding executive compensation. This trend may impact the corporate governance of PBEs in coming years significantly, particularly if the stock market begins to decline. Investors are usually less likely to become outraged by the sizable and disproportional amount of executive compensation as long as the stock market has an upward trend and the stock price continues to rise.

Final Remarks

In a survey of PBEs, PwC reported[7] that 84 percent of directors surveyed stated that say-on-pay has caused them to look at executive compensation in a different way. The say-on-pay has encouraged the PBEs to reach out directly to their shareholders (or proxy advisors in case of some institutional investors) and explain their strategies underlying their executive compensation plans. Many PBEs have changed their compensation structure from time-based to performance-based bonuses and equity awards.

The say-on-pay advisory vote has empowered shareholders to express their views on executive compensation. The Dodd-Frank Act has significantly expanded the scope of such disclosures in proxies, and PBEs have endeavored to obtain a favorable vote from their shareholders. The say-on-pay law could very well encourage shareholders to be more assertive on "right sizing" of executive pay in coming years. However, the authors of this article do not believe that say-on-pay has affected the right sizing of CEO compensations in corporate America in a meaningful way at this time. There are still companies that shrug off the result of the non-binding vote, but this trend may change in coming years, particularly if the upward trend of the stock market changes direction. ■

Footnotes

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Understanding the Changes in OMB's

Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards

By Leslie Wilks, CPA, CFE

As recipients and auditors of federal grant awards, we have grown accustomed to wading through a plethora of circulars and other guidance from the Office of Management and Budget (OMB) to find information relative to the administration and audits of federal award programs. In its attempt to clarify what many consider to be conflicting provisions, and redundant and often unnecessary language, OMB published new guidance titled *Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards* (Federal Register Vol. 78, No. 248). The final guidance was issued in December 2013, with OMB stating in its first-page summary: "This clarification will make compliance less burdensome for recipients and reduce the number of audit findings that result more from unclear guidance than actual noncompliance."

Background and Timeline

Since its inception in 2011, the Council on Financial Assistance Reform (COFAR) has been busy working to overhaul the audit requirements, cost principles and administrative requirements prescribed by OMB. A few of the objectives identified by COFAR as they went through this process included:

- Ease administrative burden by streamlining guidance for federal awards.
- Strengthen oversight over federal funds to reduce risk of waste, fraud and abuse.
- Focus grant policies on areas that emphasize the achievement of better grant outcomes at a lower cost.

The following timeline illustrates the series of events that led to OMB's December 2013 issuance of the *Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards*.

November 2009 – The first of two directives was issued by the president of the United States with an executive order on *Reducing Improper Payments*. With this order, the president emphasized: "When the federal government makes payments to individuals and businesses as program beneficiaries, grantees or contractors, or on behalf of program beneficiaries, it must make every effort to confirm that the right recipient is receiving the right payment for the right reason at the right time."

January 2011 – The second of two directives was issued by the president of the United States with an executive order on *Improving Regulation and Regulatory Review*. The objective of this directive was to reduce administrative burden related to the administration of federal awards. According to the order, each federal agency must "tailor its regulations to impose the least burden on society, consistent with regulatory objectives, taking into account, among other things and to the extent practicable, the costs of cumulative regulations." To that end, it is important that federal agencies identify those "rules that may be outmoded, ineffective, insufficient or excessively burdensome," and "modify, streamline, expand or repeal them in accordance with what has been learned."

October 2011 – COFAR was formed to research and develop efficient and effective polices related to federal awards. COFAR is comprised of

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Figure 1. COFAR Priorities: Strong Controls Yield Better Outcomes

Source: COFAR's Office of Executive Councils, Chief Financial Officers Council at https://cfo.gov/cofar/

senior officials from eight federal granting agencies and the controller of OMB. Figure 1 illustrates COFAR's focus areas in its approach to developing the new policies.

COFAR held a series of roundtable discussions that were webcast and are available for viewing at https://cfo.gov/cofar/.

February 2012 – OMB published advanced notice of proposed guidance, *Reform of Federal Polices Relating to Grants and Cooperative Agreements; cost principles and administrative requirements (including Single Audit Act)*. Over 300 public comments were received and taken into consideration in drafting the proposed guidance.

February 2013 – OMB published the proposed guidance, *Reform of Federal Polices Relating to Grants and Cooperative Agreements; cost principles and administrative requirements (including Single Audit Act)*. Originally scheduled to end May 2, 2013, OMB extended the public comment period until June 2, 2013. The American Institute of CPAs (AICPA) Government Audit Quality Center responded with several comments and observations, including concerns with the effective date of implementation and other audit-related concerns. A copy of the comment letter can be found at: http://www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/OMBCircularA133/DownloadableDocuments/AICPAResponsetoOMBProposedA-133ChangesandOtherGrantReforms.pdf.

December 2013 – OMB issued its final guidance, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*.

Overview of Changes - 2 CFR 200

OMB Circulars

One of the most notable changes in the Uniform Guidance is the consolidation of eight regulations into one circular. The following OMB circulars have been superseded by the Uniform Guidance, which contains three broad categories and is often referred to as the "super-circular."

Administrative Circulars

- A-21 *Cost Principles for Educational Institutions*
- A-87 *Cost Principles for State, Local and Indian Tribal Governments*
- A-110 *Uniform Administration Requirements for Grants and Other Agreements with Institutions of Higher Education, Hospitals and Other Non-Profit Organizations*

Cost Principles

- A-122 *Cost Principles for Non-Profit Organizations*
- A-89 *Catalog of Federal Domestic Assistance*
- A-102 *Grants and Cooperative Agreements with State and Local Governments*

Audit Requirements

- A-133 *Audits of States, Local Governments and Non-Profit Organizations*
- A-50 *Audit Followup*

Navigating the Uniform Guidance

It is important to note that the Uniform Grant Guidance has three main parts and six subparts. They are as follows.

Administrative Requirements

- Subpart A, 200.XX – Acronyms and Definitions
- Subpart B, 200.1XX – General
- Subpart C, 200.2XX – Pre-award – Federal
- Subpart D, 200.3XX – Post-award – Recipients

Cost Principles

- Subpart E, 200.4XX – Cost Principles

Audit Requirements

- Subpart F, 200.5XX – Audit

The Electronic Code of Federal Regulations allows the user to search for key words. The searchable Electronic Code of Federal Regulations can be found at: http://www.ecfr.gov/cgi-bin/text-idx?SID=1a8540547b4f60c40f6c4da7afdf272c&mc=true&node=pt2.1.200&rgn=div5.

Acronyms and Definitions

Those of us who have worked for or with governmental entities are well aware that there are numerous acronyms that are used in our daily vocabulary. At times, it may sound as though we are speaking an entirely different language. Title II of 2 CFR 200, Subpart A §200.0 of the Uniform Guidance lists 45 acronyms along with their definitions. So, anyone who may be interested in learning what a FAIN, DUNS or SAM is, this is the place to look.

Subpart A §200.1 lists nearly 100 definitions, making it easy to quickly research certain terms that may require clarification for auditors and auditees alike. For example, if you are unsure of which date is considered the federal award date, you can look up the definition of "federal award date" in this section and see that OMB clearly defines it as the date when the federal award is signed by the authorized official of the federal awarding agency. This eliminates the need to search through the entire document to find OMB's definition of key items.

The lengthy definition for internal control outlines the non-federal entity's responsibilities for establishing and maintaining effective internal control over federal awards. As the Uniform Guidance points out, internal control was previously only discussed in the audit requirements and as a result, was often only considered after the funds had been spent. Moving this guidance into the administrative requirements encourages non-federal entities to better structure their internal controls earlier in the process.

Reporting of Time and Effort

A recurring theme we see in the Uniform Guidance is an emphasis on internal control. In proposing guidance over time and effort, COFAR focused on internal control over federal payroll rather than on requiring specific language on how to document time and effort. COFAR pointed out that requiring specific language would result in audit findings more likely to be based on incorrect documentation rather than uncovering weaknesses in internal control or instances of fraud. The Uniform Guidance does not provide an example of proper time and effort documentation, but focuses more on "overall internal controls that will mitigate the risk that a non-federal entity or their auditor will focus solely on prescribed procedures such as

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reports, certifications or certification time periods, which alone may be ineffective in assuring full accountability." What this means is that while internal controls over compliance are required, the guidance does not specify how management must report time and effort. However, it does specify that budget estimates may not be used to determine the final amount of payroll charged to federal awards; thus, charges must be based on records that accurately reflect the work performed.

Additionally, the guidance addresses the framework that must be used for establishing internal controls in its definition of the word "internal control" in Subpart D §200.303. It states that "internal controls to be in compliance with the guidance in *Standards for Internal Control in the Federal Government*, issued by the comptroller general of the United States and the *Internal Control Integrated Framework*, issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO)." As grant recipients, this means being able to implement adequate controls in accordance with this framework. For example, as it relates to time and effort (and each applicable compliance requirement), the grant recipient should have controls in place to address the control environment, risk assessment, control activities, information and communication, and monitoring, in accordance with the COSO internal control framework. The Uniform Guidance mentions that if entities believe they currently have an effective system of controls in place that complies with the standards, there is no need to change it. As auditors, this means being able to properly document these controls over compliance and designing audit procedures accordingly.

Indirect Costs

In its roundtable discussions, COFAR addressed the topic of indirect costs, specifically addressing the need for consistent and transparent treatment. Section 200.331 of the Uniform Guidance addresses requirements for pass-through entities, requiring the pass-through entities to provide an indirect cost rate to sub-recipients. The pass-through entities may use the de minimis rate of 10 percent of modified total direct costs. This provision also applies to those non-federal entities that have never had a negotiated indirect cost rate. Under the Uniform Guidance, financial statements will require documentation of usage of the rate to allow for future evaluation of its effectiveness.

While there are some exceptions (other status or regulations), federal agencies will be required to accept negotiated indirect cost rate. The guidance allows entities to use the one-time extension of a current negotiated indirect cost rate without further negotiation for a period of up to four years, subject to review and approval of the cognizant agency.

Change in Thresholds

With the changing thresholds in the Uniform Guidance, we see a bit more consistency in approach. While various amounts were proposed to and discussed by COFAR, the amount proposed for the federal expenditure threshold triggering a single audit will be the same amount of the Type A threshold for programs with expenditures less than or equal to $25 million. Previously, these two thresholds differed from one another.

Single Audit Threshold

While there was initial discussion of increasing the single audit threshold to $1,000,000, ultimately the threshold was increased from federal expenditures of $500,000 under the former guidance to $750,000 under the Uniform Guidance in Subpart A §200.518. Early implementation was not permitted. In their recommendation, COFAR explained that while this would decrease the number of entities requiring a single audit by approximately 5,000, it would still maintain 99.7 percent oversight of the federal expenditures that were subject to single audit under the $500,000 threshold and 87.1 percent coverage of the entities already subject to single audit under the previous threshold. The new threshold can be applied to entities with a year-end of Dec. 31, 2015 or later.

Threshold for Low-Risk Auditee

Another threshold change found in Subpart A §200.518 relates to the percentage of coverage rule. As a low-risk auditee, the 25 percent coverage rule has decreased to 20 percent. Likewise, the 50 percent coverage rule has decreased to 40 percent of total federal awards expended for those entities not identified as a low-risk auditee. When evaluating each of the preceding two audit periods, additional criteria in the determination of a low-risk auditee requires that the auditor did not report a substantial doubt about the auditee's ability to continue as a going concern.

Figure 2. Threshold

Total Federal Expenditures	Type A/Type B Threshold
$750,000, but less than or equal to $25 million	$750,000
Exceed $25 million, but less than or equal to $100 million	Total federal awards expended x .03
Exceed $100 million, but less than or equal to $1 billion	$3 million
Exceed $1 billion, but less than or equal to $10 billion	Total federal awards expended x .003
Exceed $10 billion, but less than or equal to $20 billion	$30 million
Exceed $20 billion	Total federal awards expended x .0015

Threshold for Type A/Type B Programs

During the planning and risk assessment process, auditors are required to perform a major program determination. In making the determination of major programs, the auditor must use an approach that incorporates a set of guidelines as prescribed by OMB, which incorporate a combination of specifically defined criteria along with auditor judgment. One of the first steps in this process is to identify "Type A" programs and "Type B" programs. The identification of the Type A/Type B programs is based on a threshold. Under the Uniform Guidance, these thresholds increased as shown in Figure 2 (see above).

As was the case under the previous guidance, for a Type A program to be considered low risk, it must have been audited as a major program in one of the two most recent audit periods. Type A programs cannot be considered low risk if they meet one of the following criteria in the most recent audit period:

- Deficiencies in internal control that were identified as material weaknesses in the auditor's report on internal control for major programs.
- A modified opinion on the program in the auditor's report on major programs.
- Known or likely questioned costs exceeding 5 percent of the total federal awards expended for the program (a change from the previous threshold of $10,000).

Changes were also made in the determination of high-risk Type B programs. The following are some of the more significant changes:

- The number of high-risk Type B programs that are required to be tested as major have been reduced from at least ½ to ¼ of the low-risk Type A programs.
- The auditor is allowed to stop the risk assessment of Type B programs after this number of high-risk Type A programs are identified.
- Classify Type B programs that are 25 percent of the Type A threshold as small Type B programs. The benefit of this is that auditors are not required to perform risk assessment on the small Type B programs.

Reduction in the Number of Compliance Requirements

While there was much discussion regarding the reduction in the number of compliance requirements, OMB's compliance supplement is published as part of a separate process and therefore, no final changes to the compliance supplement were reflected in the initial Uniform Guidance. Reference to the compliance supplement is included as Appendix XI to Part 200 of the Uniform Guidance, referring the reader to the OMB website, www.whitehouse.gov/omb/circulars/, where the compliance supplement is updated annually.

The proposed changes called for a reduction in the overall number of compliance requirements, while realigning and combining some of the existing requirements that have similar objectives. In the 2015 compliance supplement, Part 2, *Matrix of Compliance Requirements*, columns D. Davis-Bacon Act and K. Real Property Acquisition and Relocation Assistance were removed. Likewise, Part 3, *Compliance Requirements*, no longer includes sections D. Davis-Bacon or K. Real Property Acquisition and Relocation Assistance. Sub-award reporting requirements under the *Federal Funding Accountability and Transparency Act* (FFATA) were removed from Section L. Reporting, so this will no longer be a compliance requirement to be tested by auditors. While Davis-Bacon was removed from Part 3 as a compliance requirement, some federal programs opted to retain this requirement and it can be found in the Special Tests and Provisions section included in Part 4 of the compliance supplement, *Agency Program Requirements*. The Real Property Acquisition and Relocation Assistance compliance requirement was removed in its entirety.

Schedule of Expenditures of Federal Awards

The Schedule of Expenditures of Federal Awards (SEFA) is addressed under Subpart F – Audit Requirements in §200.510 Financial Statements. While the majority of the reporting requirements are consistent with the current requirements, the SEFA schedule must include the total amount provided to sub-recipients from each federal program.

Audit Findings

Section 200.516 addresses the requirements that auditors must follow when reporting audit findings related to federal programs. A standard referencing system will be used for reporting each audit finding. This referencing system is based on the format required for reporting in the Federal Audit Clearinghouse's data collection form. For example, findings identified in fiscal year 2015 would use the format 2015-001, 2015-002 and so on. The Federal Audit Clearinghouse implemented this change at the beginning of 2014. The Uniform Guidance places greater emphasis on repeat findings. Repeat audit findings from the immediate prior year must be identified as such in the summary of findings and questioned costs, with a reference to the prior year finding number.

The threshold for reporting questioned costs changed from $10,000 to $25,000 for a type of compliance requirement for a major program. The auditor must also report known questioned costs when likely questioned costs are greater than $25,000 for a type of compliance requirement for a major program. Questioned costs should be identified by CFDA number and award number.

Other Changes

One notable change in the cost principles is the requirement for the non-federal entity to certify that expenditures charged to the federal program are proper and in accordance with the federal grant requirements. This applies to annual and final fiscal reports and vouchers requesting payment.

Date of Implementation

The Uniform Guidance is effective for federal award recipients for awards issued by federal agencies on or after Dec. 26, 2014.

Audits performed under the Uniform Guidance began for entities with fiscal years beginning on or after Dec. 26, 2014; thus, the earliest year end will be Dec. 31, 2015. Early implementation of the audit requirements is not permitted.

In an effort to assist in facilitating with implementation, COFAR offers guidance on its website at www.cfo.gov/cofar/, including answers to frequently asked questions, published Aug. 29, 2014. ■

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Executive Order 13563 of Jan. 18, 2011 on *Improving Regulation and Regulatory Review* (76 FR 3821; Jan. 21, 2011).

Federal Register Volume 78, Nol. 248, Part III, Office of Management and Budget, 2 CFR Chapter I, Chapter II, part 200, et al. *Uniform Administrative Requirements, Cost Principles and Audit Requirements for Federal Awards; Final Rule*

Fraud Deterrence and Fraud Detection

By Patricia Z. Galletta, MBA, CPA, CGMA

To protect against fraud, a company must actively work on deterring individuals from perpetuating the fraud and if that doesn't work, make sure you have controls in place to detect any fraud.

Deterrence

Traditionally, the fraud triangle shows us fraud is perpetrated when there is motive/pressure, opportunity and rationalization. It has been suggested that within the fraud triangle, rationalization should be substituted with what the individual feels about the chances of the fraud being detected.

Deterrence is creating an environment where the opportunities for fraud are identified and eliminated, and an employee's behavior is changed as a result of the *perception* of being jailed, fired or forced to reimburse the company as a result of participating in a fraudulent activity. A 1999 Committee on Sponsoring Organizations of the Treadway Commission (COSO) study found the CEO and/or CFO was involved in a minimum of 82 percent of the fraud-related cases examined. In deterring management fraud, the perception that auditors will discover the CEO and CFO's involvement in fraud should be high. The removal of the opportunity for fraud is what businesses should concentrate on in the war on fraud, since pressure and rationalization may not be observed in the normal business setting. Some fraud deterrent tools include the following.

Strong internal controls. Internal controls are the most effective tool in fraud deterrence. While it is important to trust that your employees will effectively do their jobs, it is equally important to have procedures in place to verify they are performing their jobs effectively. In the words of a Russian proverb frequently quoted by President Reagan, "Trust, but verify." Management of publicly held companies attest in their annual report and external auditors evaluate the effectiveness of the internal control. Knowing strong controls are in place should both deter and help prevent losses due to errors and defalcation.

Legal ramifications. Civil and criminal prosecution of offenses will show the company has no tolerance for fraud and that there will be serious consequences for fraudulent activity. Policies and procedures not documented or not enforced increase the chance of fraud or defalcation. The Fiat Group 2014 Code of Conduct states the company is responsible for "the imposition of sanctions that are fair and proportionate to the violation of the Code and to apply such sanctions consistently amongst all directors, officers and other employees (and, if applicable, third parties) subject to the Code."

Curriculum: Accounting and auditing

Level: Basic

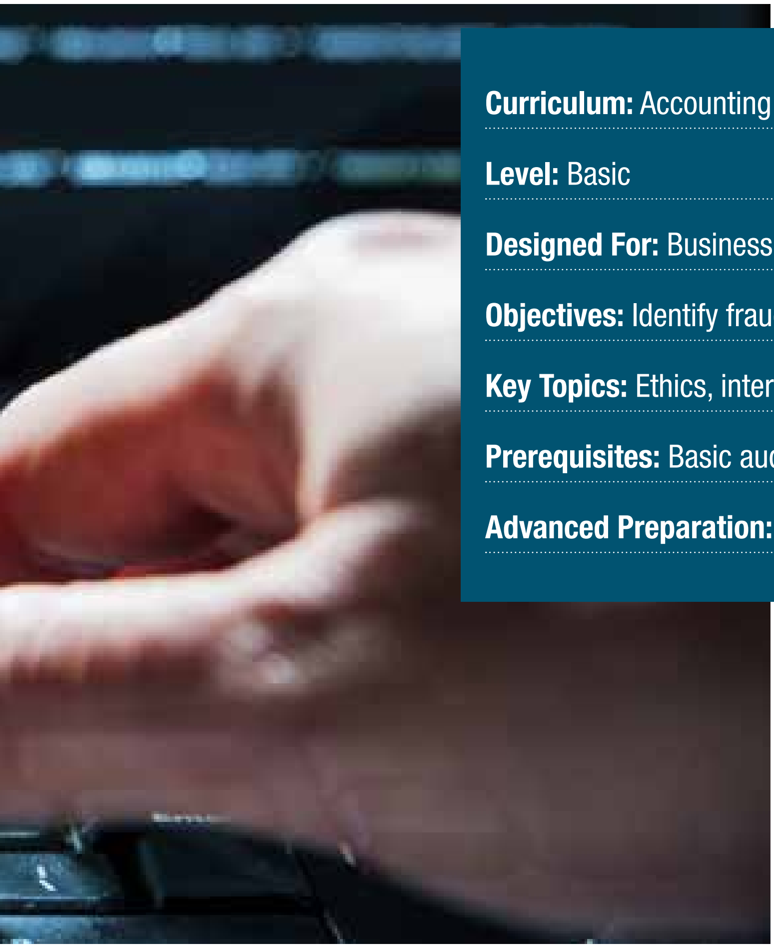
Designed For: Business and industry

Objectives: Identify fraud deterrent and detection tools

Key Topics: Ethics, internal controls, audits, risk assessment and fraud red flags

Prerequisites: Basic auditing knowledge

Advanced Preparation: None



Surprise audits either externally or internally should be conducted randomly throughout the year. Annual external audits serve their purpose, but not primarily as a fraud deterrence since the audit team's visits are usually planned. Auditors for the Phar-Mor, Inc. drugstore chain advised management months in advance which of their stores would be audited. Because of the advance notice, management ensured the auditors would find nothing wrong in those stores. As a result, the auditors failed to detect that the company was reporting fictitious inventory and financial statement fraud resulting in their filing for Chapter 11 bankruptcy.

Annual audits. Even though it may not be required for some smaller companies, hiring someone external to the company to conduct an audit may not only help to deter fraud, but may also provide suggestions for improvements in internal controls as a result of looking at financial data with an outside view. Audits can help employees stay focused, since they don't always know what type of documents the auditor will request. According to the ACFE *2014 Global Fraud Study*, only 56 percent of small businesses had external audits of their financial statements.

Employees' ongoing ethics training with sign-offs by employees should be implemented. This will serve as a refresher course or new training if the code of ethics has changed. Training can be in the form of lectures, case studies or articles and should be stressed at all levels of responsibilities. Live lectures are the best, because of the immediate feedback participants may receive and indications by employees of possible risky activities that could be addressed immediately. Some companies spend their resources on training senior leaders thinking that this will create the "tone at the top;" however, research has shown that fraud risk has a greater chance of occurring at the lower level of employees. Many employees do not even feel their managers understand or stress the importance of risk management to the employees. Bruker Corporation (SEC Administrative Proceeding File No. 3-16314) created materials to train their employees in ethics, but neglected to translate the documents into the native languages of their employees in China. This control failure contributed to the $2.4 million payment Bruker had to pay the SEC to settle the proceedings.

Again, smaller companies may not recognize the need for this training, since the owners may have directly hired the employees and therefore trust them. Kristy Watts was a trusted bookkeeper for the author Danielle Steel for 15 years before Steel realized that Watts had been embezzling money from her.

Ongoing fraud prevention training specific to each company should be offered to employees at all levels at least annually. At a minimum, training should include how everyone is affected by fraud, how to identify fraud and how to report it. The company should also promote professional skepticism whereby employees should feel comfortable asking questions regarding their job responsibilities. The professional skepticism along with training and experience will aid in the employees' detection of fraud.

Perform a fraud risk assessment. A risk assessment should be completed at least annually to identify inadequate internal controls so that new, effective controls can be implemented to reduce the risk of fraud. In the KPMG *2014 Global Audit Committee Survey* of 1,500 audit committee members, 65 percent of the respondents wanted their internal audit department to spend time on risk management

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Appendix 1. 2014 AICPA Survey on International Trends in Forensic and Valuation Services: Methods of Detecting Fraud

HOW DID RESPONDENTS DETECT FRAUD?

General internal controls	85%
Appropriate oversight by management and directors	81%
Physical controls	69%
Computer-based controls	62%
Internal audit function, including conduct of fraud risk assessments	47%
Whistleblower hotline	44%
Cyber information security procedures	25%

***Source**: 2014 AICPA Survey on International Trends in Forensic and Valuation Services*

processes, but were not confident internal auditors had the skills necessary to be effective in this role. According to the International Standards for the Professional Practice of Internal Auditing 1210.A2: "Internal auditors must have sufficient knowledge to evaluate the risk of fraud and the manner in which it is managed by the organization, but are not expected to have the expertise of a person whose primary responsibility is detecting and investigating fraud." The survey respondents also felt the CFO should be spending more time in the organizations' "risk management efforts."

Detection

While prevention controls are to prevent fraud from occurring and deterrence controls are to remove the opportunities for fraud, detection controls are designed to detect fraud in a timely manner after it has occurred, without necessarily getting to the cause. Detecting and responding will allow the company to improve controls, which in turn will hopefully prevent the same type of fraud in the future. In a survey conducted by AICPA (Appendix 1) 85 percent and 81 percent of the respondents detected fraud through internal controls and management oversight respectively. Additional aids in the detection of fraud not previously discussed in this article might include the following.

Accounts susceptible to misappropriation. The COSO Fraudulent Financial Reporting Survey determined inventory and accounts receivable were the two most common asset accounts misstated. Management and staff should get together to identify high-risk accounts. Knowing which accounts are the most susceptible for an organization will help to ensure a system of controls exists to prevent, deter and detect fraud within these accounts, and also provide a starting point for any self-reviews.

Data analytics/data mining/exception reporting. Data analytics, data mining and exception reporting should be used to test and monitor internal controls and transactions and possibly uncover fraud. Using a software package to look at every transaction and not just using a sample to test against certain criteria can reduce sampling risk, can be repeated throughout the year and can detect anomalies more quickly. Using data analytics on a continuous basis will allow management or auditing to identify and report fraudulent activity more rapidly. Numeric (fraudulent invoice number), time (increase in activity during a certain time period) and name (similar vendor names/addresses) patterns may be detected through data mining and are frequently used in analyzing liabilities and payroll. The software can then prepare exception reports such as FirstStrike Software (http://www.apexanalytix.com/), which can create an automated report that can be generated daily/weekly/monthly to flag questionable vendors and can then be reviewed by management.

Email/regular mail should be reviewed for the passing along of confidential or suspect information as part of the mail or as an attachment. For example, in small businesses, sensitive documents should be opened by a designated individual to prevent stealing. Software programs, such as Websense Triton products are designed to track common phrases that may identify a fraud such as "off the books," "override" and "nobody will find out" within an email, as well as extending security protocols to mobile devices.

Trend, vertical, horizontal and ratio analyses can be used to detect patterns, trends and anomalies. One of the red flags related to Gowex – a WiFi company, which at one time was worth $2 billion but is now defunct – was audit fees that were very low compared to its competitors. Other management reviews may include comparisons of gross profit percentages or expenses as a percentage of sales.

Red Flags

Red flags indicating a possible susceptibility to fraud may be observed by the company, employee or by management.

Company Red Flags. Company financial position – A fund was given an unqualified opinion by its auditors even though the fund reported gains in 95 percent of the months in which it operated using low-risk investments during a period of time when other firms were not reporting gains. By the time it was discovered that the fund was really a Ponzi scheme, the investors had lost their money. If it looks too good to be true, then it probably is too good to be true.

Lack of segregation of duties, manual journal entries or extensive use of suspense accounts – The 2011 AICPA *Forensic and Valuation Trend Survey* stated the division of responsibilities and the screening of new employees as the second and third best methods of preventing fraud after good internal controls. Donna worked for her company over 20 years performing treasury and accounting functions. An audit uncovered cash transfers from her employer to Donna's personal bank account, which she claimed was a repayment of a loan she made to the company. Donna recorded manual journal entries charging various accounts to offset the reduction in cash. No paperwork was discovered supporting the loan.

Employee turnover either by quitting or firing occurs within all organizations. If there is high employee turnover within the accounting function, it could indicate problems, since the expertise needed in these jobs may be leaving with the employees. In the Kroll 2013/2014 *Global Fraud Report*, 81 percent of the respondents believed their firm's exposure to fraud was increased by high employee turnover. As part of an effective control environment, the audit committee should be informed about personnel turnover in key functions within the audit team, senior executives, and accounting and reporting functions to determine if this is a normal occurrence or an indication of other problems.

Transactions between related parties as defined by the SEC Regulation S-K Section 2, Item 404 should be carefully monitored and companies should consider requiring the approval of the Board for material-related party transactions. At a minimum, in accordance with ASC 850 "Information about transactions with related parties that would make a difference in decision making shall be disclosed" and would include the nature of the relationship and a description of the transactions, including the dollar amounts.

Accounting personnel who lack experience/education would increase the potential for defalcations, due to lack of skills or fraud through persuasion by other employees. The lack of tax expertise and a deficient internal control system at Medifast led to the restatement of its financial statements to correct deferred income tax calculations over a four-year period, resulting in a fine paid to the SEC.

Major organizational or technological changes may result in internal controls not yet fully developed.

Employee Red Flags. Companies should be aware of changes in employee attitudes (refusal to take vacation or sick leave), behavior (which might indicate problems with drugs, alcohol, gambling) and lifestyles (significant new purchases). The two top behavioral red flags displayed by fraudsters based on the ACFE 2014 *Global Fraud Study* were:

- Living beyond means, which was shown by the CEO of Tyco when he used company money to purchase artwork for $12.75 million, a $7.2 million Manhattan residence and additional amounts to finance millions of dollars in jewelry purchases and a stake in a sports partnership. Embezzlement does not just pertain to corporate executives in high-level positions. When the U.S. Department of Defense conducted an audit of government funds held in a Saudi Arabia bank, it was discovered that Army finance officers had also used company (government) funds to "fund luxurious lifestyles for themselves and their families" (according to the FBI) when they returned to the United States after their tour of duty.
- Financial difficulties indicated by borrowing money from co-workers or creditors appearing at the employee's workplace. Susan was a bookkeeper at a local church. An audit discovered that Susan had embezzled funds, which she used to pay her personal debts. With student loans at an all-time high, revolving debt (mostly credit cards) approximating $850 billion and the interest on credit cards in the double digits according to the Federal Reserve, the propensity to steal to pay off the debt is strong.

Unusually close association between vendor/customer, control issues/unwilling to share duties and wheeler dealer attitude round out the top five behavioral red flags according to the ACFE survey. Employees becoming annoyed at reasonable questions/providing unreasonable responses, rewriting financial records, inadequate compensation, lack of defined work responsibilities and personal life issues are additional employee-related red flags.

Management Red Flags. The ACFE 2014 *Global Fraud Study* reported executives and upper management were perpetrators of fraud in 11.8 percent of the companies surveyed. There are some key red flags related to management:

- Management decisions are centralized by an individual or small group that would not allow the necessary oversight.
- Disrespect for regulatory bodies and company policies or does not cooperate/ has disputes with auditors/outside regulators.
- Frequent changes of auditors. Auditor changes occurring due to the company's or auditor's action must be reported in form 8-K with the SEC if the company is publicly held and include any disagreements between the company and the auditor over the application of accounting principles, financial statement or auditing scope or the auditor's inability to rely on the company's internal controls or management representation. According to a 2007 COSO survey of 347 alleged cases of fraudulent financial reporting by publicly held companies from 1998 to 2007, 26 percent of the firms changed auditors between the last time "clean" financial statements were issued and the last time fraudulent financial statements were issued. Auditor changes due to internal control weaknesses and illegal acts and disagreements with management/accounting interpretations will affect more than just the current year's financial statements.
- Is management compensation based on stock ownership or profit? If stock ownership, then decisions made by management would be towards company growth as opposed to ties to profit that would increase the potential for financial statement fraud.
- Frequent changes to estimate procedures, such as bad debt expense. In the 1990's MCI accounting scandal, the recording of bad debt expense was inconsistently applied, resulting in the delay of the discovery of accounting fraud.

Frequently, auditors can uncover these schemes by examining insiders' personal financial statements, tax returns and bank statements. If executives were aware of the possibility that auditors might scrutinize their finances, it could serve as a deterrent to fraud.

Some controls, such as a whistleblower program, both deter fraud by their presence and help detect incidents of fraud. An important prevention and deterrence tool is to show everyone the company is serious about fraud prevention.

A fraud response plan should be created before the discovery of fraud and include:

- Designation of manager to receive and investigate fraud complaints.
- Actions to be taken in the event of fraud, which could be employee suspension, criminal prosecution or something in between. Strong and fast actions are factors in the deterrence of fraud.
- Determination of how to prevent further losses.
- Determination if/ how to communicate the fraud.

In a 2013 KPMG *Integrity Survey*, 64 percent of the respondents felt pressured to do "whatever it takes" to meet business targets. It is in the company's best interest to use whatever proactive measures are available to prevent, deter and detect fraud in the early stages so as to limit their losses. ■

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By Patricia Z. Galletta, MBA, CPA, CGMA

Fraud Deterrence and Fraud Detection

1 Lack of segregation of duties is considered a:

- **A.** Company red flag.
- **B.** Employee red flag.
- **C.** Management red flag.
- **D.** Not a red flag.

2 A key lesson in the Bruker Corporation case is:

- **A.** Companies should impose sanctions for violation of the company's code of conduct.
- **B.** Companies should make sure training materials are created in a format easily understood by all employees.
- **C.** Don't embezzle because you will get caught.
- **D.** If it looks too good to be true, then it probably is too good to be true.

3 All of the following are key red flags in detecting employee fraud except:

- **A.** Unusually close association with vendor
- **B.** Wheeler dealer attitude
- **C.** Living beyond means
- **D.** Disrespect for regulatory bodies

4 Which of the following is a key red flag in detecting management fraud?

- **A.** Employee turnover
- **B.** Extensive use of manual journal entries
- **C.** Employees unwilling to share duties
- **D.** Frequent changes in estimating depreciation

5 Which of the following statements is true about fraud deterrence?

- **A.** Audits are the most effective tool in fraud deterrence.
- **B.** A risk assessment should be conducted at least once every other year.
- **C.** Case studies are the best delivery method of ethics training.
- **D.** An outcome of fraud deterrence could be to change an employee's behavior.

6 According to the ACFE *2014 Global Fraud Study*

- **A.** Financial statements of the majority of small businesses surveyed are audited.
- **B.** Executives and upper management were perpetrators of fraud in over 20 percent of the companies surveyed.
- **C.** Inventory and accounts receivable were the two most common asset accounts misstated.
- **D.** Twenty-six percent of the firms surveyed changed auditors between the last time "clean" financial statements were issued and the last time fraudulent financial statements were issued.

7 A fraud response plan should include all of the following except:

- **A.** Whistleblower program
- **B.** Designation of manager to receive and investigate fraud complaints
- **C.** Determine how to prevent further losses
- **D.** Actions to be taken in the event of fraud

8 Data mining can detect patterns except for:

- **A.** Numeric pattern
- **B.** Time pattern
- **C.** Name pattern
- **D.** Horizontal pattern

9 Frequent change of auditors duties is considered a:

- **A.** Company red flag
- **B.** Employee red flag
- **C.** Management red flag
- **D.** Not a red flag

10 The key to fraud deterrence is:

- **A.** Data analytics
- **B.** Ratio analysis
- **C.** Perception of getting caught and facing consequences
- **D.** Internal and external audits

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April 29	Personal and Professional Ethics for Texas CPAs	4	Addison
May 2-May 3	2016 Texas CPA Technology Conference	16	Richardson
May 5-May 6	2016 Texas CPA Technology Conference	16	Houston
May 13	From Hiring to Firing and Everything in Between: Health Care, Retirement and Fringe Benefit Tax Issues	4	Corpus Christi
May 13	Mastering Basis Issues for S Corporations, Partnerships and LLCs	4	Corpus Christi
May 16	FASB Annual Update and Review: Critical Developments for All CPAs	8	Houston
May 16-May 17	Energy Conference	18	Austin
May 16	Annual Update for Controllers	8	Dallas
May 17	Financial Forecasting and Decision Making	8	Dallas
May 17	New Financial Reporting Framework for Small & Medium-Sized Entities	8	Houston
May 18	Financial Statement Presentation and Disclosures – A Realistic Approach	8	Austin
May 18	Personal and Professional Ethics for Texas CPAs	4	Houston
May 19	Current Economic Issues and Their Impact on the CFO/Controller	8	Houston
May 19	Personal and Professional Ethics for Texas CPAs	4	Addison
May 20	Revolutionizing Accounting for Decision Making - Successfully Implementing Lean and Activity-Based Costing	8	Houston
May 23	Audits of 401(k) Plans: New Developments and Critical Issues for an Effective Audit	8	Houston
May 23	Auditing Employee Benefit Plans	8	Dallas
May 23-May 24	Nonprofit Organizations Conference	18	Plano
May 24	Accounting and Auditing Update for Tax Practitioners	8	Houston
May 24	Forensic Accounting Investigative Practices	8	Dallas
May 24	Annual Update for Controllers	8	Austin
May 25	Internal Control and COSO Essentials for Financial Managers, Accountants and Auditors	8	Dallas
May 25	Annual Update for Controllers	8	San Antonio
May 26	FASB Annual Update and Review: Critical Developments for All CPAs	8	Dallas
May 26	Financial Forecasting and Decision Making	8	Houston
May 26	Financial Statement Presentation and Disclosures – A Realistic Approach	8	Fort Worth
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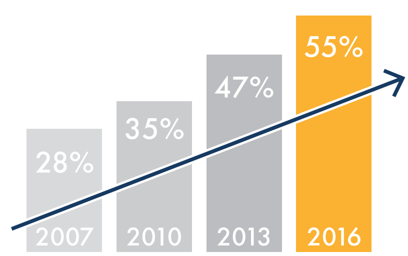

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