


# Accounting for Emissions

Emerging issues and the need for global accounting standards

by James M. Fornaro, Kenneth A. Winkelman and David Glodstein



For several decades, the environmental, economic and health effects from greenhouse gases (GHG) have been closely studied and debated by the scientific community, regulatory authorities and other diverse groups. GHGs are emitted into the atmosphere mainly as a by-product of waste disposal and the burning of fossil fuels by individuals, households and businesses. Of the six principal types of GHGs, the Environmental Protection Agency (EPA) estimates that carbon dioxide (CO<sub>2</sub>) makes up 85% of these emissions in the U.S. Because GHGs can trap the sun's heat in the Earth's atmosphere, many scientists have targeted them as a leading cause of global warming.

This article introduces practitioners to the fundamental accounting issues concerning emissions of GHGs. The key elements of "cap and trade" programs are discussed since they are the predominant market mechanism employed globally to limit GHG emissions. Finally, we examine attempts by standard setters to fill the void in the authoritative accounting guidance in this area and the consequences of the diverse accounting practices that have emerged globally.

## CONTROLLING GHG EMISSIONS: "CAP AND TRADE" PROGRAMS

Currently, countries are pursuing alternative strategies in their quest to curb the level of GHG emissions and meet national targets. While President Obama and congressional Democratic leaders have said controlling GHGs is a priority, the probability of limitations being adopted in the U.S. in the near term remained unclear at the time of this writing. But globally, cap-and-trade programs have emerged as the most prevalent market mechanism. Such programs present

a variety of complex accounting issues.

A cap-and-trade program is a market-based approach in which "allowances" or "credits" are used to provide incentives to companies to reduce emissions by assigning a monetary value to pollution. In the European Union (EU), each carbon allowance permits the holder to emit one metric ton of CO<sub>2</sub>. The "cap" phase of the program begins when a government or regulatory body establishes an economywide target for the maximum level of specific emissions permitted by companies in a specified time frame. Then, a specific number of emissions allowances equal to the national target are allocated (or auctioned) to participating companies based on a formula that generally includes past emissions levels. Companies report their actual emissions at the end of the compliance period and deliver an equivalent number of allowances to satisfy actual levels.

The "trade" aspect of the program occurs when a company's actual emissions are greater or less than the amount covered by its owned allowances. Companies that emit less than their target will have excess allowances; those that exceed their target must acquire additional allowances. Additional (or excess) allowances can be purchased (or sold) directly between companies, through a broker, or on an exchange. Excess allowances can often be "banked" and used to satisfy compliance targets in subsequent years. Fines are generally levied if insufficient allowances are surrendered at the end of the compliance

period. Cap-and-trade programs provide companies with added flexibility to choose the most cost-effective way to manage their emissions.

A number of cap-and-trade programs exist globally, and several are under development (see sidebar, "Markets for Emissions Trading"). Effective implementation and compliance with possible future mandates require timely and relevant authoritative accounting guidance from standard setters. Unfortunately, past attempts by FASB and the International Accounting Standards Board (IASB) to provide guidance in this area have been unsuccessful. In the meantime, the void in the existing authoritative literature has enabled diversity in global accounting practices to emerge.

### DISPARATE ACCOUNTING SOLUTIONS

The current state of U.S. GAAP and IFRS related to GHG emissions is discussed below along with diversity in existing practices.

**U.S. GAAP:** In an initial effort to establish guidance, the Emerging Issues Task Force (EITF) met in November 2003 to discuss Issue no. 03-14, *Participants' Accounting for Emissions Allowances under a "Cap and Trade" Program*. The discussion materials for that meeting indicate that U.S. accounting practices for emissions allowances are contained in the "Uniform System of Accounts" published in 1993 by the Federal Energy Regulatory Commission (FERC). Utilities

and other regulated energy companies use the FERC guidance to account for emissions programs designed to curb "acid rain" (primarily sulfur dioxide) as mandated under the Clean Air Act Amendments of 1990. FERC requires that emissions allowances be accounted for as follows:

- Allowances are reported at historical cost and are classified as *inventory*. Purchased allowances are recorded at their exchange price while those received from the EPA at no charge have a *zero basis*.
- The weighted-average cost method is required, and calculations should be performed monthly based on actual data or reasonable estimates.
- Periodic expense is recognized based on the historical cost of allowances needed to satisfy actual emissions of sulfur dioxide during the period.

After only one meeting, the EITF decided to remove Issue 03-14 from its agenda. Some EITF members noted the broader implications of this issue beyond cap-and-trade programs. Others were concerned that changes to the FERC's requirements might conflict with other areas of U.S. GAAP and introduce certain accounting anomalies. Some EITF members also indicated that "they did not perceive a practice issue or diversity in the accounting for emissions trading programs."

This inventory-based, historical cost methodology remains the primary source of U.S. GAAP in this area. However, since a large percentage of allowances are presently

### EXECUTIVE SUMMARY

■ **Concerns over the environmental, economic and health risks posed by greenhouse gas emissions** have become a frequent topic of discussion. Recent events and initiatives suggest that climate change ranks high on the U.S. political agenda.

■ **Cap-and-trade programs have emerged globally** as the most prevalent market mechanism used by countries to limit greenhouse gas emissions. In such programs, a government

sets a targeted level of emissions for companies for a specified time period and uses "allowances" to assign a monetary value to pollution. Companies that emit less than their target may have excess allowances, whereas those that exceed their targets can acquire additional allowances. Companies generally can sell or purchase allowances directly with other companies, through a broker, or on an exchange.

■ **Users of financial statements require expanded and transparent disclosure** of the financial results related to pollution emissions. However, attempts by FASB and the IASB to provide definitive accounting guidance have been unsuccessful, leading to diversity in global accounting practices.

■ **FASB and the IASB are working jointly** to examine the accounting issues related to cap-and-trade programs and other

market-based mechanisms designed to limit emissions. A final standard is anticipated in 2010.

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received from the EPA for free and have a zero cost basis, accounting practices under the FERC guidelines can distort the assets, liabilities, and operating income of U.S. companies with respect to emissions.

At its Feb. 21, 2007, meeting, FASB agreed to add a comprehensive project to its agenda to address the accounting by participants in emissions trading programs. In 2008, FASB and the IASB agreed to work jointly on the project titled *Emissions Trading Schemes*. The joint project will examine cap-and-trade programs as well as other market-based mechanisms.

As of its April 8, 2009, meeting, FASB had not reached a conclusion on the initial recognition and measurement aspects of emissions allowances received at no charge. An exposure draft on the project is expected by the end of 2009 with a final standard anticipated in 2010.

**IFRS.** In May 2003, the International Financial Reporting Interpretations Committee (IFRIC) of the IASB issued Draft Interpretation D1, *Emissions Rights*, in an effort to fill the existing void in authoritative accounting guidance. The draft examined several key issues under cap-and-trade programs, including asset valuation, income recognition for rights received from a government body, and the measurement and recognition of a liability (and expense) for actual emissions. In a comment letter written in response to this proposal, the influential European Financial Reporting Advisory Group (EFRAG) contested elements of the proposal and indicated that it "might be conceptually pure but is too complex and does not reflect business reality."

After much deliberation, IFRIC 3, *Emissions Rights*, was finally issued in December 2004 and included the following key conclusions:

- Emissions allowances are *intangible assets* to be accounted for under IAS 38, *Intangible Assets*. IAS 38 permits a choice between the historical cost method and a revaluation method.
- Purchased allowances are recorded at cost. Allowances received from a government body at no cost or for less than fair value are reported at *fair value* when received. Allowances rec-

ognized under either method are subject to periodic impairment tests. If the revaluation method under IAS 38 is elected, increases in fair value are reported in stockholders' equity and decreases in fair value are recognized in profit and loss to the extent they exceed the revaluation surplus. The difference between the price paid and fair value of allowances received from the government should follow the guidance in IAS 20, *Accounting for Government Grants and Disclosure of Government Assistance*. The difference is initially reported as deferred income (a liability) and then systematically recognized as revenue over the compliance period regardless of whether the allowances are held or sold.

- The recognition of a liability and expense for actual emissions should follow the guidance in IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*. The liability is measured as the present obligation needed to satisfy actual emissions made through the balance sheet date. Essentially, it represents the fair market value of allowances to be delivered at the end of the compliance period.
- The netting of assets and liabilities related to emissions is *not permitted*.

After IFRIC 3 was issued, the EFRAG continued its objections and recommended that it *not* be endorsed by the EU. At its June 2005 meeting, only six months after issuance, the IASB withdrew IFRIC 3. Though the IASB "affirmed that IFRIC 3 is an appropriate interpretation of existing IFRSs for accounting for the EU [trading] Scheme," it also acknowledged concerns by EFRAG and other commentators that the application of IFRIC 3 "creates unsatisfactory measurement and reporting mismatches." Coupled with other factors, the IASB concluded that the issue required a more comprehensive examination.

With the withdrawal of IFRIC 3, participants in the growing EU emissions trading markets were left without authoritative accounting guidance. Not surprisingly,

diversity in accounting practices emerged. In 2007, PricewaterhouseCoopers and the International Emissions Trading Association (IETA) published a joint survey of prevailing accounting practices used by 26 prominent companies in the EU. The study revealed the following key areas of diversity among the sample companies:

- 76% recorded allowances granted by the government for free at a zero basis and did not recognize related income under IAS 20. The remainder recorded them at fair value on the date of receipt and recognized revenue during the compliance period.
- 58% classified purchased allowances as intangible assets, while others classified them as inventory, other current assets, or elsewhere on the balance sheet. Few amortized or depreciated their allowances.
- 79% chose to value owned allowances using the historical cost approach.
- 47% reported a liability for emissions at the carrying value of allowances owned using the FIFO or weighted-average cost method. An accrual was also made for the fair value of additional allowances needed to satisfy the liability. Numerous other methods were also being used.

### ILLUSTRATION OF GLOBAL ACCOUNTING DIVERSITY

The analysis below examines the diverse accounting practices for GHG emissions presently being used and the conflicting financial results. The analysis highlights the lack of comparability among companies globally and the questionable relevance of financial information provided to users.

**Assumptions:** Clean Co. is a participant in a national cap-and-trade program aimed at reducing the level of CO<sub>2</sub> emissions below a prior-year baseline. On Jan. 3, 2010, Clean Co. received 24,000 allowances (at no cost) from a regulatory agency. Each allowance permits Clean Co. to emit one ton of CO<sub>2</sub> during 2010. This allocation is below the company's prior-year levels and its most recent internal emissions projections for 2010. Actual emissions are reported at the

## Markets for Emissions Trading

During 2007, activity in the carbon markets totaled approximately \$64 billion globally, with the bulk of activity in the EU. Below is a brief description of selected markets in the EU and the U.S.:

### THE EUROPEAN UNION

The European Union Greenhouse Gas Emissions Trading Scheme (EU-ETS) began in 2005 and is the world's largest trading program for CO<sub>2</sub>. The EU-ETS is a cap-and-trade program whose objective is to assist member countries to meet their commitments under the Kyoto Protocol, an international agreement on greenhouse gas reductions. The EU's goal for the current trading period (2008–2012) is set at reducing CO<sub>2</sub> emissions by an average of 6.5% below 2005 levels. Each member country is provided with a national allocation approved by the European Commission. Presently, most allowances are provided free to more than 11,000 companies, and annual reporting is required. Allowances are tracked in electronic registries established by each EU member.

### THE U.S. ENVIRONMENTAL PROTECTION AGENCY (EPA): ACID RAIN PROGRAM

The U.S. sulfur dioxide (SO<sub>2</sub>) emissions program began in 1995 in response to the requirements under the Clean Air Act Amendments of 1990. The program is designed to reduce SO<sub>2</sub> levels by 50% below 1980 levels. The EPA allocates and also auctions allowances to utilities with emissions limitations. Those utilities must acquire allowances sufficient to meet their limits each year.

### THE REGIONAL GREENHOUSE GAS INITIATIVE (RGGI)

The RGGI is the first mandatory cap-and-trade program in the U.S. that specifically targets GHG emissions. It was established in 2005 by 10 states in the Northeast and Middle Atlantic region (Connecticut, Delaware, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Rhode Island and Vermont). Beginning in 2009, the states will initially cap CO<sub>2</sub> emissions from power plants and will require a 10% reduction in emissions by 2018.

### THE WESTERN CLIMATE INITIATIVE (WCI)

The WCI was established in February 2007 and currently includes seven states in the U.S. (Arizona, California, Montana, New Mexico, Oregon, Utah and Washington) and four Canadian provinces (British Columbia, Manitoba, Ontario and Quebec). This cap-and-trade program's goal is to reduce GHG emissions by the electric, industrial, transportation and other sectors by 15% (below 2005 levels) by 2020. Phase 1 of the program will begin on Jan. 1, 2012, with a three-year compliance period.

### THE CHICAGO CLIMATE EXCHANGE (CCX)

The CCX was established in 2003. Members represent prominent companies from various sectors in the U.S. and overseas, as well as municipalities and government bodies. The goal of the CCX is to reduce GHG emissions through a voluntary, yet legally binding compliance program subject to third-party verification. Members are allocated annual emission allowances in accordance with specified guidelines. As needed, additional "CCX Carbon Financial Instrument" contracts can be purchased by members, and surplus allowances can be sold or banked. In the current phase of the program, emissions reductions by 2010 are targeted at a level that is 6% below a baseline amount.

end of each calendar year, and sufficient allowances must be delivered to the regulatory authority by the end of the first quarter of the following year. Additional (or excess) allowances can be purchased (or sold) through an organized exchange.

During 2010, the market price for an emissions allowance at specific dates was as follows:

Jan. 3	\$6.00
March 31	\$7.00
June 30	\$7.50
Dec. 31	\$8.00

Business activity exceeded expectations, and during 2010 Clean Co. emitted a total of 28,000 tons of CO<sub>2</sub>. Anticipating this annual shortfall in emissions allowances, Clean Co. purchased 1,000 additional allowances on both March 31 (\$7,000) and June 30 (\$7,500) at the existing market price. Finally, to ensure that it had sufficient allowances on hand to satisfy actual emissions for the year, Clean Co. purchased 2,000 additional allowances on Dec. 31, 2010 (\$16,000). In January 2011, Clean Co. delivered 28,000 allowances to the regulatory agency to settle its outstanding emissions obligation.

The analysis below summarizes Clean Co.'s accounting activity under three scenarios: (1) existing U.S. GAAP under the FERC regulations, (2) the requirements originally proposed under IFRIC 3, and (3) common practices being used to account for EU-ETS activity noted in the PwC/IETA survey. Differences in the financial results for 2010 are also presented.

## U.S. GAAP - FERC

- On Jan. 3, 2010, Clean Co. prepares a memo entry to record the receipt of 24,000 allowances in *inventory* at a zero basis. Deferred revenue equal to the fair value of the allowances received ( $24,000 \times \$6.00 = \$144,000$ ) is not recognized.
- During 2010, the purchases of 4,000 additional allowances are recorded as inventory at a total cost of \$30,500 (\$7,000 + \$7,500 + \$16,000). Emissions expenses are recorded (and inventory relieved) based upon the weighted-average cost of allowances necessary to satisfy actual emissions.
- For 2010, total emissions expense is \$30,500, which represents the historical cost of 28,000 allowances. The balance sheet would not reflect any additional assets or liabilities from these transactions.

## IFRIC 3

- On Jan. 3, 2010, Clean Co. recognizes an *intangible asset* and deferred revenue of \$144,000 upon receipt of the 24,000 allowances. (Assume that Clean Co. elects the historical cost option under IAS 38 to measure the cost of allowances owned.)
- During 2010, the purchases of 4,000 additional allowances for \$30,500 are recorded as intangible assets. Moreover, revenue is recognized on a systematic basis,

and periodic emissions expenses (and a related liability) are measured and reported based on actual emissions to date using the market value of allowances on the reporting date.

- For 2010, Clean Co. reports total revenue of \$144,000 and emissions expenses of \$224,000 (actual emissions of 28,000 tons  $\times$  the year-end market price of \$8.00) for a net expense of \$80,000. The "grossed-up" balance sheet reports an intangible asset of \$174,500 (original allocation of \$144,000 plus purchases of \$30,500) and the liability for emissions of \$224,000.

## COMMON PRACTICES IN THE EU

- Similar to the FERC practices above, Clean Co. prepares a memo entry on Jan. 3, 2010, to record the receipt of 24,000 allowances at a zero basis—as an *intangible asset*. Deferred revenue equal to the fair value of the allowances received is not recognized.
- During 2010, the purchases of 4,000 additional allowances for \$30,500 are recorded as intangible assets. Periodic emissions expenses and a related liability are measured and reported based on the carrying amount of allowances needed to satisfy actual emissions (using FIFO or weighted-average cost method).
- Clean Co. reports emissions expenses of \$30,500 for 2010. The balance sheet reports an intangible asset and a separate liability for emissions of \$30,500, which are based on historical cost practices.

## Financial Results for 2010

### Partial Income Statement

	U.S. GAAP (FERC)	IFRIC 3	Prevailing Practices in the EU
Revenue	\$ - 0 -	\$ 144,000	\$ - 0 -
Emissions Expense	30,500	224,000	30,500
Net Expense	\$ 30,500	\$ 80,000	\$ 30,500

### Partial Balance Sheet

	U.S. GAAP (FERC)	IFRIC 3	Prevailing Practices in the EU
Inventory/Intangible Asset	\$ - 0 -	\$ 174,500	\$ 30,500
Emissions Liability	- 0 -	224,000	30,500
Net Asset (Liability)	\$ - 0 -	\$ (49,500)	\$ - 0 -

## SETTLEMENT IN 2011

In January 2011, Clean Co. would deliver 28,000 allowances to the regulatory authority to satisfy its emissions obligation for 2010. Under U.S. GAAP and prevailing EU practices, no gain or loss would be recognized at settlement. Under IFRIC 3, however, a "mismatch" in the measurement of allowances owned (at the carrying amount of \$174,500) and the related liability for emissions (at the Dec. 31, 2010, market price of \$224,000) would

result in a recognized gain of \$49,500 at settlement.

### COMMENTS AND ANALYSIS

The partial income statement for 2010 reveals disparate results and highlights certain controversial aspects of the IFRIC 3 model. Under U.S. GAAP and prevailing EU practices, Clean Co. reports emissions expense of \$30,500. Under IFRIC 3, Clean Co. reports a net emissions expense of \$80,000 for 2010 and a gain of \$49,500 upon settlement in 2011 (a net expense of \$30,500 over two years). This is a direct consequence of recognizing allowances received as revenue based upon the market price on the date of receipt (under IAS 20) and emissions expense at fair value on the reporting date (under IAS 37). This "mismatch" and related volatility were some of the key reasons for the opposition to IFRIC 3.

The partial balance sheet also reveals clear differences in results among the three accounting treatments, and again high-

lights the gross-up and mismatch concerns under IFRIC 3. The financial results are indicative of the lack of comparability among companies in the EU and between those in the EU and the U.S. Moreover, distortions in leverage ratios, return on assets, and other profitability measures can diminish the relevance of financial information for users.

### CHALLENGES AND OPPORTUNITIES AHEAD

Government mandates are likely in the future because of mounting concerns over GHG emissions. Given these challenges, the time has arrived for standard setters to provide definitive global accounting guidance

*For additional resources including Excel worksheets to calculate carbon output by individuals and certain businesses and links to emissions and climate change resources, view the online version of this article at [www.journalofaccountancy.com](http://www.journalofaccountancy.com). Enter 20081312 in the search box.*

to ensure consistent and transparent reporting of financial results associated with accounting for GHG emissions. ♦

### AICPA RESOURCES

#### JofA articles

- "Checklist: Be an 'Energy Star,'" March 09, page 34
- "The Future of Corporate Sustainability Reporting," Dec. 06, page 65

#### CPE

*Business Sustainability: Keeping Lean but With More Green for the Company's Long Haul*, a CPE self-study course (#733060)

For more information or to place an order, go to [www.cpa2biz.com](http://www.cpa2biz.com) or call the Institute at 888-777-7077.

#### Web site

The AICPA's "FAQs on Sustainability Reporting," [www.aicpa.org/innovation/baas/environ/faq.htm](http://www.aicpa.org/innovation/baas/environ/faq.htm)

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#### ■ Accounting for Emissions (cont.)



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# NCI

SUCCESS STORY

## Small Market, Big Success

### \$0 to \$225,000 in less than 2 years



DAVID HENSLEY, CPA, SPRINGFIELD, IL

I had the pleasure of recently conducting an interview with another success story of ours. For this feature, as you can tell by the title, we wanted to focus on someone from a smaller market who is doing very well utilizing our program. The man who I refer to is David Hensley and his firm is located in Springfield, IL. "When I went into it, we started with zero. This was April of '05. Right now, we're going to end this year, 2007 at \$225,000. And I know that other markets do better, they're bigger. Despite what some would see as a set back, David has managed to succeed and in a short time frame.

"I had just started my company but I hadn't done anything with it and I got a flyer in the mail from all places, **NCI**. It was unbelievable because I had already started thinking, I've got to resolve this problem, how am I going to market this? I still didn't know how to do that. I knew a lot more about accounting by then, I knew how to get lines of credit, but not the marketing. [So] when I got that flyer I couldn't believe it, and I called and I started to do all the due diligence. I must have called like 30 of your references." David then made up his mind to do our Plan 2 Client Acquisition Program. He told me his concerns before starting, would it work (and speaking to our references convinced him of this) and secondly, can I handle the growth this will generate? So he spoke with Duane Gravelly (for those who don't know, this is the gentleman who conducts our Advanced Processing Seminar and he also built a 1.4 million dollar practice using our Plan 2 program) to make sure he was ready and that was all it took.

I then asked David what his future plans and goals for his relatively new practice are. He responded, "One of the goals is to buy a practice. But you said something that is absolutely critical. People would be so smart to go the direction of starting their practice first and building one before they ever think about acquiring one because... you absolutely have to have everything in place. Now when we open up our next office, everything is in place, it's ready to go." What advice he would have for someone out there considering these programs. "I would say number one, always take the Plan 2 [program]."

"[My quality of life has improved] a thousand percent. Number one, getting rid of the pressure of a job that was the pressure from hell, to a position I just love. Probably the most concise way I can say this, I would not be where I am now without **NCI**."



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