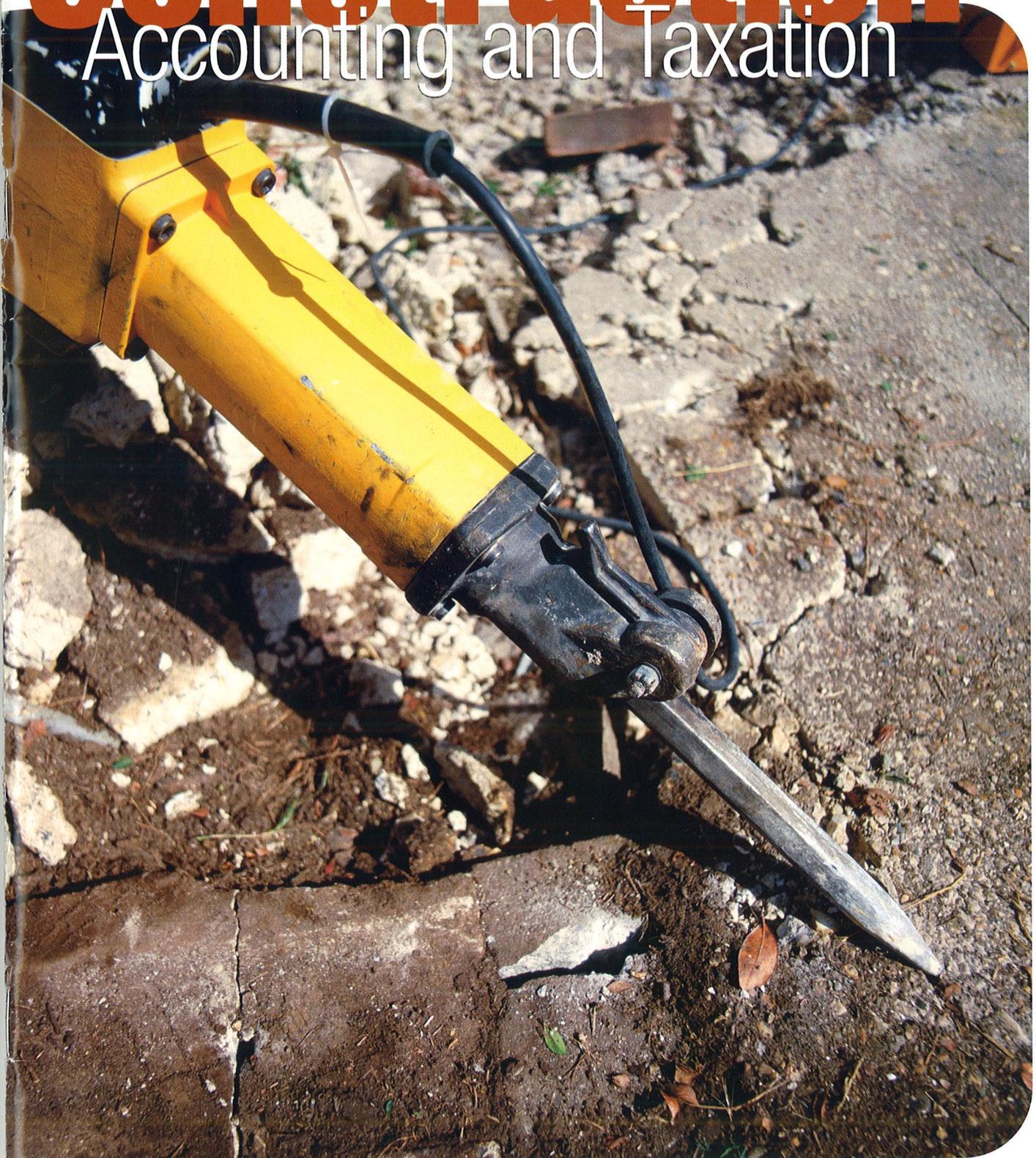


March
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Accounting and Taxation



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UPCOMING FINANCIAL REPORTING DEVELOPMENTS:

Proper assignment of values to plant, machinery and equipment assets is central to the measurement and management of a company's risks and its return on investment.

ACCOUNTANT, AUDITOR AND APPRAISER— THE NEED TO COLLABORATE

KWEKU BOISON

The assets on the balance sheet of a company are often dominated in terms of total by property, plant, and equipment (PP&E). Of the total PP&E, real estate often tends to be the most substantial. There are, however, some industries where plant, machinery and equipment dominate in value. The plant, machinery and equipment are more valuable than the historical cost of the real estate on which they perch. Examples of these include processing

complexes such as oil refineries; auto parts fabrication plants; pharmaceutical plants.

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**OLDER ASSETS
MAY BE UNDER-
DEPRECIATED
REGARDLESS OF
THE IMPACT OF
THE MARKET ON
VALUE.**

Importance of accurate representation of physical assets on the sheet

The accounting profession has traditionally relied on historical cost to represent property, plant and equipment on the financial statements. The economic melt-down of 2008, if anything, emphasizes the need for relevance and representational faithfulness of financial statements. In a broad sense at the core of the financial melt-down was the problem of contemporaneous valuation of assets. The accounting professionals will be well served by engaging appraisers trained in the valuation of plant, machinery and equipment to assist in estimating the values of plant, machinery and equipment. Proper assignment of values to plant, machinery and equipment assets is central to the measurement and management of risks and a company's return on investment, particularly when it comes to companies in which plant, machinery and equipment takes up a significant portion of the value of the fixed assets. Currently the balance sheet reflects the historical costs of a company's physical assets. However, economic downturns, for instance, may cause the values of many assets that were purchased in the past to be overstated. Furthermore, older assets may be under-depreciated regardless of the impact of the market on value. (The opposite is true in inflationary times.) This, without doubt, would skew any ratio analysis and by extension any decisions based on such analysis. Inherent in this is that accountants are not trained to value physical assets. Therefore, reliance on intuition by accountants to fairly value physical assets is a recipe for impending disaster.

Recent developments in the world of accountants: The need for collaboration with appraisal professionals in financial reporting

On July 1, 2009 the Financial Accounting Standards Board (FASB) unveiled the Accounting Standards Codification. This is now the authoritative source of

U.S. Generally Accepted Accounting Principles (GAAP) for non-governmental entities. The codification does not change U.S. GAAP; it only restructures the way the GAAP is organized. The unique feature of the new codification is the election by the FASB to make it online-based. The document, therefore, has the following benefits:

- it provides access to all FASB standards and other authoritative literature related to a topic in one place;
- it reduces the amount of time and effort required to research accounting standards;
- it diminishes the risk of noncompliance with standards through improved usability; and
- it provides accurate information with real-time updates.

Accountants can now turn to U.S. GAAP Codification of Accounting Standards—Codification Topic 360: Property, Plant and Equipment for all the authoritative pronouncements affecting physical assets.

Alongside the evolution of the Statement of Financial Accounting Standards (SFAS) has been the development of the International Financial Reporting Standards (IFRS). The IFRS is a set of accounting standards developed by the International Accounting Standards Board (IASB), an independent accounting standards body based in London.

The globalization of business and finance has led more than 12,000 companies in more than 100 countries to adopt IFRS. In 2005, the European Union (EU) began requiring companies incorporated in its member states whose securities are listed on an EU-regulated stock exchange to prepare their consolidated financial statements in accordance with IFRS-1 (*First-time Adoption of International Financial Reporting Standards*). Australia, New Zealand, and Israel have essentially adopted IFRS as their national standards. Canada, which previously planned convergence with the U.S. Generally Accepted Accounting Principles (GAAP), now plans to require IFRS for publicly accountable entities in 2011. The Accounting Standards Board of Japan (ASBJ) and the International Account-

ing Standards Board (IASB) plan convergence in 2011. On November 11, 2008, Mexico announced it would adopt IFRS for all listed entities starting in 2012.¹ The Institute of Chartered Accountants of India and the Indian Ministry of Corporate Affairs have announced their commitments to adopt IFRS from April 1, 2011.² Brazil, one of the world's largest economies, has also announced plans to adopt IFRS.

Following their meeting in Pittsburgh, Pennsylvania in September 2009, the leaders of the G20 nations issued a Final Statement identifying a range of additional steps that should be taken to strengthen international financial regulatory system to avoid a future global financial crisis. One of their stated goals was to complete convergence of accounting standards across the G20 member nations by June 2011.³

"We call on our international accounting bodies to redouble their efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process, and complete their convergence project by June 2011. The International Accounting Standards Board's (IASB) institutional framework should further enhance the involvement of various stakeholders."⁴

There is a growing acceptance of International Financial Reporting Standards (IFRS) as a basis for U.S. financial reporting. This represents a fundamental change for the U.S. accounting profession. On November 14, 2008, the Securities and Exchange Commission (SEC) released for public comment a proposed roadmap with a timeline and key milestones for adopting IFRS beginning in 2014.⁵ If this roadmap is adopted, IFRS will open the way for a much wider application of fair value accounting to non-financial assets in the United States. (In a statement approved on February 24, 2010 the SEC has said it is not pursuing the 2014 roadmap. Though much remains uncertain, the SEC made clear that it envisions 2015 as the earliest possible date for the required use of IFRS by U.S. public companies. The SEC, however, makes it unambiguous that it continues to support the move toward adopting IFRS for U.S. public companies.⁶)

The SEC roadmap applies only to publicly traded companies. Small- and medium-sized private firms in the United States do not fall under the jurisdiction of the SEC and so are not required to issue any financial statements, unless mandated by industry regulations or contractual agreement. The private firms which choose to issue financial statements usually follow USGAAP to facilitate competitive comparisons with public companies in the same industry, augment the perception of reliability of their financial reports, and to ease negotiations and transactions. So, if the United States stock exchanges move away from USGAAP, most private firms will likely follow suit.

Private firms issuing financial statements while following USGAAP have had to contend with overly burdensome and in some cases utterly redundant disclosures which were designed for publicly traded companies. The recognition of a demand for a special version of standards for small enterprises was brought to the attention of the IASB by the outgoing Board of the International Accounting Standards Committee in December 2000. The IASB, shortly after its inception in 2001, began a project to develop accounting standards suitable for small- and medium-sized entities (SMEs).⁷ The IASB has since published a separate standard intended to apply to the general purpose financial statements of, and other financial reporting by, entities that in many countries are referred to by a variety of terms, including small- and medium-sized entities (SMEs), private entities, and non-publicly accountable entities. That standard is the *International Financial Reporting Standard for Small- and Medium-sized Entities (IFRS for SMEs)*.⁸ The IFRS for SMEs is a self-contained standard designed to meet the needs and capabilities of SMEs, which are estimated to account for over 95 percent of all companies around the world. Compared to full IFRSs (and many national GAAPs), the IFRS for SMEs is less complex. Whereas full IFRSs allow accounting policy choices, the IFRS for SMEs allows

THERE IS A GROWING ACCEPTANCE OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) AS A BASIS FOR U.S. FINANCIAL REPORTING.



**THE CPA HAS TO
PLAN ON
ENGAGING THE
SERVICES OF
THE "QUALIFIED
APPRAISER."**

only the easier option. In the case of plant, property and equipment, the standard gives no option to revalue.⁹ In addition significantly fewer disclosures are required when using this standard for SMEs. Interestingly and somewhat belatedly, the accounting profession in the United States is seeking to address similar concerns of SMEs and private companies in the country. In February 2010 the American Institute of Certified Public Accountants (AICPA), the Financial Accounting Foundation (FAF), and the National Association of State Boards of Accountancy (NASBA) announced the establishment of a "blue-ribbon panel" to address how U.S. accounting standards can best meet the needs of users of private company financial statements. The panel will provide recommendations on the future of standard setting for private companies, including whether separate, standalone accounting standards for private companies are needed. It is expected to issue a report containing its recommendations to the FAF Board of Trustees in approximately one year. Obviously, how the recommendations are going to tie into the IFRS and the IFRS for SMEs (which the SEC has unambiguously declared its support for) is yet to be known.

If companies are to adopt IFRS, then Certified Public Accountants (CPAs) have the responsibility of leading their clients in the planning effort. Regarding physical assets IFRS-1 (*First-time Adoption of International Financial Reporting Standards*) has the following provisions;

- An entity may choose, at the date of transition to IFRS, for valuing an item of tangible fixed assets at fair value, and use this fair value as deemed cost at that date.
 - The entity to take first IFRS may use the amount of tangible fixed assets revalued under previous GAAP, either at the date of transition or earlier, as deemed cost in revaluation date, provided that it was, when performed, broadly comparable:
1. at fair value, or

2. the cost or the cost depreciated according to IFRS, adjusted to reflect, for example, changes in a general price index or specific.¹⁰

Clearly, the CPA has to plan on engaging the services of the "qualified appraiser" whether the client company chooses to revalue its assets at the date of transition to the IFRS or revalue the assets under previous GAAP prior to transitioning to IFRS. The Pensions Protection Act of 2006 defines the "qualified appraiser" as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.¹¹ These provisions are amplified by the Internal Revenue Service in IRS Notice 2006-96, which provided transitional guidance between August 17, 2006 and February 16, 2007 leading to the full implementation of the 2006 Pensions Protection Act. The Notice says in part . . . (ii) For returns filed after February 16, 2007, the appraiser has (A) successfully completed college or professional-level coursework that is relevant to the property being valued, (B) obtained at least two years of experience in the trade or business of buying, selling, or valuing the type of property being valued, and (C) fully described in the appraisal the appraiser's education and experience that qualify the appraiser to value the type of property being valued.¹²

In addition to the reporting standard mentioned, the IASB has also issued accounting standards which are to guide CPAs in the measurement methods to be used in arriving at values of physical assets. IAS 16, International Account-

ing Standards for Property Plant and Equipment and IAS 36 for Impairment of Assets, both provide CPAs with guidance for measuring values of physical assets. As a practical matter these remain as guidance and it takes the trained appraiser to assist the CPA meet the goals of the standards.

For both publicly traded and private companies the IASB addressed the need for an electronic standard to transmit IFRS financial information by providing the IFRS Taxonomy. The IFRS Taxonomy is the XBRL representation of IFRSs, including International Accounting Standards (IASs), Interpretations, and the IFRS for SMEs issued by the IASB. All IFRSs that contain disclosure requirements are included in the IFRS Taxonomy. XBRL (eXtensible Business Reporting Language) is a standard that is used to communicate information between businesses and other users of financial information. It provides a common, electronic format for business reporting. As with the IFRS Bound Volume, the IFRS Taxonomy is released once a year to incorporate new IFRSs, improvements to existing IFRSs, and also changes in XBRL technology.¹³

Within the IFRS Taxonomy 2010 the following notes are required among hierarchy [822100] Notes—Property, Plant and Equipment: Classes of property, plant and equipment; Effective date of revaluation of property, plant and equipment; Explanation of independent valuer used for revaluation of property, plant and equipment; Explanation of revaluation methods and assumptions, property, plant and equipment; Fair value of property, plant and equipment materially different from carrying amount.¹⁴ These required notes, it is submitted, may only be objectively and adequately completed with the assistance of a “qualified appraiser.”

It is anticipated that in the immediate years after the IFRS is required for use by publicly traded companies, state and local governmental sectors will, as a matter of pragmatism, be compelled to follow suit because the communications within the community of users of financial statements will at that point be

centered on fair values and no longer on historical values. The IFRS is going to impact the financial representations of state and local governments. At the state and local level significant plant, machinery and equipment are utilized to provide services for the respective jurisdictions. Property professionals at the state and local levels will need to be aware of the changes of IFRS and how these will affect their profession. These changes will go beyond the accounting and finance departments. Under IFRS rules some components of properties may have to be reclassified because the values of such components are material to the value of the whole property. This raises challenges as to the classification, recording and valuation of such properties. For example under IFRS, separate accounting is required for a finance lease, requiring the separation of the value of the building and the land on which it stands. Furthermore, as required, significant items such as boilers or elevator systems will have to be valued and accounted for separately. In addition similar properties used throughout the operations of the respective state and local governments will have to be accounted for, and valued under, similar classifications as the standards require valuation measures chosen to be applied to all classes of balance sheet items consistently. For this and other reasons, the property professionals at the state and local levels will have to more than acquaint themselves with the rules of IFRS.

For CPAs in the public sector other than Government Business Enterprises, the International Public Sector Accounting Standards (IPSAS) is the accounting guide. IPSAS 17 Plant, Property and Equipment prescribes the accounting treatment for plant, property and equipment, including specialist military equipment and infrastructure. This standard is drawn primarily from IAS 16. The IPSAS 17 is also published by the IASB. Similarly, IPSAS 21—Impairment of Non Cash Generating Assets—is drawn from IAS 36. Therefore, in the adoption and implementation of these standards, the CPA will have to rely on the “qualified



PROPERTY PROFESSIONALS AT THE STATE AND LOCAL LEVELS WILL HAVE TO MORE THAN ACQUAINT THEMSELVES WITH THE RULES OF IFRS.

AUDITORS HAVE INCREASINGLY FOUND THE NEED TO HIRE SPECIALIZED EXPERTS TO REVIEW AND EVALUATE VALUATION ESTIMATES WHICH THEIR CLIENTS ORDER FROM THIRD PARTIES.

appraiser” to be able to fairly represent the financial statements of their clients.

The CPA needs to have a vision of when, where, and how the reporting changes are going to occur. It may be in the strategic interest of the CPA and his/her clients to advise investors, analysts, and other stakeholders of the coming changes and what they should expect. Early communication of the impact of IFRS

conversion on key performance metrics—such as return on assets, return on investment, earnings per share—will enable CPAs and their clients to appropriately frame reported IFRS results in a manner in which they will not be misinterpreted. Engaging the analysts community can help ensure that companies’ interests are not overlooked. For example, choices made between different options allowed under IFRS should be meaningful and helpful to analysts. Choice of accounting policies should enhance transparency and comparability. Companies also need to consider how IFRS policies selected compare with their competitors.¹⁵

At this juncture it should be emphasized that the focus of this article is not to debate the merits of using fair value accounting as opposed to historical cost accounting. Rather, the author’s focus is on how CPAs can implement the adoption of IFRS and IPSAS. After all, it is worth noting that in the joint “Declaration of the Summit on Financial Markets and the World Economy” released by the leaders of G-20 in Washington on November 15, 2008, the root causes of the then economic crises were listed. Fair value accounting was not listed as part of the root causes of the economic crises.¹⁶

Appraisers and auditors: The need to collaborate in audit engagements

The advent of these new standards mentioned above, all of which postulate fair value measurements, calls for the need for collaboration between auditors and appraisal and valuation experts. While appraisals have been a consulting service to auditing firms in the past, the requirements of recent standards have

found appraisers being engaged in supporting roles within audit teams. Auditors have increasingly found the need to hire specialized experts to review and evaluate valuation estimates which their clients order from third parties. As a consequence of the drive for reporting relevant information, the requirement by accounting standards for reporting fair values is only going to increase. Additionally, the auditor remains duty-bound to report on the representational faithfulness of the financial statements. The challenge facing auditors today is: “Can an audit opinion provide the same level of comfort for fair value as it does for historical cost?”¹⁷ This observation was aptly made in 2007 by Charles Niemeier, a board member on the Public Company Accounting Oversight Board (PCAOB).

The arrow seems to point in the direction of closer scrutiny of fair market value estimates. In its release numbered 2010-006 the PCAOB on September 29, 2010 issued the “Report on Observations of PCAOB Inspectors Related to Audit Risk Areas Affected by the Economic Crisis.”¹⁸ In this report the board focused on the three years of 2008, 2009, and 2010 during which time it looked at the effect of the 2008 economic crisis on the work of audit firms in areas of audit risk. A key element of many of the Board’s programs, including the inspection program, is the monitoring of economic events. The Board’s inspection staff monitored developments and emerging audit risks related to the economic crisis by, among other things, interacting with other PCAOB offices and divisions, such as the Office of Research and Analysis (ORA) and the Office of the Chief Auditor (OCA), and using the results of tools available through the PCAOB, such as the ORA market surveillance program. When the Board’s inspection staff began to recognize the audit challenges that would be created by the financial market disruption, inspectors participated in dialogue with some of the larger registered audit firms to discuss those challenges and to make clear that inspectors would focus on auditor’s adherence to all relevant standards.¹⁹

As the effects of the economic crisis spread to the broader economy, the Board's inspection staff considered additional audit risk factors, as well as audit risk factors previously considered that had become more significant during the 2009 inspection cycle, which generally involved reviews of firms' 2008 audits. These additional or heightened risk factors were identified in audit areas such as fair value measurements. Fair value measurements are used to establish or evaluate the recorded values of many categories of assets.²⁰

Certain non-financial assets, such as certain long-lived assets acquired in business combinations, are required to be recorded at their fair values upon acquisition. Fair value measurements for non-financial assets such as long-lived assets and reporting units generally require issuers to make assumptions regarding market multiples, discount rates, and the amount and timing of future cash flows, which might be subject to greater uncertainty in times of economic distress.²¹ PCOAB's Inspectors observed that firms often planned

to test issuers' estimates of fair value for non-financial assets by performing procedures that included evaluating the reasonableness of the issuer's significant assumptions and testing the valuation model and the underlying data. Inspectors sometimes identified deficiencies in these instances that included audit firms' failures to evaluate, or evaluate sufficiently, the reasonableness of significant assumptions used by issuers to estimate the fair value of reporting units in their goodwill impairment assessments. For example, inspectors identified instances in which firms failed to test, or tested only through inquiry of management, issuers' significant assumptions, such as forecasted revenue growth rates, operating margins, discount rates, implied control premiums, and weighted average cost of capital measures.²²

When it comes to long-lived assets such as plant, machinery and equipment (and indeed all long-lived assets) the auditor is best served utilizing the expertise of the appraiser specialized in the respective assets. The appraisers' opinion of value are based on thorough



APPRAISERS' OPINION OF VALUE ARE BASED ON THOROUGH RESEARCH OF THE MARKET AND GUIDED BY UNIFORM STANDARDS OF PROFESSIONAL APPRAISERS PRACTICE (USPAP).

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research of the market and guided by Uniform Standards of Professional Appraisers Practice (USPAP), which channels assumptions used in the valuation, if any. The appraisers are trained to evaluate among other things the assertions of management and whether management's assertions are supported by the market of the respective assets. For *fair value* is the value the market gives to the assets at any point in time in an arm's length transaction. The assumptions which are tied to the market conditions of the respective machinery or equipment are clearly laid out in the appraisers' reports as required by the standards of the profession. The appraisal professionals are best positioned to complement the auditor firms' efforts to properly test issuers' fair value measurements and disclosures. The evaluations of the "qualified appraisers" better complement the auditors' duty to attest to the representational faithfulness of the fair values of the long-lived assets of issuers of financial statements.

The economic crisis increased uncertainty regarding issuers of financial statements' estimates of fair value, which significantly increased audit risk. Issuers' fair value measurements and disclosures are often important to investors relying on issuers' financial statements. If auditors do not properly test issuers' fair value measurements and disclosures, auditors might fail to detect material misstatements in issuers' financial statements relating to such measurements and disclosures, and investors might be misled.²³ The standards of the appraisal profession are open to be co-opted by the auditing firms to assist them to meet the expectations of the accounting standards for measuring fair values.

Even though the worst of the economic crisis of 2008 seems to be a thing of the past, the road ahead, on the other hand, does not seem smooth or upbeat either. The general consensus among economists is that the economic recovery is going to be slow and long with gyrations of anxiety along the way. Until the economy attains full recovery, which might be many years hence, we will be living with this new normal which will challenge

auditors to ensure that fair value measurements and disclosures in the financial statements they sign off on are not misleading to investors and other users of financial statements. In addition, whether the United States eventually adopts IFRS or expands existing US GAAP we are witnessing the onset of the changing face of auditing as it has hitherto been known. Auditing teams increasingly realize the need to include appraisal experts to validate fair value estimates. This is the trajectory of the auditing and appraisal professions in the second decade of the twenty-first century and beyond.

Conclusion

The article has examined the need for collaboration between the Plant, Machinery and Equipment Appraiser and the Accounting profession. The pending switch to new reporting standards by the accounting profession points to urgency and proactive planning. Above all management, boards of directors and auditors have the ethical, fiduciary, and legal obligation to ensure that financial statements going out to users do represent faithfully the physical assets of the companies. It is envisioned that CPAs and Appraisers will be joined in this service to companies to increase the prospects of experiencing a smooth, economical, and effective transition to IFRS and or to new US GAAP, whichever option the SEC may require public companies to adopt. Either way, United States companies with international presence have to commit to following the IFRS as regulatory bodies in most countries are planning to. The importance of awareness and preparedness cannot be overemphasized. Practitioners and their clients who identify these key issues early will be in a better position to recommend or take appropriate action in a timely manner. Prepared companies will understand their options, determine which options are most appealing, and know the best way forward to pursue their selections.²⁴ ■

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