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The Practicing

CPA

THE NEWSLETTER OF THE AICPA PRIVATE COMPANIES PRACTICE SECTION



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Succession Planning for Businesses With One Owner

When the topic of succession planning comes up in professional circles, the discussion almost always centers on issues that presume there is a surviving partner or natural successor in the picture. The discussion topics start with whether the buy-sell arrangement should be a stock redemption agreement

By John P. Napolitano
CPA, PFS, CFP®, MST

or a cross-purchase agreement and go through the valuation formula and funding mechanism. In reality, however, many excellent small businesses have no multiple owners, partners, or even a natural successor. It seems clear that these businesses and their owners need the kind of servicing that isn't commonly provided by most of the financial planners, accountants, and attorneys that I know. Even worse, surveys have shown that more than 90% of all sole practitioner professionals, including CPAs, attorneys, and financial planners, do not have a succession plan in place.

So where do we start? I suggest that we start with the exit planning concept developed by John Brown's Business Enterprise Institute, Inc. According to Brown, "Exit planning is the deliberate, adaptable, and customized process that a business owner uses so that he (or she) can leave the business on his or her terms and schedule." Even if an owner's succession is sudden and unexpected, it still may be possible to exit the

business on his or her own terms and time frame.

Let's consider some possible succession variables. First, a planned succession may be undertaken because the owner thinks it's time to retire or just wants to get out because he or she is burnt out. Second, a disability may trigger the formulation of a plan. Third, succession may be necessitated by a sudden death.

In the case of retirement or burnout, the owner has time to plan. The best use of this time is to find or groom an internal successor or put together a combination of an external buyer and an internal successor. The internal successor would be a key person who is capable of stepping into the owner's shoes tomorrow, someone who may be developed from within or discovered through a professional search effort.

Addressing typical excuses

Clients with a one-person dental office or legal office will use every excuse in the book to explain why they cannot find someone to groom as a successor. They'll claim that they can't find the right person, can't afford to pay them for the grooming period, along with a host of other obstacles. If you agree that the practice is too small to sustain an owner in training and waiting, then you'll have to help them go right to plan B, which is to sell the business to another practitioner as soon as they can find one who can do the job.

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In either case, the sole owner can do several things to make the transition easier for a successor. Among the best practices employed for businesses with one owner to ensure a smooth succession are the following strategies:

- Document all systems and processes well.
- Maintain good client and customer records, with records of their buying patterns, preferences, and unique situations clearly spelled out. A well-maintained contact management system can do that.
- Maintain a complete contact list of key suppliers and vendors.
- Develop a list of the daily activities of the owner.
- Maintain job descriptions and personnel records of all employees.

Qualifying prospective new owners

For larger businesses with only one owner, the process is a bit more complicated. The business undoubtedly has key people, some of whom have dedicated years of their lives to help build the business—but that may not mean that they should become the new owners. The first question is whether they have the talent to replace the owner and take the business to the next level. If the answer is *yes, they do have the talent*, it is necessary to examine their financial qualifications. Can they get the financing to make the purchase? When selling to insiders, an earn-out method is frequently used, whereby the down payment is only a small percentage of the selling price, such as 25% or 33%. For substantial purchases, outside collateral is often requested. Also, make sure that the owner protects his or her interests by retaining a director's seat, if not the chairman's seat, and insist that the new owner purchases insurance on the seller's note.

If the management team clearly does not have the capital or desire to purchase the business, their operational abilities are still front and center. The new owner of a substantial business will want to maintain the management team for an extended period, at least, and maybe indefinitely. Moreover, the seller will want to do whatever is possible to encourage these key personnel to stay on and cooperate with their new employer in order to maximize the selling price.

Among the considerations and agreements that should be made with key employees before entering into a sale are:

- Confidentiality and nondisclosure agreements
- Employment contracts
- Noncompetition clauses
- Bonus arrangements based on the success of any transition

Contingent service agreement

Regardless of whether an exit is planned or unexpected, all single-owner companies should have a contingent service agreement between the business owner and some other skilled person who will agree to step into the owner's shoes. This person could be a friend, colleague, employee, or competitor. In the event of an unexpected exit, a contingent service agreement may be the key to preserving the value of the business. Think of the sole practitioner accountant who suddenly becomes disabled or passes away on March 5. Key staff would have just enough time to start their own practice and complete all of the tax season work for the same clients that they've been servicing over the years. But these staff will now send out invoices on their letterhead and keep 100% of the fees.

This outcome can be prevented by having a contingent service agreement in place, which would provide for another professional to quickly step into the owner's shoes. An owner needs to negotiate the rate for these contingent professional services and, in doing so, should not look for a bargain. On the contrary, experts in contingency planning often recommend paying surplus compensation for this type of contingent plan. A contingent service agreement may also lead into a buy-sell arrangement if the disability lasts longer than a certain period or the parties wish to go that route.

Informing clients and customers

A significant part of the process is to inform clients and customers of the succession plan. They may not have asked, but you can be sure that they wonder what will happen to them if something happens to the firm's owner. The owner can apprise clients and customers informally through a newsletter, for exam-

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ple, or face to face at a client event or in a meeting. The owner can choose to name the successor or simply indicate that provisions have been made for continuous and uninterrupted service in the event that something happens to him or her. Either way, this is just one more way for an owner to show that he or she is a diligent business person interested in doing what is best for clients, customers, and family.

Whether the owner operates a small professional practice or a \$50 million manufacturing firm, a contingency arrangement sends a clear message that arrangements have been made to address an unexpected exit by the owner. Without this clear message to clients, employees, and vendors, someone, including a competitor or an employee, may try to scoop up a significant part of the business.

Adequate insurance

To facilitate a possible unexpected exit, an owner should always further protect the business by having a few insurance policies in place. One reason is to insure the company as if there were partners. I'd recommend enough disability insurance to pay the owner's salary. This leaves what the owner was taking in salary in the till and helps to ensure that the company will have the cash flow to pay a replacement chief executive. I'd also recommend that the owner purchase enough life insurance to keep the surviving heirs out of harm's way for lack of income or in the event that it is not possible to sell the business quickly. The coverage purchased should be equal to the value of the business or at least the amount that the family would need to survive comfortably. This level of coverage would protect against the business's demise even though the owner didn't complete a planned succession. All would not be lost.

If a disabled owner is lucky enough to salvage the company and still get some sale proceeds, he or she may be more flexible regarding the terms of the sale and eventually net more than the fair market value, including the insurance proceeds.

The sole owner should also think about the possible buyer of the company in the event of a premature exit. This process is very similar to the process that one would follow in the event of a sale of the business, except that it is contingent in nature. While the owner and the business are still healthy, the owner should find a potential acquirer on a contingency basis. With a little luck, he or she will find someone with a similar business in the same position that he

or she is in, that is, a sole owner without a succession strategy. This sounds too good to be true, but for small professional practices, it is actually quite easy to accomplish. It gets increasingly difficult, however, if a solely owned business has many employees and or locations.

Many owners fear taking this step because it entails releasing confidential information about their business and their customers. Such fears may be the incentive to find a potential buyer who is in the same position and probably feels the same way. Nevertheless, an owner should work with a bigger company if he or she believes that to be the best option, in spite of the fear that the bigger company will be only too happy to succeed. An owner can get a pretty good feel for a competitor's desire to participate before divulging too much confidential information.

AICPA Member Guidance on FIN 48, Accounting for Uncertain Tax Positions

For years beginning after December 15, 2006, all GAAP-based financial statements must account for uncertainty in income taxes in accordance with FIN 48, *Accounting for Uncertain Tax Positions*. Adoption of FIN 48 requires an analysis of all tax positions at the beginning of the period or, for calendar-year-end businesses, as of January 1, 2007. Tax positions may be recognized only if they meet a "more-likely-than-not" threshold of being realized if challenged by a taxing authority with full knowledge of the facts. If this level of certainty does not exist, no tax benefit may be booked, and, even if this level of certainty does exist, only the amount that has a greater than 50% chance of being sustained may be booked. Specific financial statement disclosures are required with respect to uncertain tax positions.

To help financial statement preparers, auditors, and tax advisers meet this new requirement, the Accounting Standards, Auditing and Attest Standards, and Tax Teams have developed a Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48. The AICPA's 13-page practice guide includes highlights of FIN 48 and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative, but intended to assist members in quickly understanding the requirements of FIN 48. The practice guide is available without charge to all AICPA members at www.aicpa.org/FIN48Guide.

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Backup 101 for Small Business

Whether locking the front door, stashing cash and jewelry in a hidden household safe, or storing critical documents in a bank safety deposit box, we all take precautionary measures to protect our valuables. But when it comes to providing similar degrees of protection for essential business data, many companies fall short. Some believe an uninterruptible power supply (UPS) is all the protection they need; others believe their PC or server is so reliable that they simply do not have to worry about data loss. And others believe that protecting data is a complex, technical, and expensive operation that requires extra staffing or extensive time commitments to learn and execute.

But in reality none of these beliefs stands up to scrutiny: A UPS prevents power loss, not data loss or corruption. Applications can still fail no matter how reliable a PC or server is, and backup software, although once costly and complex, is now inexpensive, simple-to-use, and, depending on the solution implemented, completely automated.

To debunk myths about backup, Yosemite Technologies has compiled the following FAQs that address initial concerns of individuals and small businesses who want to understand the importance of data protection.

Why back up data and applications?

There are two kinds of computer users: those who have lost data, and those who will. Data loss can be a simple annoyance or it can translate into lost productivity, the degradation of customer relationships, or even the loss of clients. A firm should back up its data because they are the lifeblood of the business and rarely can be recreated from memory. And even if they can, valuable time and resources can be lost in the effort. You don't leave your credit cards lying around. Why would you not exercise the same care with the very foundation of your livelihood?

Is backing up the same thing as archiving?

Functionally, backing up data and applications or archiving them is the same. Both backups and archives can rely on the same technology, give the same peace of mind, and be stored in the same media. The difference between these two terms is one of degree: Backup files are not typically retained as long

as those meant for archiving. Additionally, files that are archived normally are deleted from the source, for example, the primary storage disk on which they reside.

What is the difference between copying and backing up data?

Copying data is a manual, time-intensive, one-to-one process that requires a lot of storage space and media; the original file size dictates the amount of space required for the copy. For these reasons, multiple copies of data are seldom kept for any length of time, often leaving individuals who use this approach to protect data resources without copies of past versions of data. If this week's data are copied over last week's, for example, you will not be able to restore a file from last week if you need to do so. A similar problem occurs if a copy is made of a corrupted file. Backing up data is far faster and more efficient than copying it, and backups take up less space on the storage media because you can make backups only of new or changed data. As a result, it is easier and more cost effective to make frequent backups of multiple versions of data. In addition, backup processes can be streamlined with backup software solutions.

What does backup software really do?

Backup software automatically copies data from any application — or multiple applications — into a single file in a format that cannot be directly read by the original applications. It then compresses this file (which can also contain backups of the applications themselves) and prevents unauthorized access with the protection of passwords or encryption. The backup file can be made on any media, such as a local hard disk, a remote hard disk, blank CDs/DVDs, or magnetic tape.

Why favor one backup media over the next?

Although backing up data to a local hard drive may seem like a good idea, you will lose the original data as well as the backed up versions if this drive fails. On the other hand, if you use a remote hard drive, the amount of data that can be backed up is limited to the size of that hard drive. Of course, multiple remote drives can be used, but this gets to be quite expensive as the volume of backed up data accumulates over time. CDs and DVDs offer more flexibility because you can always burn additional media, but the capacity of each CD or DVD is small. Furthermore, backing up to these media is slow.

Often, for business data, the best backup media is

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tape or RDX removable disks. Both are removable and so can be used to back up unlimited amounts of data. In addition, individual tapes are the largest capacity removable media, storing from 10 gigabytes to more than 600 gigabytes on a single tape. And finally, writing data to tape is a far faster operation than writing to any other removable media.

How do I keep track of backup media once they contain data?

Backup software creates internal labels on the tape that correspond to external labels (most likely barcodes) that are physically on each media. The media are part of a “media pool” that is used as a pool of resources to be the target media for backups. To make the most efficient use of tapes, the backup software will append multiple backups to the tape until it is full. The software maintains a database of all files that are backed up to each tape, how full the tape is, and when the tape will expire. Most backup software also tracks whether tapes have incurred errors and should be removed from the pool.

What is media rotation?

If a large percentage of your backup data is on one tape, and that tape fails, the data are lost. To avoid this unfortunate scenario, tapes should be rotated. In other words, rather than using tape A for three consecutive weeks, for example, use three tapes, one for the first week, another for the second, and another for the third. Then, at the end of this interval, at week four, reuse tape A.

Do I have to back up to a tape drive?

Absolutely not. Backup operations can also be performed to a hard disk or even CDs or DVDs, although tape is still a very reliable and economical medium for managing multiple file versions and for offsite storage. Often, to achieve a balance of performance and protection, it is in your best interest to combine both disk and tape backup operations. This can be achieved by implementing a Disk-to-Disk-to-Tape solution, which assists with disk space management and automates the movement of the data to tape.

Where should tapes be stored?

Tapes can be stored wherever you find it convenient, but for maximum safety and protection, many companies keep tapes offsite. If you will need frequent access to the tape, select backup software that lets you automatically make multiple copies of a single backup tape. That way, you can keep one copy locally, and take the second copy home or to any secure remote location. Or, you can keep the most recent copy onsite, and store the next most recent offsite.

Don't the operating systems of my servers and PCs come with backup utilities?

Yes, they do. But these native utilities only support local, no-frills backups. This means that if you have multiple servers or multiple PCs, or a single server and multiple PCs, each device will require its own separate backup. Each of these backups needs to be managed independently, and so, too, do the tapes or CDs/DVDs from each device. Also, native utilities are slow, backing up only one file at a time, in series. Consequently, backing up large amounts of data can take a long time, sometimes exceeding the “backup window,” the amount of time your systems are idle. Like any window of opportunity, this idle period, during which a computer isn't in use and is able to be backed up, often doesn't stay open as long as you'd like.

Are third-party backup solutions better than native utilities?

If speed, automation, and efficiency are concerns, then a third-party backup solution is the only way to go. Depending on which of these solutions you purchase, you should be able to back up multiple servers and workstations to a single tape device. Equally important, the solution should back up multiple data streams — from multiple applications and/or devices — concurrently. This means that these solutions can be far faster than serial native utilities. In addition, third-party solutions typically offer easy interfaces that simplify and automate backup processes. Finally, if native utilities can only back up files from applications that are closed, some backup software products offer modules that can back up open files as well. This enables active databases to be fully protected without having to shut down business-critical operations.

Do I have to back up my data every day?

You should back up your data as often as it changes, if those changes are business-critical. This means that backups for some data may be done several times each day, others only weekly. Deciding which files to back up and when is important. Some backup software simplifies this task with wizards that guide you through the creation of a backup schedule that sets policies and priorities.

If I back up data, do I have to back up all of it or just what's changed, and what is the difference between full and incremental backups?

If you start a backup program, you should back up all business data and applications that you want to protect in a process called a full backup. For security, this

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full backup may need to be repeated periodically, maybe even weekly. But in between you can do what are called incremental backups, to protect only data that are new or have changed since the last full backup. Incremental backups save time and space because they are smaller than full backups. Incremental backups can also minimize the need for frequently changing tapes since more backups can fit on a single tape.

Besides doing incremental instead of full backups, is there any other way to minimize the number of times I have to change tapes, and what is a tape library?

You can minimize the frequency with which you have to manually replace tapes by using a robotic tape library. Libraries contain one or more tape devices and multiple media storage slots called magazines. The library automatically loads and unloads tapes from a drive to a magazine as requested. With a tape library, you may still need to load and unload the magazine, but much less frequently than you would with a single tape drive.

How do I recreate data files from my backups, and what is a data restore?

Backup solutions maintain records, also called backup databases or catalogs, which keep an index of all files that have been backed up, including the date and time of creation, file size, and location on the backup media. By browsing this catalog, you can locate and select the files you wish to restore and they will be automatically restored, or recreated, to the primary storage in its original location. Alternatively, you can restore the data to a different location, or even restore the data under another name. The backup software loads the appropriate media as indicated by the catalog. Remember, the more often you back up your data, the more versions you have to restore from.

What happens if my entire server or PC fails, and what is a bare metal restore?

If a server, PC, or laptop fails completely, you will need to perform a system recovery. This process calls for fixing or replacing the damaged hardware, reloading the operating system, reloading all applications and device drivers and settings, and finally restoring the data. To speed and simplify these processes, some backup software offers a disaster recovery feature that creates a bootable CD, including a bare-bones operating system and a lightweight copy of the backup software that is then used to restore the full system to the state it was before. Because the backup contains the full operating system, including all the customization that was done, and all the files associated with the

various applications, this form of recovery is extremely attractive for those who need to get up and running again quickly.

Data protection is among the most important insurance policies you can have for your business. Even though restoring data can be an uncommon occurrence with the continued reliability of hardware, most restores occur because of corruption, infection, or deletion of data. And lastly, statistics show that most businesses that suffer a data disaster and do not have a backup plan in place never recover and ultimately go out of business.

Jim Lee is Director of Marketing for San Jose, CA-based Yosemite Technologies, Inc. He has nearly 30 years in the technology industry, in direct and channel sales and marketing roles, with worldwide experience and responsibility.

SBA Requires Small Businesses to Recertify Size Status

New regulations may have an impact on CPA firms and their small business clients.

The U.S. Small Business Administration (SBA) introduced several measures to help small businesses secure more federal government contracts. The centerpiece of the SBA's efforts is a new regulation requiring small businesses to recertify their size status on long-term contracts when a contract option is exercised, when a small business is purchased by or merged with another business, or at the end of the first five years of a contract.

Historically, size status has been determined at the time of the initial offer on the contract and is retained over the life of the contract. However, federal agencies are increasingly using long-term contracts that with the exercise of contract options can extend to 20 years. The new regulation does not require termination of contracts if size status changes, nor does it require changes to contract terms and conditions.

The SBA also announced that additional procurement personnel will be hired to help identify government contracting opportunities for small businesses and will work with the Administration's Integrated Acquisition Environment initiative to more effectively cover the federal buying activities.

The recertification regulation is available at The Federal Register's Web site: www.archives.gov/federal-register/the-federal-register/indexes.html. Click on "Today" at that site to view the regulations.



This month, don't miss the news on the newly scheduled PCPS Practice Management Forum on Statement on Auditing Standards (SAS) No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, Professional Standards, vol. 1, AU sec.) and the timely update on standard-setting developments being monitored by the PCPS Technical Issues Committee. PCPS members should also be on the lookout for a new commentary that will review highlights of the 2006 PCPS/TSCPA National Management of an Accounting Practice Survey.

Save the Date: Forum on SAS 112 Takes Place January 19

To help practitioners implement an important new standard, PCPS has scheduled another in its popular series of free online Practice Management Forums. SAS No. 112 became effective for audits of periods ending on or after December 15, 2006, and it is expected to have an impact on small practitioners and their clients. The new Forum, "Understanding SAS 112," will help members understand the SAS and put it into practice. It will take place January 19, 2007, 2:00 to 3:30 P.M.

EST, and will be presented by Chuck Landes, AICPA Vice President, Professional Standards and Services, who will explain the standard and offer practical implementation insights. PCPS members can register by sending an e-mail by January 12, 2007, to PCPS@aicpa.org.

In addition, the AICPA has prepared an alert on the subject entitled *Understanding SAS No. 112 and Evaluating Control Deficiencies—Audit Risk Alert*. It can be found at <https://www.cpa2biz.com/CS2000/Products/CPA2BIZ/Publications/Understanding+SAS+No+112+and+Evaluating+Control+Deficiencies+Audit+Risk+Alert.htm>.

Gaining a Perspective on the MAP Survey

The 2006 PCPS/TSCPA National Management of an Accounting Practice Survey is the most comprehensive body of benchmarking data available to local and regional CPA firms today. It can help firms gain a perspective on nationwide CPA firm growth trends, new developments in firms' service mix, and what other practitioners are offering staff in order to attract and retain the best people. In addition to the survey results, PCPS members will also be receiving shortly a commentary that offers a perspective on what the results say about firms and how they compare with the findings of other studies. "The State of CPA Firms Today: An Analysis of the 2006 PCPS/ TSCPA

National Management of an Accounting Practice Survey" will also provide brief summaries of key survey findings in areas that include growth, compensation, billing and realization rates, leverage, benefits, expenses, and more. Don't miss this commentary if you're seeking a quick briefing on some important survey highlights. To access the survey itself, go to <https://pcps.aicpa.org/Resources/National+MAP+Survey/>.

All About TIC

The PCPS Technical Issues Committee (TIC) advocates for small firms and their clients in the standard-setting process. TIC regularly monitors standards as they are being developed and comments on them during the exposure period. Recent TIC activities included:

- Recommending changes that were ultimately incorporated into Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)*. TIC successfully argued for a delayed effective date for the recognition and disclosure provisions of the standard for companies that don't have publicly traded equity securities; a two-year deferral on the standard's measurement date provisions; and against

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proposed retrospective application of the standard. TIC recognized that a number of entities may have defined benefit plans and one or more contractual or regulatory restrictions that provide for minimum net worth requirements or other book-value-based thresholds and would need time to plan for the upcoming accounting changes.

- Commenting on the proposed *Statement on Standards for Accounting and Review Services, Elimination of Certain References to SASs and Incorporation of Appropriate Guidance into the SSARS*. TIC supported the premise of the exposure draft, which is to provide, to the extent possible, a stand-alone codification of compilation and review standards without incorporating auditing standards by reference. The *TIC Alert*, a news summary of recent stan-

dard-setting developments of interest to small practitioners and their clients, can be found at the PCPS Firm Practice Center at <http://pcps.aicpa.org/Resources/Technical+Issues+Committee+and+Communications/>.

Letters to the Editor

The *Practicing CPA* encourages readers to write letters on practice management and on published articles. Please remember to include your name and telephone and fax numbers. Send your letters by e-mail to pcpa@aicpa.org.

“Courage is what it takes to stand up and speak; courage is also what it takes to sit down and listen.”

—Winston Churchill

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