Chapter 1

Principles of Financial Statements, Disclosure, Analysis, and Interpretation

CONTENTS

¶1000 Overview

The general objective of financial reporting is to provide reliable information on resources, obligations and progress. The information should be useful for comparability, completeness and understandability. The basic features involved in financial accounting are the individual accounting entity, the use of approximation and the preparation of fundamentally related financial statements.

The financial statements—balance sheet, income statement, change in stockholders' equity and statement of cash flows, as well as segment reports and interim reports—will summarize a firm's operations and ending financial position. Analysts, investors, creditors and potential investors and creditors will analyze these documents in their decision-making processes.

¶1001 Fair Presentation in Conformity with GAAP

When a business is audited, the CPA's audit report attests to the fact that the financial statements are presented in conformity with GAAP. This means a number of things, but high in importance is the use of accrual basis accounting as opposed to cash basis, tax basis or some other comprehensive basis of accounting. As the day approaches when what constitutes generally accepted accounting principles in the U.S. (U.S. GAAP) gives way to International Financial Reporting Standards (IFRS), it is important to understand what has really changed and what has remained the same. The process of bringing U.S. GAAP and IFRS together, called convergence, means that when the transition to IFRS finally takes place, the two sets of standards, while not identical, will closely resemble each other in most major respects. This is expected to minimize the difficulty of the transition and to buffer the shock to the financial markets.

Fair presentation in conformity with GAAP requires that the following four criteria be met:

1. GAAP applicable in the circumstances have been applied in accumulating and processing the accounting information.
2. Changes from period to period in GAAP have been properly disclosed.
3. The information in the *underlying* records is properly *reflected* and *described* in the financial statements in conformity with GAAP.
4. A proper balance has been achieved between the conflicting needs to:
   a. Disclose the important aspects of financial position and results of operation in conformity with conventional concepts, and

   b. Summarize the voluminous underlying data with a limited number of financial statement captions and supporting notes.

These criteria are fundamentally the same for U.S. GAAP and IFRS.

¶1003 12 Principles of Financial Statement Presentation

1. *Basic Financial Statements*. At minimum, these statements must include:
   a. Balance Sheet
   b. Statement of Income
   c. Statement of Changes in Stockholders' Equity
   d. Statement of Cash Flows
   e. Disclosure of Accounting Policies
   f. Full Disclosure in Related Notes

   Information is usually presented for two or more periods. Other information also may be presented, and in some cases required, as supplemental information (e.g., price-level statements, information about operations in different industries, foreign operations and export sales, and major customers (segment reporting)).
2. *The Balance Sheet*. A complete balance sheet must include:
   a. All assets
   b. All liabilities
   c. All classes of stockholders' equity
3. *The Income Statement*. A complete income statement must include:
   a. All revenues
   b. All expenses
4. *The Statement of Cash Flow*. A complete statement of cash flow includes and describes all important aspects of the company's operating, financing and investing activities.
5. *Accounting Period*. The basic time period is one year. An interim statement is for less than one year.
6. *Consolidated Financial Statements*. In the context of a parent company and its subsidiaries statements are presumed to be more meaningful than separate statements of the component legal entities. They are usually necessary when one of the group owns (directly or indirectly) over 50 percent of the outstanding voting stock. The information is presented as if it were a single enterprise.

7. *The Equity Basis*. For unconsolidated subsidiaries (consolidated is used where over 50 percent is owned) where ownership is between 20 percent and 50 percent of the voting stock and the investor has significant influence over investees, the equity method is used to report the amount of the investment on the investor's balance sheet. The investor's share of the net income reported by the investee is picked up (debited if income, credited if loss) and shown as investment income and an adjustment of the investment account is made for all earnings subsequent to the acquisition. Dividends are treated as an adjustment (credit) to the investment account. This approach, based on former APB 18 (now FASB codification ASC 232-10-15), employs the same ownership test, 20 percent or more up to 50 percent, to indicate the use of the equity method is appropriate, as IAS 28, the IASB rule.
8. *Translation of Foreign Branches*. Data are translated into U.S. Dollars by conventional translation procedures involving foreign exchange rates.
9. *Classification and Segregation*. These important components must be disclosed separately:
   a. Income Statement—Sales (or other source of revenue); Cost of Sales; Depreciation; Selling Administration Expenses; Interest Expense; Income Taxes.
   b. Balance Sheet—Cash; Receivables; Inventories; Plant and Equipment; Payables; and Categories of Stockholder's Equity:
      - Par or stated amount of capital stock; Additional paid-in capital
      - Retained earnings affected by:
        — Net income or loss,
        — Prior period adjustments,
        — Dividends, or
        — Transfers to other categories of equity.
      - Working capital—current assets and current liabilities should be classified as such to be able to determine working capital—useful for enterprises in manufacturing, trading and some service enterprises.
      - Current assets—cash and other that can reasonably be expected to be realized in cash in one year or a shorter business cycle.
      - Current liabilities—liabilities expected to be satisfied by the use of those assets shown as current; by the creation of other current liabilities; or in one year.
      - Assets and liabilities—should *not* be offset against each other unless a legal right to do so exists, which is a rare exception.

      - Gains and losses—arise from disposals of other than products or services and may be combined and shown as one item. Examples are the sale of equipment used in operations, gains and losses on temporary investments, non-monetary transactions and currency devaluations.
      - Extraordinary items or gain or loss—should be shown separately under its own title. Items distinguished by unusual nature and infrequent occurrence should be shown net of taxes.
      - Net income—should be separately disclosed and clearly identified on the income statement.
      - Earnings per share information is shown for net income and for individual components of net income.
10. *Other disclosures (Accounting policies and notes)*. These include:
    a. Customary or routine disclosures:
       - Measurement bases of important assets
       - Restrictions on assets
       - Restriction on owners' equity
       - Contingent liabilities
       - Contingent assets
       - Important long-term commitments not in the body of the statements
       - Information on terms of equity of owners
       - Information on terms of long-term debt
       - Other disclosures required by the AICPA
    b. Disclosure of changes in accounting policies
    c. Disclosure of important subsequent events—between balance sheet date and date of the opinion
    d. Disclosure of accounting policies ("Summary of Significant Accounting Policies")
11. *Form of Financial Statement Presentation*. No particular form is presumed better than all others for all purposes. Several are used.
12. *Earnings Per Share*. This information must be disclosed on *the face of the Income Statement* and should be disclosed for:
    a. Income before extraordinary items
    b. Net income

    Disclosure should consider:
    a. Changes in number of shares outstanding
    b. Contingent changes
    c. Possible dilution from potential conversion of:
       - Preferred stock
       - Options
       - Convertible bonds
       - Warrants

This information is disclosed both for basic earnings per share and for fully-diluted earnings per share which adjusts the denominator for potentially dilutive shares arising from possible exercise of stock options, conversion of convertible debt to stock and the like. If the conversion of potentially dilutive securities is anti-dilutive—that is the fully diluted earnings per share is actually greater than the basic earnings per share—the shares are reported as not being dilutive. The anti-dilutive EPS is not shown on the face of the income statement.

¶1005 Materiality

Financial statements are subject to the constraint of materiality. There have been attempts by authoritative rule-making bodies, scholars of accounting, users of financial statements, and others to develop quantitative criteria for determining the materiality of items in the financial statements. They postulate that if Item A is X percent of a total, Item A is material. If Item B is Y percent of a total, then Item B is material, but... All efforts have proved fruitless, and there are no accepted quantitative standards that can be wholly relied upon for an unquestioned determination of whether an item is material or immaterial (and thus can be omitted from the financial statements or notes thereto).

The courts to some extent have helped. However, it should be cautioned that different jurisdictions in different geographic areas of the country have established many opinions and definitions of materiality. For example, the Tenth Circuit Court of Appeals ruled that information is material if "...the trading judgment of reasonable investors would not have been left untouched upon receipt of such information." (*Mitchell v. Texas Gulf Sulphur Co.*) In the "landmark" *Bar Chris* case the judge said that a material fact is one "...which if it had been correctly stated or disclosed would have deterred or tended to deter the average prudent investor from purchasing the securities in question" (*Escott et al. v. Bar Chris Construction Corporation et al.*).

Principally because the U.S. Supreme Court defined materiality in the *TSC Industries Inc. v. Northway Inc.* case, the following statement of the Court is considered to be an authoritative basis upon which to render a judgment of materiality:

> "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote. This standard is fully consistent with the general description of materiality as a requirement that the defect have a significant *propensity* to affect the voting process."
>
> [Note: This decision dealt with omissions of material information.]

> "The Securities and Exchange Commission defines *material information: 'The term material when used to qualify a requirement for the furnishing of information as to any subject, limits the information required to those matters as to which an average prudent investor ought reasonably to be informed.'*"

.01 What's Material?

The accountant must decide precisely what information requires disclosure. To do this, the accountant must exercise judgment according to the circumstances and facts concerning material matters and their conformity with Generally Accepted Accounting Principles. A few examples of material matters are:

1. The form and content of financial statements.
2. Notes to the statements.
3. The terminology used in the statements.
4. The classification of items in the statements.
5. Amount of detail furnished.
6. The bases of the amounts presented (e.g., for inventories, plants, liabilities).
7. The existence of affiliated or controlling interests.

A clear distinction between materiality and disclosure should be noted. Material information involves both quantitative (data) and qualitative information. Additionally, the information must be disclosed in a manner that enables a person of "average" comprehension and experience to understand and apply it to an investment decision. Contra speaking, information disclosed in a manner that only an "expert" can evaluate is not considered within the meaning and intent of disclosure requirements.

Materiality should be thought of as an abstract concept. Many efforts to define the term can be found in the literature (e.g., accounting and auditing books, law books, and Regulation S-X). Nevertheless, in the final analysis, judgments with respect to what is material resulting from court decisions, SEC actions, accountants' interpretations, and corporate and financial officers' judgments have ultimately evolved into the subjective judgment of individuals (accountants and management) responsible for deciding what is and is not material.

¶1007 Disclosures Required in Financial Statements

Following is an overview of the most important disclosures required in financial statements with a brief comment on the substance of each requirement.

Chapter 12

International Standards: Accounting

Contents

¶12,000 Overview

During the current evolutionary period for global markets, the unification of accounting practices has lagged behind the market forces driving business globalization. Opportunities for business expansion could not wait for the accounting profession to recognize and implement the needed international accounting standards. Advances in information technology, transportation, and communication, including the Internet, have served as catalysts, allowing businesses to seek new customers and new markets in the international arena. The rapid pace of cross-border business growth has arisen in spite of the fact that accounting practices differed from country to country. Individual accounting practices in each country were the natural result of diverse economic policies, legal frameworks, social factors, and cultural traditions. The imminent standardization of accounting practices, however, is clearly visible upon the horizon.

While progress has not been fast by some measures, the urgency of the problems have led to a great deal of agreement and convergence between the FASB and the IASB. In 2011, it was expected that the long-awaited revenue recognition principles would be finalized, but that was moved to the 2012 agenda. In 2012, completion of this project was rescheduled for 2013.

¶12,001 IASB and FASB Agree on Lease Accounting Approach

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) agreed in June 2012 to an approach for accounting for lease expenses as part of a project to revise lease accounting in International Financial Reporting Standards (IFRSs) and the U.S. Generally Accepted Accounting Principles (U.S. GAAP).

The boards undertook the leases project to address the widespread concern that many lease obligations currently are not recorded on the balance sheet and that the current accounting for lease transactions does not represent the economics of all lease transaction. Decisions on the leasing project reached to date are preliminary. The boards plan to release a joint exposure draft in the fourth quarter of this year.

The boards previously agreed that leases should be recorded on the balance sheet, but have continued to discuss the classification and pattern of expenses in the income statement. In the decision reached today, the boards decided upon an approach in which some lease contracts would be accounted for using an approach similar to that proposed in the 2010 Leases exposure draft and some leases would be accounted for using an approach that results in a straight-line lease expense.

¶12,002 The Nature of International Accounting

One of the central goals of the movement to unify international accounting practices is the need for financial reporting comparability. Whereas U.S. GAAP

seeks meaningful comparison in financial reporting among companies in the same industry, the impetus in international accounting is to avoid reporting that produces different income statement results for the same company during the same period, when the reports are prepared in one country rather than another.

To accommodate relevant differences between countries, one of the principles underlying the desire to unify international accounting practices is to allow reporting flexibility without producing distortion. Since the goal of international accounting, like that of U.S. GAAP accounting, is to produce general-purpose financial statements, it is not necessary to impose a strict standardization. Rather, a coordination or harmonization of reporting that leaves room for legitimate differences but still produces meaningful financial reporting is the desired result.

The Financial Accounting Standards Board (FASB) believes the ideal outcome of cooperative international accounting standard-setting efforts will be the worldwide use of a single set of high-quality accounting standards for both U.S. and cross-border financial reporting. The FASB's objective is to increase the international comparability and the quality of standards used in the United States. Here, domestic firms that are registrants with the Securities and Exchange Commission (SEC) must file financial reports using U.S. generally accepted accounting principles. Foreign firms filing with the SEC can use U.S. GAAP, their home country GAAP, or international standards. However, if they use their home country GAAP or international standards, foreign issuers must provide reconciliation to U.S. GAAP. As international standards and U.S. GAAP converge the reconciliation will become easier and involve fewer substantive issues.

In 2002 the FASB and the International Accounting Standards Board (IASB) announced the issuance of a memorandum of understanding, the "Norwalk Agreement." The Agreement was a significant step toward formalizing their commitment to the convergence of U.S. and international accounting standards. At their joint meeting in Norwalk, Connecticut, the FASB and the IASB each acknowledged their commitment to the development of high-quality, compatible accounting standards that can be used for both domestic and cross-border financial reporting. At that meeting, both the FASB and IASB pledged to use their best efforts to (a) make their existing financial reporting standards fully compatible as soon as practicable and (b) to coordinate their future work programs to ensure that once achieved, compatibility is maintained.

In 2006 a new Memorandum of Understanding was drafted and in 2008 this Memorandum was updated to reflect progress to date and establish priorities. The purpose of the Memorandum was to lay out the steps necessary to complete the convergence process. In 2009 the boards of the two organizations met to set milestone targets for completing the major projects listed in the Memorandum, with an expected completion during 2011. In 2011 the expected completion date was extended until 2012.

¶12,003 2005 Reporting Standards for Listed Public Companies in the EU

Starting January 1, 2005, listed public companies in European Union (EU) were required to report financial results using International Accounting Standards (IASs) and IFRSs. There was a temporary exception for companies that are currently traded in the United States and use U.S. GAAP and for companies that had issued debt instruments but not equity instruments. Those companies were required to comply with international standards by January 1, 2007.

¶12,005 Exemptions for Small and Medium-Sized Entities

Those responsible for establishing International Accounting Standards recognize the disparity in size between large entities and medium-sized or smaller entities. In the U.S. the issue of "big GAAP" and "little GAAP" has been around for long time. The central question regards the relative financial reporting responsibility of entities whose stock is traded on public markets as opposed to privately held entities. The initial measures addressing this concern in the arena of international accounting sought to establish by number of employees, balance sheet or revenue measures, eligibility requirements for small or medium-sized entities to report on a more modest basis.

The IASB has begun addressing the question of small and medium-sized entities (SMEs) in relation to its standards. The result has been a statement of the Board's preliminary views through May 7, 2004, which include the following:

1. The objectives of financial reporting stated in IASB framework are appropriate for SMEs. Therefore, according to the Board, full IFRSs should be regarded as suitable for all entities.
2. The IASB has determined to allow the use of the SME standards *without a specific size test*. National jurisdiction should determine whether all entities that meet the IASB's characteristics, or only some, should be required or permitted to use the IASB Standards for SMEs.
3. Public accountability is the overriding characteristic that distinguishes SMEs from other entities. An entity has public accountability if, according to the Board "there is a high degree of outside interest in the entity from nonmanagement investors or other stakeholders, and those stakeholders depend primarily on external financial reporting as their only means of obtaining financial information about the entity; or the entity has an essential public service responsibility because of the nature of its operations."
4. The test of public accountability is based on meeting any one of the following criteria:
   a. The entity "has filed, or it is in the process of filing, its financial statements with a securities commission or other regulatory organization for the purpose of issuing any class of instruments in a public market;
   b. It holds assets in a fiduciary capacity for a broad group of outsiders, such as a bank, insurance company, securities broker/dealer, pension fund, mutual fund, or investment banking entity;
   c. It is a public utility or similar entity that provides an essential public service; or
   d. It is economically significant in its home country based on criteria such as total assets, total revenue, number of employees, degree of market dominance, and nature and extent of external borrowings."
5. The IASB will develop a set of financial reporting standards suitable to entities that do not have public reporting responsibilities.
6. SMEs using the modified standards must disclose this in the basis of presentation as well as in the auditor's report.
7. IASB reporting rules for SMEs will provide a single set of high-quality, understandable, and enforceable accounting standards.
8. The IASB focus in preparing the SME standards is on the needs of users of SME financial statements.
9. The foundation for these standards will be the same conceptual framework as that used for the IFRSs.
10. The IASB's goal is to reduce the financial reporting burden on SMEs that want to use global standards.
11. For those SMEs that subsequently become publicly accountable, the transition from the SME standards to the full IFRSs should involve minimal inconvenience.
12. An entity will be regarded as not having public accountability only if all of the holders of its shares, including those not otherwise entitled to vote, have been informed about, and do not object to, the entity preparing its financial statements on the basis of IASB Standards for SMEs rather than on the basis of full IFRSs.
13. A subsidiary, joint venture, or associate of an entity with public accountability should comply with full IFRSs, not IASB Standards for SMEs, in its separate financial statements if it prepares financial information in accordance with full IFRSs to meet the requirements of the parent, venturer, or investors.

When the IASB issued the IFRS for SMEs in July 2009, it said that it would undertake an initial comprehensive review of the Standard to enable the IASB to assess the first two years' experience in implementing the Standard and consider whether there is a need for any amendments. Companies have been using the IFRS for SMEs in 2010 and 2011. Therefore, the initial comprehensive review commenced in 2012. The IASB also said that, after the initial review, it expected to consider amendments to the IFRS for SMEs approximately once every three years.

The SME Implementation Group, is providing recommendations to the IASB throughout the comprehensive review of the IFRS for SMEs, including recommendations about possible amendments. As a result, according to IASB, the SME Implementation Group and the IASB will consider whether to amend the IFRS for SMEs.

¶12,007 International Accounting Standards Changes

The International Accounting Standards Board (IASB) adopted the Standards issued by its predecessor body, the International Accounting Standards Committee (IASC). It is now in the process of reviewing and, where necessary, making changes to those standards. Those pronouncements continue to be designated "International Accounting Standards." Following are lists of the IASs to be applied in preparing financial statements, though they are subject to revision. They represent the core group of international standards necessary for cross-border reporting. The IASB employs an annual improvement process to determine which standards need revision and improvement. In April of 2009 it released the results of its most recent improvement project. IASs affected by this round of modifications include numbers IAS 1 (modifying the classification of convertable securities as current or noncurrent), IAS 7 (relating to expenditures on unrecognized assets), IAS 17 (relating to leases of land and buildings), IAS 18 (whether entity is principal or agent), IAS 36 (goodwill impairment), IAS 38 (fair value of intangible assets) and IAS 39 (exemption for business combination contracts, relating to loan repayment penalties and cash flow hedge accounting).

.01 IAS 1, *Presentation of Financial Statements*

The Standard is applicable for annual periods beginning on or after January 1, 2005. Critical judgments made by management in applying accounting policies must be disclosed (par. IN12). Disclosure is also required for management's assumptions that are important in determining accounting estimates and could cause material adjustment to the carrying amounts of assets and liabilities

(par. IN12) the Standard does not apply to interim financial statements (IAS 34, *Interim Financial Reporting*). The financial statement is to consist of a balance sheet, an income statement, a statement of changes in equity, and a cash flow statement, as well as notes comprising a summary of significant accounting policies, and other explanatory disclosures.

The following specific requirements are mandated:

- Accrual basis accounting.
- Going concern basis.
- Consistent classification schemes from one period to the next.
- Related assets and liabilities are not offset.
- Presentation of comparative information.
- Separate statement of current and noncurrent assets and liabilities.

2011 amendments to IAS 1 Presentation of Financial Statements require companies preparing financial statements in accordance with IFRSs to group together items within Other Comprehensive Income (OCI) that may be reclassified to the profit or loss section of the income statement. The amendments also reaffirm existing requirements that items in OCI and profit or loss should be presented as either a single statement or two consecutive statements.

.03 IAS 2, *Inventories*

The Standard is applicable for annual periods beginning on or after January 1, 2005. According to IASB the guidance "specifies the requirements for the recognition of inventory as an asset and an expense, the measurement of inventories and disclosures relating to inventories." The cost of inventories, other than those for which specific identification of cost are used, is assigned using first-in, first-out (FIFO) or a weighted average cost flow method. LIFO (last-in, first-out) inventory valuation method sometimes used in the U.S. and elsewhere has been removed (par. IN13). Inventories are measured at the lower of cost or net realizable value. Net realizable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to sell. The amount of any write-down of inventories to net realizable value is recognized as an expense in the period the write-down or loss occurs.

.04 IAS 7, *Cash Flow Statements*

Like U.S. GAAP, cash flows are segregated into operating, investing and financing activities. Reporting cash flows allows readers of the financial state-

Chapter 23

Expert Witness

Contents

¶23,000 Overview

With the plethora of high profile legal cases which have inundated the news in the last few years, we've all become trial experts. After being briefed on a variety of cases, we're aware of all the legal terms—and ramifications.

But of a less spectacular nature has been the steady increase of experts in more dignified, straightforward, less publicized cases; in fact, to the lay person, these are often downright boring. However, to the accountant who has found his niche as an "expert witness," they are not only fascinating, but can be quite remunerative. (After all, it was accounting that finally put Al Capone behind bars.) Many accountants are discovering they can increase business, gain public awareness, and enjoy using their special knowledge and experience as expert witnesses. Their financial knowledge and ability to follow a paper trail of figures gives them importance as investigators as well as witnesses in complicated court cases involving financial dealings. There can also be pitfalls along the way.

The need for the accountant as an "expert witness" has increased proportionately with the growing complexity of business affairs. For a number of years, the courts had permitted a rather liberal use of experts in trials; however, the days of relative immunity from prosecution of the expert witness seem to have ended as litigation threatened to become a national pastime. Obviously, the more lawsuits, the more losers. And the loser has to take it out on someone. (That loser may be the opposing party—or it could be the accountant's client.) Why not go after that expert who caused all the trouble? And his firm, too!

¶23,001 Engagement Letter

Therein lies the raison d'etre of a well thought-out, carefully constructed engagement agreement containing buffers against both parties. This agreement needs, at the minimum, to spell out carefully:

1. What the accountant has agreed to do.
2. What information the client *must* make available to the expert witness to enable him or her to investigate the evidence and reach an opinion.
3. Lines of effective communication with both the client(s) and the attorney(s).
4. What the client can expect if the accountant is *required* to reveal on the stand any and all information on which his opinion is based.
5. That the attorney *must* keep the accountant informed in a timely fashion of any and all legal requirements such as filing times, submission of written documents, when any graphic presentations are due, and the like.

The corollary of this is, of course, that the accountant needs to guarantee to do or not do several things of concern to the client and/or attorney. If the accountant feels that he may not "fit the bill" as an expert witness in a case, he must not accept the engagement. The accountant must:

1. Possess the necessary qualifications and background.
2. Be cognizant of the accounting profession's technical and ethical standards applicable to litigation services, specifically those applying to expert witnesses.
3. Schedule adequate time and opportunity to investigate the case thoroughly.
4. Be prepared to furnish testimony in a forceful, confident manner.
5. Be prepared to defend a position "properly taken" in a polite, matter-of-fact manner in cross-examination.
6. Keep foremost in mind that the objective is to aid the client and attorney in winning the case, but *not* at the cost of the accountant's integrity.
7. Remember that the expert witness is *not* a client advocate, but an advocate of the accountant's own opinion and point of view.
8. Be positive that there can be no taint of conflict of interest that could be detrimental to the case.
9. Steer away from any engagement where there could be a possibility of divulging privileged information.
10. Withdraw as expeditiously as possible if there are any doubts about the litigation in question.
11. Adhere to the strategy of the lawyer, but here again, *not* at the expense of the accountant's integrity.

¶23,003 Prep Time

Preparing for the first trial may be the most difficult part of joining the growing number of accountants entering the expert witness niche. This is the time when the accountant, if he's been lucky or hasn't served on a jury, really becomes familiar with the down-to-earth aspects of the judicial system.

There's nothing like familiarity in developing confidence and ease of presentation; therefore, preparation should include:

1. Becoming familiar with the general rules governing real-life courtroom procedure in the locale where the testimony will be given.
2. A visit to a court, preferably one where there is a trial being held involving an accountant expert witness. In metropolitan areas, this should be relatively easy.
3. When apprised of the specific court assignment of the case, the accountant should visit the particular judge's courtroom to observe his attitude and demeanor.

4. Role playing. This activity is recommended for all sorts of therapy, where it may or may not work, but it definitely works in a situation like this. (The attorneys had to play out their role for moot court in law school. Why not the accountant turning expert witness?) Partners, staff and/or family members make great critics—as well as actors in this courtroom drama. Even a full-length mirror can ask questions and talk back.

¶23,005 Definition of an Expert Witness

The courts uniformly agree that the accountant possesses the qualifications of an expert witness on any subject matter falling within the scope of his experience, training, and education.

There are perhaps as many definitions of an "expert witness" as there are statutes, judges, and writers concerned with testimony. The following definition of an expert witness is designed to cover all aspect of "expert" definitions (without any whereases or wherefores): *A witness is an expert witness and is qualified to give expert testimony if the judge finds that to perceive, know, or understand the matter concerning which the witness is to testify requires special knowledge, skill, experience, training, and/or education, and that the witness has the requisite special knowledge, skill, experience, training, and/or education deemed necessary and appropriate.*

If the opposing party offers any objection to the use of an expert's testimony, the accountant's special knowledge, skill, experience, training, or education must be shown before the witness may testify as an expert. Regardless, this information should be made known to the court. A witness's special knowledge, skill, training, or education may be shown by his own testimony, but it will probably "set" better with the jury if the lawyer elicits the pertinent information from the witness relating to his or her education, experience, and specialized knowledge.

Since the basic requirement of an expert witness is that the witness possess the ability to interpret, analyze, and evaluate the significant facts on a question concerning which just a judge or a judge and jury need assistance to resolve, it is imperative that they be aware of the accountant's background. This expertise must be demonstrated in a positive but unassuming manner to be effective. No one likes a braggart.

The courts have uniformly accepted the accountant as an expert. In the majority of cases, the primary and most significant criteria in guidance of a trial court's determination of qualifications of an expert witness are based on occupational experience. Equally significant is the judicial recognition of the special

knowledge acquired by an accountant relating to a particular industry, trade, occupation, or profession to qualify her as an expert on particular business and trade practices and on other factors relating to costs and gross profit margins.

In actual practice, it is rare that the trial court will refuse to permit the witness to testify as an expert because he is insufficiently qualified. Rather, any weakness or deficiency will show up in the quality and impact of the testimony rather than its admissibility.

Therefore, it is imperative that an accountant be very cautious about accepting an assignment that may be beyond his or her area of expertise.

¶23,006 *Daubert* and Federal Rule of Evidence 702

The rules behind the admissibility of scientific or expert testimony in Federal Courts prior to *Daubert* were based on relevancy and the *Frye* test. The latter was based on a 1923 case involving the admissibility of evidence from a polygraph or "deception" test. The court decided, "the systolic blood pressure deception test has not yet gained such standing and scientific recognition among physiological and psychological authorities as would justify the courts in admitting expert testimony deduced from the discovery, development, and experiments thus far made."

In *Daubert*, the U.S. Supreme Court ruled that the 1923 Frye test was superseded by the 1975 Federal Rules of Evidence. specifically Rule 702. Testimony by Experts. Rule 702 originally stated (in its entirety),

> "If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise."

By 2008, this stipulation had been added to Rule 702, "or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case."

The Supreme Court clarified in the *Daubert* case that trial judges are "gatekeepers" who may prevent dubious scientific testimony from being introduced at trial. The eight concurring judges went further to extend substantial discretion to admit or exclude expert testimony to *all* areas, not just scientific ones. Thus, the gatekeeping obligation of judges imposed in *Daubert* applies to any "expert" testimony. The judge may inquire into the particular methodology used. If the evidence appears to be questionable or unreliable, the judge at his or her discretion may exclude the testimony.

¶23,007 Function of the Expert Witness

The function of the expert witness is to form an opinion or inference on matters when individuals in the normal course of affairs would probably not be able to do so. Therefore, an expert witness is needed in any case where by reason of his special knowledge, the expert is able to form a valid opinion on the facts while the man on the street would—or should—not.

Courts vary in their conception of when the expert is needed. Some courts maintain that expert testimony is admissible only when the subject matter is beyond the common experience of the ordinary juror who would then be unable to reach an informed opinion or draw a valid inference from the facts. In effect, they apply a "strict" test of necessity. More often, the determination is made on the basis of whether this testimony would be of "assistance" to the judge or jury.

¶23,009 Basis of Investigation

In his investigation preparatory to giving testimony, an expert may rely upon various sources. He may:

1. Rely on known facts if such facts are material to the inquiry.
2. Obtain information gained from a demonstrably reliable source.

   This could include previous audit reports, certified financial statements, books and records of the business—even though they were not kept by the expert witness—or demonstrable customs and practices within the business or industry of the client for whom the expert is testifying.
3. If the expert has firsthand knowledge of the situation, inferences or opinions may be stated directly. However, care should be taken to be absolutely sure that the practitioner states fully the facts relied upon, the reliable source, and the permissibility of the basis upon which an opinion was founded. Otherwise, the testimony will do more harm than good. If a judge and/or jury become aware of even one instance in which the accountant has slipped up, his expertise will henceforth be open to question.

In addition, the expert witness must have a thorough knowledge of the substantive issue in the case. The investigation and subsequent conclusion may be incomplete and unrelated to the issue if he either has not been informed properly of the particulars in a case, or has not done his homework thoroughly. It is also

necessary that he know the issues of the case so that he can anticipate and respond promptly and forcefully to cross-examination and avoid answers that are incomplete, confusing, and irrelevant. In other words, the expert must be made privy to all relevant facts in the case as well as to the direction of the lawyer's attack or counterattack.

The "need to know" policy should not be carried so far that the accountant appears "in the dark" or at best ill-informed. Therefore, it is important for the accountant to ascertain whether the attorney is willing to work closely with the "expert witness." If the accountant finds it impossible to work in good faith with a particular attorney or law firm, he should withdraw from the case, if possible, or at least refuse to work with that individual or firm in the future. Failure to be aware of or to consider all of the facts not only diminishes the value of the expert's testimony to the case but quite often leaves the expert vulnerable to attack on cross-examination. Not only can the accountant become surprised and confused by the additional facts, but the image as an expert will be damaged in the minds of the judge and jury. The individual's credibility and reputation could be severely damaged.

¶23,011 Exhibits

It is almost mandatory that the expert witness prepare, or have prepared, some type of exhibit for several obvious reasons, not the least of which is the fact that very few individuals can make any sense of numbers from just *hearing* them. Oversize charts, graphs, schedules, diagrams—whatever aids the court in visualizing the accountant's findings—can be useful in focusing their attention. Visual aids not only help the expert witness explain his conclusions but they can have a greater impact on the judge and jury. *If* these graphics can be presented in an interesting, imaginative way, they might also tend to lessen the tedium of often very dry facts and figures.

This "demonstrative evidence" (in the parlance of the court) must not appear to be a way of "lecturing" to the judge and jury. At the same time, these are not people preparing for the CPA exam. The visual materials must present readily understood, clearly identifiable steps the accountant took in arriving at opinions and conclusions—not just a jumble of numbers.

It may be appropriate to provide copies of the material to the judge and the members of the jury so that they can use both eyes and ears to follow the testimony of the expert. Even then, it is probably better to have too little information on a graph or schedule than too much.

Chapter 34

Mutual Funds

CONTENTS

¶34,000 Overview

On June 30, 2009, in response to the credit crisis' impact on money market funds, the SEC issued a comprehensive set of proposals to strengthen the money market fund regulatory regime. The proposals focused on tightening the credit quality, maturity and liquidity standards for money market funds to better protect investors and make money market funds more resilient to risks in the short-term securities markets such as those that unfolded last fall (because of losses on IOUs from brokerage Lehman Bros. Holdings Inc.). In addition, the proposals would require money market funds to stress test their portfolios and report their portfolio holdings each month to permit investors and regulators to better assess their risk characteristics.

A money market fund is a type of mutual fund that is required by law to invest in low-risk securities. Typically these funds invest in government securities, certificates of deposit, commercial paper of companies, or other highly liquid and low-risk securities. They attempt to keep their net asset value (NAV) at a constant $1.00 per share—only the yield goes up and down. But a money market's per share NAV may fall below $1.00 if the investments perform poorly. While investor losses in money markets have been rare, they are possible, and did happen in this case for only the second time ever. Unlike a "money market deposit account" at a bank, money market funds are not federally insured.

The proposals also seek to facilitate an orderly liquidation of any money market fund that has "broken the buck" (re-priced its securities below $1.00 per share) by requiring funds to have the capability to process trades at prices other than $1.00 and permitting them to suspend redemptions in order to distribute assets in an orderly manner. In addition, the SEC requested comment on whether more fundamental changes may be warranted, such as converting money market funds to a floating rate net asset value, in order to better protect investors from abuses and runs on the funds.

In addition, on June 18, the SEC and the Department of Labor held a joint hearing on target date funds. Target date funds and other similar investment options are investment products that allocate their investments among various asset classes and automatically shift that allocation to more conservative investments as a "target" date approaches. These funds have become popular, with growth in target date fund assets likely to continue since these funds can be default invest-

ments in 401(k) retirement plans under the Pension Protection Act of 2006. Target date funds, however, recently have produced some troubling investment results. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results, as returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent. The average loss in 2008 among 31 funds with a 2010 retirement date was almost 25 percent. In addition, varying strategies among these funds produced widely varying results, as returns of 2010 target date funds ranged from minus 3.6 percent to minus 41 percent.

The Chairman stated that the SEC staff had also been asked to prepare a recommendation on rule 12b-1, which permits mutual funds to use fund assets to compensate broker-dealers and other intermediaries for distribution and servicing expenses. These fees, with their bureaucratic sounding name and sometimes unclear purpose, are not well understood by investors. Despite this, in 2008, aggregate rule 12b-1 fees amounted to more than $13 billion. It is essential, therefore, that the SEC conduct a comprehensive re-examination of rule 12b-1 and the fees collected pursuant to the rule. If issues relating to these fees undermine investor interests, then we at the SEC have an obligation to adjust our regulations.

¶34,001 Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies

On January 13, 2009, the Securities and Exchange Commission (SEC) adopted amendments to Form N-1A used by mutual funds to register under the Investment Company Act of 1940 and to offer their securities under the Securities Act of 1933 in order to enhance the disclosures that are provided to mutual fund investors. The amendments require key information to appear in plain English in a standardized order at the front of the mutual fund statutory prospectus.

The Commission is also adopting rule amendments that permit a person to satisfy its mutual fund prospectus delivery obligations under Section 5(b)(2) of the Securities Act by sending or giving the key information directly to investors in the form of a summary prospectus and providing the statutory prospectus on an Internet Web site. Upon an investor's request, mutual funds are also required to send the statutory prospectus to the investor. These amendments are intended to improve mutual fund disclosure by providing investors with key information in plain English in a clear and concise format, while enhancing the means of delivering more detailed information to investors. Finally, the SEC adopted additional amendments that are intended to result in the disclosure of more useful information to investors that purchase shares of exchange-traded funds on national securities exchanges.

.01 Amendment to Form N-1A and Related Rules

The amendments to Form N-1A and related rules include the following:

- Requires each mutual fund statutory prospectus to include a summary section that lists certain specified information about the fund covered by the prospectus;
- Amends certain disclosure requirements for exchange-traded funds (ETF) that register as open-end funds on Form N-1A;
- Allows a fund to satisfy its prospectus delivery requirements by providing to investors a summary prospectus, which is composed of the summary section of the statutory prospectus.

The amendments were effective on March 31, 2009. Compliance is mandatory on or after January 1, 2010 for initial registrations and post-effective amendments that add a new series or provide annual updates. Compliance is mandatory for other post-effective amendments filed on or after January 1, 2011. A fund may elect to comply with the new form requirements at any time after the effective date. It is important to note that because the post-effective amendments using the new format must be filed under Rule 485(a) under the 1933 Act, they are, therefore, not effective for at least 60 days.

.03 Specific Requirements for Summary Section of Prospectus

Amended Form N-1A requires each statutory prospectus to include, at the beginning, a summary section that contains, in plain English and in a prescribed numerical order, certain required disclosures. Registrants are not permitted to omit any of the prescribed disclosures or include any additional information that is not otherwise required. Furthermore, nothing other than the cover page and the table of contents may precede the summary section.

The SEC believes that a standardized summary section will enhance investor understanding and the ability to compare funds. Information included in the summary section need not be repeated elsewhere in the prospectus. While a fund may continue to include information in the prospectus that is not required, a fund may not include any such additional information in the summary section of the prospectus.

Although the amendments do not include a specific page limit for the summary portion of a statutory prospectus, the SEC stated, "it is our intent that funds prepare a concise summary (on the order of three or four pages) that will provide key information."

The following disclosures are required to be included in the summary portion of each statutory prospectus:

- Investment objectives;
- Costs;
- Principal investment strategies, risks, and performance;
- Investment advisers and portfolio managers;
- Brief purchase and sale and tax information;
- Financial intermediary compensation.

These items will appear in this prescribed order.

.05 Small Entities Subject to the Rule

For purposes of the Regulatory Flexibility Act, an investment company is a small entity if it, together with other investment companies in the same group of related investment companies, has net assets of $50 million or less as of the end of its most recent fiscal year. Approximately 127 mutual funds registered on Form N-1A meet this definition. Of the approximately 593 registered open-end investment companies that are ETFs, only one is a small entity.

The Commission believes at the present time that special compliance or reporting requirements for small entities, or an exemption from coverage for small entities, would not be appropriate or consistent with investor protection. We believe that the amendments to Form N-1A will provide investors with enhanced disclosure regarding funds. This enhanced disclosure will allow investors to better assess their investment decisions.

¶34,002 SEC Enhanced Disclosure and New Prospectus Delivery Rule

On January 13, 2009, the Commission adopted a final rule for an improved mutual fund disclosure framework that was originally proposed in November 2007. This improved disclosure framework is intended to provide investors with information that is easier to use and more readily accessible, while retaining the comprehensive quality of the information that is available today. The foundation of the improved disclosure framework is the provision to all investors of streamlined and user-friendly information that is key to an investment decision.

To implement the new disclosure framework, the SEC adopted amendments to Form N-1A that require every prospectus to include a summary section at the front of the prospectus, consisting of key information about the fund, including investment objectives and strategies, risks, costs, and performance. There is also a new option for satisfying prospectus delivery obligations with respect to mutual fund securities under the Securities Act. Under the option, key information is sent or given to investors in the form of a summary prospectus ("Summary Prospectus"), and the statutory prospectus will be provided on an Internet Web site. Funds that select this option will also be required to send the statutory prospectus to the investor upon request.

In addition, the Commission is adopting amendments to Form N-1A relating to exchange-traded funds ("ETFs") that are proposed in a separate release in March 2008. These amendments are intended to result in the disclosure of more useful information to investors who purchase shares of exchange-traded funds on national securities exchanges.

Numerous commentators have suggested that investment information that is key to an investment decision should be provided in a streamlined document with other more detailed information provided elsewhere. Furthermore, recent investor surveys indicate that investors prefer to receive information in concise, user-friendly formats.

The SEC is adopting amendments to Form N-1A that will require every prospectus to include a summary section at the front of the prospectus, consisting of key information about the fund, including investment objectives and strategies, risks, costs, and performance. This key information is required to be presented in plain English in a standardized order. The intent is that this information will be presented succinctly, in three or four pages, at the front of the prospectus.

.01 Background

Millions of individual Americans invest in shares of open-end management investment companies ("mutual funds"), relying on mutual funds for their retirement, their children's education, and their other basic financial needs. These investors face a difficult task in choosing among the more than 8,000 available mutual funds. Fund prospectuses, which have been criticized by investor advocates, representatives of the fund industry, and others as being too long and complicated, often prove difficult for investors to use efficiently in comparing their many choices. Current Commission rules require mutual fund prospectuses to contain key information about investment objectives, risks, and expenses that,

while important to investors, can be difficult for investors to extract. Prospectuses are often long, both because they contain a wealth of detailed information, as per SEC requirements, and because prospectuses for multiple funds are often combined in a single document. Too frequently, the language of prospectuses is complex and legalistic, and the presentation formats make little use of graphic design techniques that would contribute to readability.

A new option is also being adopted for satisfying prospectus delivery obligations with respect to mutual fund securities under the Securities Act. Under the option, key information will be sent or given to investors in the form of a Summary Prospectus, and the statutory prospectus will be provided on an Internet Web site. Upon an investor's request, funds will also be required to send the statutory prospectus to the investor. The intent in providing this option is that funds take full advantage of the Internet's search and retrieval capabilities in order to enhance the provision of information to mutual fund investors.

This disclosure framework has the potential to revolutionize the provision of information to the millions of investors who rely on mutual funds for their most basic financial needs. It is intended to help investors who are overwhelmed by the choices among thousands of available funds described in lengthy and legalistic documents to access readily key information that is important to an informed investment decision. At the same time, by harnessing the power of technology to deliver information in better, more useable formats, the disclosure framework can help those investors, their intermediaries, third-party analysts, the financial press, and others to locate and compare facts and data from the wealth of more detailed disclosures that are available.

In addition, effective February 28, 2010, The Securities and Exchange commission is adopting rules amendments that will enhance information provided in connection with proxy solicitations and in other reports filed with the Commission. The amendments will require registrants to make new or revised disclosures about: compensation policies and practices that present material risks to the company; stock and option awards of executives and directors; director and nominee qualifications and legal proceedings; board leadership structure; the board's role in risk oversight; and potential conflicts of interest of compensation consultants that advise companies and their boards of directors. The amendments to these disclosure rules will be applicable to proxy and information statements, annual reports and registration statements under the Securities Exchange Act of 1934, and registration statements under the Securities Act of 1933 as well as the Investment Company Act of 1940. The requirement to disclose shareholder voting is transferred from Forms 10-Q and 10-K to Form 8-K.