Kakimoto & Nagashima LLP
Certified Public Accountants
Consultants

NEWSLETTER

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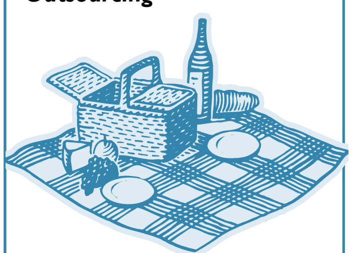

Summary of Articles

The AICPA Clarity Project

The AICPA Auditing Standards Board ("ASB"), which establishes auditing standards for non-public companies, initiated its "Clarity Project" in 2004; this project's goal was to make auditing standards easier to comprehend and apply in conjunction with providing for a better alignment with international auditing standards. In October 2011, the ASB issued Statements on Auditing Standards Nos. 122-124 which marked a significant achievement in the Clarity Project. The issuance of these standards resulted in an almost complete redrafting and recodification of U.S. generally accepted auditing standards in addition to converging these standards with the International Standards on Auditing. Our current article addresses certain changes made by the issuance of these standards.

Interim Changes to ITIN Application Requirements

Effective from June 22, 2012 through December 31, 2012, the IRS has made changes to the application procedure to obtain an Individual Taxpayer Identification Number (ITIN). Applicants who wish to obtain an ITIN during this period should carefully review the new requirements.

Tangible Property Temporary Regulations

In December of 2011, the IRS issued comprehensive regulations pertaining to the tax treatment of expenditures made to acquire, produce, repair, and improve tangible property. The regulations were aimed to further standardize the rules pertaining to capitalization and mitigate any inconsistent treatment on the standards set forth in the prior regulations. These rules affect practically all taxpayers; therefore, it is essential to understand how these rules affect your tangible property expenditures.

Preparation for Outsourcing

Recently, many companies are considering outsourcing a job function to reduce costs and enhance work quality. This article will briefly cover important points to consider before outsourcing work.

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We look forward to providing you with up-to-date accounting and tax information through our website.

Any Questions?

We are committed to providing our clients with quality and excellent services. If you have any questions or comments, please let us know by either e-mail or phone. Our company profile is available on the internet at:

http://www.knllp.com

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The AICPA's Clarity Project: Making It Clear

In 2004, the AICPA Auditing Standards Board ("ASB") launched its "Clarity Project". The Clarity Project was undertaken in an effort to make U.S. generally accepted auditing standards ("U.S. GAAS") used for the audits of nonpublic companies easier to comprehend and put into use. In addition, the Clarity Project was designed to converge U.S. GAAS with International Standards on Auditing ("ISAs"); ISAs are issued by the International Auditing and Assurance Standards Board ("IAASB"). In October, 2011, the ASB achieved a major milestone in its clarity project by issuing Statements on Auditing Standards ("SAS") Nos. 122-124. SAS No. 122 brings together and codifies 39 clarified SASs, while SAS Nos. 123/124 amend or supersede specific standards. Also as part of the project, SAS No. 125 (auditor's written communication) and SAS No. 126 (going concern) were issued in December, 2011 and July, 2012, respectively.

With the issuance of the above standards, two notable changes were made relating to the auditor's report and to the audits of group financial statements.

Auditor's Report

The auditor's report will change in the following manner:

- the introduction paragraph will no longer make a reference to either management's or the auditor's responsibility
- the report will require the use of headings to highlight new sections –
  (1) management's responsibility for the financial statements
  (2) the auditor's responsibility
  (3) the auditor's opinion
- management's and the auditor's responsibilities will be described in greater detail
- the opinion will be clearly differentiated from other sections in the report

Audits of Group Financial Statements

In aligning U.S. auditing standards with ISAs, a primary change resulting from clarification was the introduction of the "Group Audit" standard (based on ISA 600/revised). A group audit refers to the audit of financial statements that include the financial information of more than one component ("group financial statements"). Included in the clarified standards are a number of new terms, concepts and requirements related to group audits that will significantly affect current practice. The clarified standards also provide additional guidance for auditors involved with group audits and the work of component auditors.

Other Changes

Additional auditing requirements will include more specific procedures to detect illegal acts as well as additional procedures relating to the opening balances in initial audits. Major changes will also involve changes in the terminology used in auditing standards as a result of international convergence.

The ASB expects that most ISA requirements will be requirements of U.S. GAAS. However, it has been noted that certain differences between the U.S. clarified auditing standards and those of the PCAOB and IAASB will exist because of legal, regulatory and other considerations, as well as addressing situations specific to the U.S.

Effective Date

The clarified SASs generally will be effective for audits of financial statements for periods ending on or after December 15, 2012.

Kakimoto & Nagashima LLP is dedicated to our clients and their success. We are also committed to complying with professional/technical standards and assisting our clients in understanding how any changes in these standards may affect their organization. In making the move to the clarified standards, we are currently assessing modifications in our quality control processes/audit methodologies and training our personnel to provide for a smooth transition for your next audit. If you should have any questions or concerns, we would be happy to discuss them with you.♦

Interim Changes to ITIN Application Requirements

The IRS has recently implemented interim changes to the application process for obtaining an Individual Taxpayer Identification Number (ITIN). An ITIN is an identification number issued by the IRS for individuals who require a tax identification number but are not eligible to obtain a Social Security Number. An ITIN may be obtained by submitting Form W-7 Application for IRS Individual Taxpayer Identification Number. A proof of identity and foreign status documents such as passports and visas must also be submitted along with the application.

Until recently, the original, notarized, or certified proof of identity and foreign status documents were accepted as a valid document. Effective June 22, 2012 through the end of this year, the IRS will no longer accept a notarized copy of these documents, and only the original or certified copies of these documents from the issuing agency will be considered valid. The original documentation may be submitted by mail. The documentation may also be submitted at IRS walk-in sites but will be forwarded to the ITIN centralized site for processing. The IRS will return original documents to the applicant via standard U.S. mail within 60 days of receipt and processing of the application. The IRS will issue final rules before the start of the 2013 filing season. For more information, please visit:
http://www.irs.gov/individuals/article/0,,id=96287,00.html

Tangible Property Temporary Regulations

Overview

In December of 2011, the IRS unveiled the highly anticipated tangible property temporary regulations to provide guidance on the treatment of payments pertaining to acquiring, producing, or improving tangible property. These regulations are aimed to clarify and expand on the standards set forth in the pre-existing regulations, provide new bright line tests for applying these standards, provide guidance on the accounting for, and dispositions of, property subject to depreciation, and to clarify what costs are deductible and what costs are capital expenditures.

The temporary regulations are effective for tax years beginning on or after January 1, 2012. Some of the major changes are outlined below.

Materials and Supplies (Reg. §1.162-3T)

The IRS generally allows a deduction for materials and supplies in certain cases if the items are consumed or used in the taxpayer's operations during the taxable year. However, the term "materials and supplies" were never defined, and taxpayers had to seek guidance from various judicial and administrative authorities to determine whether their property constituted materials and supplies, inventory, or depreciable property.

The new regulations clarify this confusion by defining materials and supplies as property that is used or consumed in the operations that is not inventory, and is a component acquired to maintain, repair, or improve property but not acquired as part of any single unit of property. Furthermore, the definition is expanded to include items such as water and fuel that are expected to be consumed in 12 months or less, any unit of property that has a useful life of 12 months or less, or has a cost of $100 or less (de minimis rule). The regulations however provide for an optional election to capitalize certain materials and supplies, as well as an alternative optional method of accounting for temporary spare parts and parts that need periodic replacement.

Acquisition and Production of Tangible Property
(Reg §1.263(a)-2T)

Taxpayers are generally required to capitalize amounts paid to acquire or produce a unit of tangible property, except for certain costs determined to be nominal or amounts determined to be deductible as materials or supplies. Units of tangible property include leasehold improvement property, land and land improvements, buildings, machinery and equipment, and furniture and fixtures. Among other things, the new temporary regulations provide the requirement to capitalize amounts paid to defend or perfect title to real or personal property, provide rules for determining the extent to which taxpayers must capitalize transaction costs related to the acquisition of property, provide a de minimis rule for amounts paid for the acquisition or production of property, and address the treatment and recovery of capital expenditures.

With respect to the de minimis rule, taxpayers may deduct certain amounts if the taxpayer has a written accounting policy for expensing amounts paid under certain dollar amounts, the total amount of expenditure does not exceed certain limits, and the financial statement carefully and consistently follows these rules.

Improvements (Reg. §1.263(a)-3T)

The general rule of thumb is that any payment made on a property is deductible if the payment is to maintain the property in its useful order. If, however, the amount paid is to improve the property by extending the useful life of the property and/or improving the quality or productivity, then costs for such improvements need to be capitalized. A property is considered 'improved' if the payment on the property results in the betterment, restoration, or adaptation on the unit of property.

Betterment occurs when the payment improves a condition or defect, increases capacity, productivity, efficiency, strength, or quality of property , or enlarges, expands, or extends the property. The determination of whether a payment is considered betterment will depend on each event's facts and circumstances.

A restoration to a property must be capitalized when the expenditure is for a replacement of a component that was sold or exchanged, suffered damage from a casualty loss, or restored to its operating condition if it has deteriorated to a state of disrepair and is no longer functional. In addition, rebuilding the property to a like-new condition or replacing parts that comprise a major component of a property will also constitute a restoration.

Adaptation occurs when a unit of property is brought to a new or different use and the adaptation is not consistent with the taxpayer's intended use of the property at the time it was originally placed in service. For example, when a manufacturer converts the manufacturing building into a showroom for its business, the conversion will be deemed as improvement to the building. Accordingly, any expenditure used in the conversion must be capitalized.

Unit of Property (Reg. §1.263(a)-3T)

One of most significant changes made by the repair regulations was providing a more definite definition of what constitutes a "unit of property." Understanding "unit of property" is extremely crucial since it is a fundamental concept in applying the capitalization standards.

In case of a building, each building and its structural components will constitute a single unit of property. However, the improvement standards are applied separately to the primary components of the building system. The regulations define building systems to include 1) the heating ventilation, and air conditioning (HVAC) systems; 2) the plumbing systems; 3) the electrical systems; 4) all escalators; 5) all elevators; 6) the fire protection and alarm systems; 7) the security systems; 8) the gas distribution systems; and 9) any other identified systems. The regulations require taxpayers to apply the improvement standards separately to each building system.

For example, an expenditure related to an HVAC system may not necessarily result in a betterment or restoration to the building as a whole, however, if the expenditures improve the HVAC system the cost must be capitalized as though it was an improvement made to the entire building.

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Preparation for Outsourcing

Companies often choose to outsource a function of their work to cut costs and/or enhance the quality of the work. Work performed by specialized professionals is often needed to complete jobs within the company's budget. Outsourcing will reduce the need to hire full-time employees which can result in considerable savings to the company. However, it is essential that companies properly plan and prepare before outsourcing their work. Cost efficiency deteriorates when companies do not understand the work that is being outsourced and are not able to incorporate the services provided by their clients and suppliers. Every member in the work stream must have a mutual understanding of their job function to ensure that work efforts are not duplicated. It is highly recommended to consider possible business risks and ways to overcome these risks.

Understanding Risks and Preparation

One risk of outsourcing is the possibility of overreliance on the service providers. When a company outsources certain key functions of the job, they can run the risk of not fully understanding the detailed procedures of the function. The result of simply passing on the responsibility of certain work can diminish the knowledge of the work within a company. This means that no one in the company will know how to perform or explain the work that is outsourced. The longer the same work is outsourced, the more difficult it is for a company to perform the same operations in-house in the future. Companies need to analyze the processes they are considering to outsource and identify what knowledge base they need to keep within the company to perform the process. In addition, companies need to determine which processes require intensive communication within departments. For example, accounting services such as preparation of invoices and inputting journal entries are simple and standardized procedures that are suitable for outsourcing. A company will need to keep the knowledge base to process invoices and journal entries for special circumstances (i.e. complex client and/or supplier transactions) that require in-house judgment. If processes that require in-house judgment are to be outsourced, the processes need to be reviewed so that the company can take necessary measures to prevent it from losing a valuable knowledge base in making decisions. It is recommended that the company appoint a person responsible within the company to oversee and understand the processes to be outsourced.

Create Detailed Procedural Instructions for Processes to be Outsourced

It is strongly advised that a company create instructions for the processes that it is considering to be outsourced. This will help prevent losing in-house knowledge and will help achieve the expected benefits of outsourcing. By creating detailed procedural instructions, the procedures that are standardized and those that require in-house judgment can be clearly identified. Those procedures that are simple and standardized are most suitable for outsourcing. Procedures that require in-house judgment will either be kept in-house or should be revised to be suitable for outsourcing. Detailed procedural instructions will also be useful to understand the purpose and the range of work to be covered by outsourcing so that the transition to outsourcing will be smooth. The detailed procedural instructions can also help provide an estimate of the cost of outsourcing given the number of procedures and the estimated time to perform each procedure.

Companies should consider the facts above to ensure a smooth transition of outsourcing their work.

Please feel free to contact us with any questions or concerns regarding outsourcing services.♦

Questions or comments about this issue or inquiries about our newsletter by e-mail subscription service can be sent to:

newsletter@knllp.com

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A unit of property for tangible property other than buildings includes all "functionally interdependent" components. Components are functionally interdependent if placing one component in service depends on placing the other component in service.

Capital Expenditures (Reg. §1.263(a)-1T)

The regulations do not allow a deduction for any amount paid for new buildings or permanent improvements, for betterments made to increase value of property, or for any amount paid in restoring property. In addition, any commissions and other transaction costs paid to facilitate the sale of property generally must be capitalized.

Repairs and Maintenance (Reg. §1.162-4T)

The regulations specifically state that any payments made for repairs and maintenance to tangible property can be expensed if the payments are not otherwise required to be capitalized under the tax law.

Conclusion

The new comprehensive regulations brought both relief and concern to the tax community. On one hand, the regulations provide bright-line tests to an area that has been controversial for many years. On the other hand, the regulations can be construed as too burdensome to companies and will make compliance extremely difficult for businesses.

In any case, the new regulations require taxpayers to re-evaluate their procedures in determining how expenditures made to their property will be treated for tax purposes. Should you have questions pertaining to the new temporary regulations, please contact the office of Kakimoto & Nagashima, LLP at (310) 320-2700.♦