Professional Education Services, LP

Ethics and Professional Conduct for Colorado CPAs

#4060D

COURSE MATERIAL

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CHAPTER 1: COLORADO SPECIFIC INFORMATION

Chapter Objective

After completing this chapter, you should be able to:

- Identify the requirements specific to practice in Colorado.

I. COLORADO STATE BOARD OF ACCOUNTANCY

The Colorado Board of Accountancy regulates certified public accountants (CPAs). The Board does not regulate accountants, public accountants, tax preparers, or enrolled agents.

Its mission is consumer protection.

II. CONTINUING EDUCATION REQUIREMENTS

A. QUESTIONS AND ANSWERS

Q: What is the 'reporting period' to take CPE?

A: A reporting period is a two year period from January 1st of an even-numbered year through December 31st of the odd-numbered year. The 2016-17 reporting period ends December 31, 2017.

Q: How many CPE hours are required?

A: If you are actively licensed during the entire 'reporting period', you are responsible for completing 80 hours of CPE of which no more than 16 hours may be in Personal Development, defined in the NASBA Fields of Study. Four hours of CPE must be in Ethics, of which up to two hours may be in CR&R.

If your initial date of licensure occurred during the reporting period, you are responsible for a prorated amount.

If your license was reinstated, reactivated or returned from a retired status to an active status during the reporting period, you are responsible for a prorated amount.

Q: How many CPE hours in Ethics are required?

A: If you are actively licensed during the entire 'reporting period', you are responsible for completing a minimum 4 hours of CPE in Ethics, of which up to two hours may be in CR&R. In order to meet this requirement, the Field of Study must be in Regulatory or Behavioral Ethics, defined in the NASBA Fields of Study.

If your initial date of licensure occurred during the reporting period, you are responsible for a prorated amount.

If your license was reinstated, reactivated or returned from a retired status to an active status during the reporting period, you are responsible for a prorated amount.

Q: I hold an active Colorado certificate but do not practice public accounting; do I need to complete Continuing Education?

A: Yes. If you hold an active Colorado license, you must comply with all applicable laws, Rules and Policies of the State Board of Accountancy including those related to Continuing Education. Failure to do so may result in disciplinary action.

Q: If I am not in compliance with the CPE requirements, who can I contact?

A: If you are not in compliance with the CPE requirements, you can self-report to the Board via email at dora_accountancyboard@state.co.us. Staff will provide you with additional information. Failure to comply with the CPE requirements may result in disciplinary action.

Q: If I did not complete all my CPE within the reporting period, will changing my license into an 'inactive' or 'retired' status or allowing my license to expire resolve the issue?

A: No. If your certificate was in an 'active' status during the reporting period, you were required to comply with Continuing Education requirements. When your license is not active, you cannot perform services, call yourself a CPA, or use the unqualified CPA designation. Doing so may result in disciplinary action.

Q: Can I use any of the activities I completed in order to reinstate, reactivate, or return to an active status from retired status for my CPE requirement?

A: No. Any activity submitted to meet the requirements for licensure reinstatement, reactivation, or return to an active status from retired status cannot be used for the reporting period requirements as a condition of holding an active license.

Q: Can I use any of the activities I completed before my license reinstatement, reactivation, or return to an active status from retired status for my CPE credit?

A: Yes. As long as it was completed during the reporting period, complies with the Board's requirements, and was not submitted to meet the CPE requirements for licensure reinstatement, reactivation, or return to an active status from retired status.

Q: Will I need to submit all my certificates of completion/attendance when I renew my license?

A: No. You do not need to submit documentation to renew your license. You will be asked to attest compliance with the CPE requirements at the time of renewal. You are required to maintain CPE documentation, and if audited, you will be required to submit that proof within 30 days.

Q: How long do I need to keep my CPE records/documents?

A: At least five (5) years from the end of the reporting period.

Q: Is there a limit to the number of online versus in-person classes?

A: No.

B. TOP TEN MISTAKES THAT CONTRIBUTE TO A CPE AUDIT FAILURE

1. Failure to follow the audit instructions.
2. Failure to complete, sign, and attest the Detailed Record of CPE.
3. Submitting a self-tracking tool or firm-tracking tool in place of the Detailed Record of CPE that does not contain all the items in the Detailed Record.
4. Submitting a non-compliant certificate of completion as documentation.
5. Submitting a non-compliant firm transcript as documentation.
6. Submitting hours that were used for initial licensure, reinstatement, reactivation, or as a term of a Stipulation.
7. Submitting hours taken outside of the reporting period.
8. Not taking Colorado Rules and Regulations, if required.
9. Not completing the required number of hours in Ethics.
10. Submitting fewer hours than required.

III. PEER REVIEW REQUIREMENTS

A. BACKGROUND

In 2010, the Colorado legislature changed the Accountancy statutes enacting mandatory peer review requirements of CPAs and CPA firms in Colorado. The effective date for peer review is 2014 for CPA firms and 2015 for individual CPAs. A peer review is required at least once every three years.

During renewal, CPA firms are required to provide an affirmative attestation that the firm is either subject to peer review or exempt from peer review. Every firm that issues attest or compilation reports must undergo a peer review.

Misrepresenting the applicability of the peer review requirement could result in disciplinary action.

B. DEFINITION OF A&A PRACTICE

An accounting and auditing practice for the purposes of the peer review standards is “All (even one) engagements performed under Statement on Auditing Standards (SASs), Statement on Standards for

Accounting and Review Services (SSARSs), Statements on Standards for Attestation Engagements (SSAEs), Government Auditing Standards (the Yellow Book) issued by the US Government Accountability Office, and engagements performed under Public Company Accounting Oversight Board (PCAOB) standards.

Engagements covered in the scope of the program are those included in the firm's accounting and auditing practice that are not subject to PCAOB inspection.

C. EXAMPLES OF ENGAGEMENTS

The most common examples of engagements requiring a peer review are:

- Audits (SAS, PCAOB, Yellow Book)
- Reviews (SSARS)
- Compilations, with or without disclosures, where a report is or should be issued (SSARS)
- Agreed-upon procedures engagements (SSAE)
- Services Organization Controls (SOC) engagements (SSAE)
- Examination and compilations of prospective financial statements (SSAE)

Prior to the issuance of SSARS No. 21, there was a peer review exception for firms that only submitted compilations of unaudited financial statements to their clients that were not expected to be used by a third party (management use only). These engagements were documented through the use of an engagement letter instead of issuing a compilation report. This form of compilation is no longer permitted with the implementation of SSARS No.21, and therefore, the exception is no longer applicable.

D. DOCUMENTATION

By Colorado law, you are not required to submit copies of any peer review related documents unless the Colorado State Board of Accountancy specifically requests them.

IV. TIPS FOR RESPONDING TO COMPLAINTS (REPRINTED FROM APRIL 2012 NEWSLETTER)

For most licensed professionals, receiving a letter from the Board asking for a response to a filed or initiated complaint, is a HUGE DEAL. Your first reaction may be a mixture of fear and anger. You may be tempted to either respond right away in the midst of emotional stress or you set the letter aside and forget it arrived. Yet, responding in an unprofessional way or failing to timely respond will portray you in a negative light to the body charged with the responsibility to address complaints.

Creating your response is the first step in the complaint process. Many complaints filed with the Board are fully resolved during the early stages of the process. The manner in which you respond to that first letter requesting your side of the story can make a significant difference. Try to place yourself in the position of a board appointed by the governor to protect the Colorado public. No matter what you think about the complaint itself; always keep your audience in mind when drafting a response. The following tips may seem obvious. However, licensees do not always keep them in mind when responding to a complaint.

1. Be courteous, responsive, and professional

When responding to a complaint – especially one alleging unprofessional behavior – craft your response in a professional manner. This is your opportunity to make a good first impression.

You may be surprised how often a board receives a response from a licensee that fails to address the issues raised in the complaint. Ranting and raving is unlikely to convey the impression you want to make. If anything, such behavior may lend credence to the complaint.

2. Be honest

Everyone make mistakes, including licensed professionals. At times, the strength of a true professional emerges when acknowledging an error and reporting steps taken to assure future compliance. There is a difference, of course, between a complaint alleging stolen funds and one complaining about unreturned phone calls or rude behavior. If there is a bit of truth in a routine complaint, however, don't shy away from acknowledging that you should have handled a situation in a different manner and will in the future. Remember, CPAs are held to high standards of professional conduct.

3. Take responsibility

It is common to hear licensees blame secretaries, relatives, co-workers, etc. when responding to complaints that are administrative in nature. While you may report the missteps of another if they contributed to an issue, don't attempt to place blame on someone else for a matter you are legally responsible for. This is especially true if the complaint concerns false statements on a renewal application, failing to register a firm or a failure to renew on time. Remember, the certificate is issued to you.

4. Provide facts

Be factual in your response. Please remember, the Board needs to clearly understand the situation and the facts surrounding the matter in the complaint. If necessary, provide copies of any supporting documents that you think are relevant to your response.

5. Legal counsel

You are not required to seek the assistance of legal counsel when responding to a complaint letter. If you choose to retain an attorney, please have the attorney enter their appearance with the Board when responding to the complaint or in separate letter. Division staff cannot discuss any complaint with anyone other than the respondent unless notification of representation is received in writing. Should you elect to seek the assistance of legal counsel, you should do so in a timely manner. A delay in your response based on a delay in retaining counsel is not sufficient grounds for requesting an extension of time to reply. Please remember that division staff cannot provide legal advice on how you should respond and what information you should or should not provide.

6. Respond even if you disagree with the nature of the complaint

The Board does not have control over who files complaints or the content of the complaint. Unless a complaint is blatantly frivolous or outside the Board's jurisdiction, you will likely be asked to respond. Complaints alleging rude behavior may seem "frivolous" to you, but from the public's perspective, how people are treated is important. Patterns of unprofessional or neglectful behavior may, in fact, warrant further investigation. Don't add credence to the complaint by responding in an unprofessional manner. Also, don't assume that any conclusions have been reached solely because you've been asked to respond.

7. Be timely

If you are unable to respond within the time provided, contact the division staff before the date identified for response in the letter. Please note that delays in retaining counsel will not result in additional time to respond.

8. Don't cause grounds for additional violations

If you fail to respond to the initial letter, you may face discipline for failure to respond to communication from the Board. This holds true whether you are the target of the investigation or someone with knowledge of the matter. Holding a CPA license to practice imposes certain duties and expectations as a licensed professional, including the duty to assist the Board when requested.

9. Do not retaliate

If a licensee is found to have retaliated against someone for filing a complaint, the licensee may raise new grounds for discipline. As long as the complainant does not act with malice, a complainant is generally immune from liability for filing a complaint and protected from retaliation.

10. Do not take it personally

The Board has the authority to initiate complaints against CPAs and CPA firms for violating statutes and rules. If the Board initiates a complaint for failing to register a firm, representing yourself and/or using the CPA designation without an active license, etc. do not take it personally. The Board is charged with upholding the laws and the rules related to the CPA profession and ensuring that the law is applied fairly and consistently to the regulated community.

V. DUTY TO REPORT A CHANGE OF ADDRESS OR CHANGE OF NAME

A certificate holder shall notify the Board, in a manner or on a form prescribed by the Board, of a change of the address that the certificate holder has furnished to the Board for the purpose of receiving mail from the Board or of a change of the certificate holder's name within 30 days of the change. A certificate holder's failure to notify the Board of a change of address or name within the time required shall not excuse the certificate holder from renewing a certificate or registering a firm by the date established for renewal or registration or from responding to a Board communication sent pursuant to section 12-2-123.5, C.R.S.

VI. COLORADO BOARD OF ACCOUNTANCY'S POSITION STATEMENT REGARDING CERTIFIED PUBLIC ACCOUNTANT CERTIFICATE HOLDERS PROVIDING SERVICES TO THE MARIJUANA INDUSTRY (ADOPTED DECEMBER 16, 2015).

It is the Board's position that offering to perform or performing professional services for clients in the marijuana industry who are in compliance with Colorado Medical Marijuana Code and the Colorado Retail Marijuana Code is not in itself specifically prohibited by the Accountancy Act codified in Section 2 of Title 12 of the Colorado Revised Statutes or the State Board of Accountancy Rules.

Certificate holders who choose to provide professional services to the marijuana industry will be held to the professional standards, laws, and rules applicable to all certificate holders for services provided.

The Board's Position Statement should not be construed: (a) as an endorsement for certificate holders to provide professional services to the marijuana industry; (b) as a statement about the feasibility of meeting applicable professional standards in providing services in the marijuana industry; or (c) as a statement about marijuana enforcement in any other jurisdiction or by any other local, state, or federal authority.

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CHAPTER 1: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is correct regarding the CPE requirements:**

A. the reporting period for reporting CPE is December 31 of every year

B. 40 hours of CPE must be completed each year

C. a maximum of 24 hours of CPE may be in Personal Development during a reporting period

D. four hours of CPE in ethics is required for those actively licensed during the entire reporting period

2. **Which of the following is <u>not</u> one of the top ten mistakes that contribute to a CPE audit failure:**

A. failure to complete, sign, and attest the Detailed Record of CPE

B. submitting a non-compliant certificate of completion as documentation

C. submitting more hours than required

D. not completing the required number of hours in ethics

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CHAPTER 1: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. A reporting period for CPE is a two year period from January 1st on an even-numbered year through December 31st of the odd-numbered year. **B.** Incorrect. Although 80 hours must be completed during the two year reporting period, the CPE is not required to be completed equally from year to year. **C.** Incorrect. No more than 16 hours may be in Personal Development, as defined in the NASBA Fields of Study. **D.** **CORRECT**. Up to two of the four hours may be in Colorado Rules and Regulations. *(See page 1 of the course material.)*
2.	**A.** Incorrect. One of the top ten mistakes includes not submitting a completed Detailed Record of CPE. **B.** Incorrect. One of the top ten mistakes includes submitting certificates of completion as documentation that are not compliant with the requirements. **C.** **CORRECT**. One of the top ten mistakes is submitting fewer hours than required rather than excessive hours. **D.** Incorrect. The top ten mistakes that contribute to CPE audit failure include both not completing the required number of hours in ethics and not taking a Colorado Rules and Regulations course if required. *(See page 3 of the course material.)*

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CHAPTER 2: THE AICPA CODE OF PROFESSIONAL CONDUCT

Chapter Objectives

After completing this chapter, you should be able to:

- Recall the six guiding principles in the AICPA Code of Professional Conduct.
- Recognize the rules of the Code of Professional Conduct.

Introduction

The Code of Professional Conduct provides guidelines for accounting practitioners in the conduct of their professional affairs. A member of the AICPA must observe all the Rules of Conduct unless an exception applies. The need to observe the Rules of Conduct also extends to individuals who carry out tasks on behalf of an AICPA member. A member may be held responsible for a violation of the rules committed by fellow partners, shareholders, or any other person associated with him who is engaged in the practice of public accounting. The bylaws of the AICPA provide the basis for determining whether a member has violated the Rules of Conduct. If a member is found guilty of a violation, he or she may be admonished, suspended or expelled.

A member of the AICPA also must be aware of Interpretations of the AICPA Rules of Conduct. After public exposure, Interpretations of the AICPA Rules of Conduct are published by the Executive Committee of the Professional Ethics Division. Interpretations are not intended to limit the scope or application of the Rules of Conduct. A member of the AICPA who departs from the guidelines provided in the Interpretations has the burden of justifying such departure.

Question and Answer

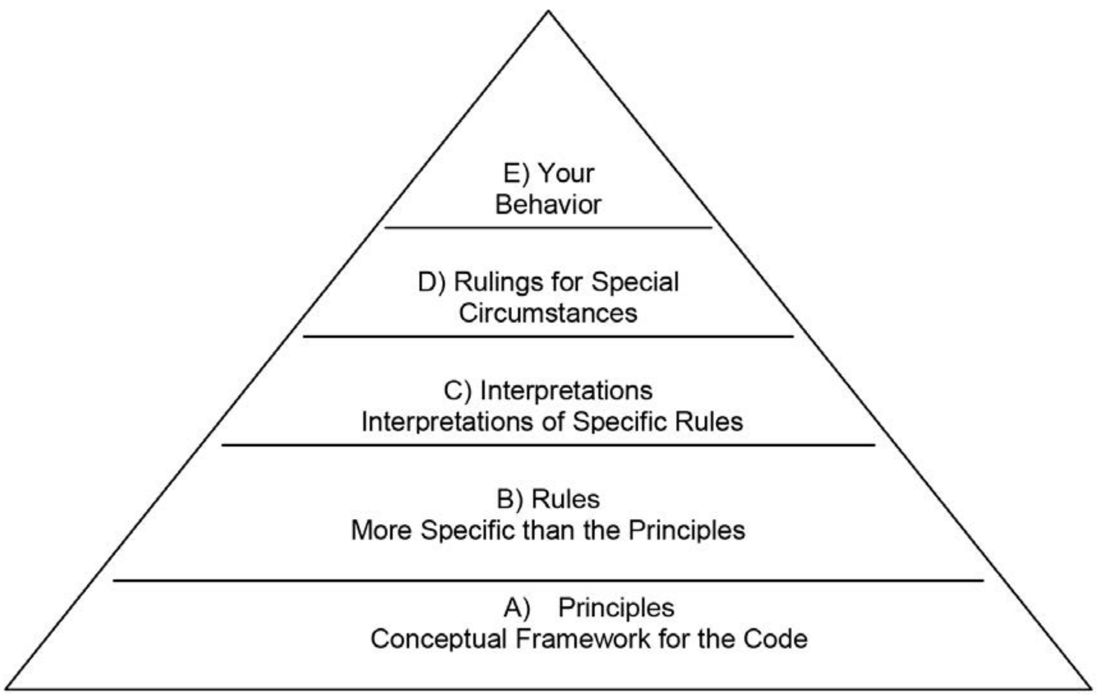
Q: Why do I care about the AICPA rules if I am not a member of the AICPA?

A: Most states pattern their rules after the AICPA. In addition, when courts look at professional negligence, they will look to national standards such as the AICPA Code of Professional Conduct.

Observation

In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the Public Company Accounting Oversight Board (PCAOB), and the U.S. Securities and Exchange Commission (SEC) if the member's report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL, the Government Accountability Office (GAO) if law, regulation, agreement, policy or contract requires the member's report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

I. AICPA ETHICS PYRAMID



The AICPA ethics pronouncements can be thought of as a pyramid.

A) Principles

The six principles of the Code of Professional Conduct provide the conceptual framework for the code. They are the cornerstone of ethical behavior.

B) Rules

The rules of the Code of Professional Conduct are more specific than the six principles. Members must observe the rules.

C) Interpretations

Interpretations are issued by the AICPA to better explain the Code of Professional Conduct. Only the principles and rules are considered part of the Code of Professional Conduct. Interpretations explain the code but are not part of it.

D) Rulings

The rulings apply the rules of conduct and interpretations to particular circumstances. AICPA members who depart from such rulings must justify their departures.

E) Your Behavior

The code, interpretations and rulings are meaningless if they do not impact your behavior. For this reason, your behavior is at the top of the pyramid.

II. PRINCIPLES

The Principles of the Code of Professional Conduct:

1. Responsibilities

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.

2. The Public Interest

Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

3. Integrity

To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

4. Objectivity and Independence

A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

5. Due Care

A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.

6. Scope and Nature of Services

A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

These principles establish the basis for characterizing the responsibilities the CPA has to clients, colleagues and the public at large. The fundamental theme of the six principles is to be committed to honorable behavior, even at the sacrifice of personal advantage.

III. RULES

The following definitions are used in the Rules of the Code of Professional Conduct:

Practice of public accounting - The practice of accounting consists of the performance for a client, by a member or a member's firm, while holding out as a CPA(s), of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council.

However, a member or a member's firm, while holding out as a CPA(s), is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph.

Professional services - Professional services include all services performed by a member with very few exceptions.

NEW CODIFIED CODE OF PROFESSIONAL CONDUCT EFFECTIVE 12/15/14

The AICPA has codified the Code of Professional Conduct to be more logical and user friendly. The code, rules, interpretations and rulings are essentially the same but have been grouped into functional areas based on the member's area of practice plus a preface that is applicable to all members. (Note: throughout the AICPA Code of Professional Conduct you will see the term "Member." This term relates to you, the CPA, whether or not you are a member of the AICPA). The three functional areas are:

Part 1: Members in Public Practice

Part 2: Members in Business

Part 3: Other Members (retired, unemployed, etc.)

The part number is followed by two sets of three digit numbers to identify the topic and, when applicable, the subtopic. For example, 1.100.001 relates to Part 1 (members in Public Practice); topic 100 Integrity and Objectivity; and subtopic 001 the Integrity and Objectivity rule.

By grouping all guidance for a particular type of member in one place, the CPA will save much time in researching a situation, as well as (hopefully) reach a more accurate conclusion. However, bear in mind that a member may be covered by more than one category. For example, one could work full time for an employer in industry and work part time during busy season preparing tax returns.

This chapter will focus on Part 1 of the Code of Professional Conduct: Members in Public Practice. Below is a listing of the topics covered in Part 1 followed by a discussion of each topic and selected corresponding interpretations, rulings, and other guidance by topic.

1.000 Conceptual Framework for Members in Public Practice

1.100 Integrity and Objectivity

1.200 Independence

1.300 General Standards

1.400 Acts Discreditable

1.500 Fees and Other Types of Remuneration

1.600 Advertising and Other Forms of Solicitation

1.700 Confidential Information

1.800 Form of Organization and Name

Throughout this course, we will attempt to use the actual AICPA code section references whenever possible. This will allow you to conduct further research on topics of interest to you. However, the source material is very voluminous and in many instances we have omitted entire sections of the code. In other instances we have greatly summarized the material – sometimes condensing several pages of material into a few bullet points or a single paragraph. We believe this approach is both appropriate and beneficial for the CPA seeking an overview or refresher course.

1.000.010 Conceptual Framework for Members in Public Practice

Introduction

.01 Members may encounter various relationships or circumstances that create threats to the member's compliance with the rules. The rules and interpretations seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to the member's compliance with the rules that is not at an acceptable level. When making that evaluation, the member should apply the conceptual framework approach as outlined in this interpretation.

.02 The code specifies that in some circumstances no safeguards can reduce a threat to an acceptable level. For example, the code specifies that a member may not subordinate the member's professional judgment to others without violating the "Integrity and Objectivity Rule" [1.100.001]. A member may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in the code.

.03 The "Conceptual Framework for Independence" interpretation [1.210.010] of the "Independence Rule" [1.200.001] provides authoritative guidance that members should use when making decisions on independence matters that are not explicitly addressed by the "Independence Rule" and its interpretations.

1.100 Integrity and Objectivity

1.100.001 Integrity and Objectivity Rule

.01 In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

Rule 1.100.001 is very broad on purpose. The Code of Professional Conduct could not possibly proscribe every action that is to be avoided. Thus, Rule 1.100.001 could cover a variety of misconduct.

Observation

It would be impractical to define all situations that would lead to an impairment of objectivity or integrity. Integrity is difficult to judge because any particular fault by omission or commission may be the result of either honest error or lack of integrity.

Interpretations Under the Integrity and Objectivity Rule

1.100.005 Application of the Conceptual Framework for Members in Public Practice and Ethical Conflicts

.01 In the absence of an interpretation of the "Integrity and Objectivity Rule" [1.100.001] that addresses a particular relationship or circumstance, a member should apply the "Conceptual Framework for Members in Public Practice" [1.000.010].

.02 A member would be considered in violation of the "Integrity and Objectivity Rule" [1.100.001] if the member cannot demonstrate that safeguards were applied that eliminated or reduced significant threats to an acceptable level.

.03 A member should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the member encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both.

1.110 Conflicts of Interest

1.110.010 Conflicts of Interest

.01 In performing a professional service for a client, a conflict of interest may occur if a member or the member's firm has a relationship with another person, entity, product, or service that, in the member's professional judgment, the client or other appropriate parties may view as impairing the member's objectivity. In such situations, adverse interest or self-interest threats may exist to the member's compliance with the "Integrity and Objectivity Rule" [1.100.001].

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under 1.200.001, its interpretations, and rulings cannot be eliminated by such disclosure and consent.

The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).

The above examples are not intended to be all-inclusive.

Question and Answer

Q: A CPA firm represents two clients. The clients have adverse interests in a controversy involving a limited partnership of which each client owns a percentage. Can the CPA continue to advise both clients? The work the CPA performs does not require independence.

A: The CPA would have a conflict of interest. If the relationships are disclosed to and consent is obtained from all appropriate parties, the CPA could continue to advise both parties. However, the CPA would have to observe 1.700.001: Confidential Client Information Rule.

1.120 Gifts and Entertainment

1.120.010 Offering or Accepting Gifts or Entertainment

.01 For purposes of this interpretation, a client includes the client, an individual in a key position with the client, or an individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests.

.02 When a member offers to a client or accepts gifts or entertainment from a client, self-interest, familiarity, or undue influence threats to the member's compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist.

.03 Threats to compliance with the "Integrity and Objectivity Rule" [1.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards and the member would be presumed to lack integrity in violation of the "Integrity and Objectivity Rule" in the following circumstances:

a) The member offers to a client or accepts gifts or entertainment from a client that violate the member's or client's policies or applicable laws, rules, and regulations; and

b) The member knows of the violation or demonstrates recklessness in not knowing.

.04 A member should evaluate the significance of any threats to determine if they are at an acceptable level. Threats are at an acceptable level when gifts or entertainment are reasonable in the circumstances. The member should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. The following are examples of relevant facts and circumstances:

a) The nature of the gift or entertainment

b) The occasion giving rise to the gift or entertainment

c) The cost or value of the gift or entertainment

d) The nature, frequency, and value of other gifts and entertainment offered or accepted

e) Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment

f) Whether other clients also participated in the entertainment

g) The individuals from the client and member's firm who participated in the entertainment

1.130 Preparing and Reporting Information

1.130.010 Knowing Misrepresentations in the Preparation of Financial Statements or Records

.01 Threats to compliance with the "Integrity and Objectivity Rule" [1.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards and the member would be considered to have knowingly misrepresented facts in violation of the "Integrity and Objectivity Rule," if the member

a) makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records;

b) fails to correct an entity's financial statements or records that are materially false and misleading when the member has the authority to record the entries; or

c) signs, or permits or directs another to sign, a document containing materially false and misleading information.

1.130.020 Subordination of Judgment

.01 The "Integrity and Objectivity Rule" [1.100.001] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services for a client, for an employer, or on a volunteer basis. This interpretation addresses differences of opinion between a member and his or her supervisor or any other person within the member's organization.

.02 Self-interest, familiarity, and undue influence threats to the member's compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist when a member and his or her supervisor or any other person within the member's organization have a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations.

.03 A member should evaluate the significance of any threats to determine if they are at an acceptable level. Threats are at an acceptable level if the member concludes that the position taken does not result in a material misrepresentation of fact or a violation of applicable laws or regulations. If threats are not at an acceptable level, the member should apply the safeguards in paragraphs .05–.07 to eliminate or reduce the threat(s) to an acceptable level so that the member does not subordinate his or her judgment.

Question and Answer

Q: Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended March 31, 2014, Steffen proposes to reduce obsolete inventory to net realizable value. The obsolete items represent a significant amount of total inventory. The CFO concurs with Steffen's position. However, he decides not to go against the CEO whose position is that reducing the inventory this quarter is a discretionary decision and the CEO would prefer to record any such reduction at year end, after Company X completes its anticipated public offering of stock later this year. What are the ethical obligations of Steffen's in this situation?

A: To avoid subordinating her judgment, Steffen should first determine whether the inventory writedown is material. If so, she should restate her concerns to the CFO and CEO and, if the latter persists in not supporting the writedown, Steffen should bring the matter to the attention of the audit committee of the board of directors. She should document the understanding of the facts, the accounting principles involved, the application of the principles to the facts, and the parties with whom discussions were held. Steffen should consider any responsibility that may exist to go outside the company, although legal counsel should be sought on this matter.

1.200 Independence

1.200.001 Independence Rule

.01 A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

Interpretations Under the Independence Rule

1.200.005 Application of the Conceptual Framework for Independence and Ethical Conflicts

.01 In the absence of an interpretation of the "Independence Rule" [1.200.001] that addresses a particular relationship or circumstance, a member should apply the "Conceptual Framework for Independence" interpretation [1.210.010].

.02 A member would be considered in violation of the "Independence Rule" [1.200.001] if the member cannot demonstrate that safeguards were applied that eliminated or reduced significant threats to an acceptable level.

.03 A member should consider the guidance in "Ethical Conflicts" [1.000.020] when addressing ethical conflicts that may arise when the member encounters obstacles to following an appropriate course of action. Such obstacles may be due to internal or external pressures or to conflicts in applying relevant professional or legal standards, or both.

Independence is a highly subjective term because it concerns an individual's ability to act with integrity and objectivity. Integrity relates to an auditor's honesty, while objectivity is the ability to be neutral during the conduct of the engagement and the preparation of the auditor's report. Two facets of independence are independence in fact and independence in appearance. The second general standard of generally accepted auditing standards requires that an auditor be independent in mental attitude in all matters relating to the engagement. In essence, the second standard embraces the concept of independence in fact. However, independence in fact is impossible to measure, since it is a mental attitude; the Code of Professional Conduct takes a more pragmatic approach to the concept of independence.

1.210 Conceptual Framework Approach

1.210.010 Conceptual Framework for Independence

Introduction

.01 It is impossible to enumerate all relationships or circumstances in which the appearance of independence might be questioned. Thus, in the absence of an independence interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to either the member's or firm's independence, or both, that is not at an acceptable level. When making that evaluation, a member should apply the conceptual framework approach as outlined in this interpretation to analyze independence matters. A member may also wish to consider the conceptual framework approach described in this interpretation to gain a better understanding of the conclusions reached in other interpretations in ET section 1.200, "Independence."

.02 The code specifies that in some circumstances no safeguards can reduce an independence threat to an acceptable level. For example, the code specifies that a covered member may not own even an immaterial direct financial interest in an attest client because there is no safeguard to reduce the self-interest threat to an acceptable level. A member may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in an independence interpretation.

1.230 Fees

1.230.010 Unpaid Fees

.01 The existence of unpaid fees to a covered member for professional services previously rendered to an attest client may create self-interest, undue influence, or advocacy threats to the covered member's compliance with the "Independence Rule" [1.200.001].

.02 Threats to the covered member's compliance with the "Independence Rule" [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards if a covered member has unpaid fees from an attest client for any previously rendered professional service provided more than one year prior to the date of the current-year report. Accordingly, independence would be impaired. Unpaid fees include fees that are unbilled or a note receivable arising from such fees.

.03 This interpretation does not apply to fees outstanding from an attest client in bankruptcy.

1.240 Financial Interests

1.240.010 Overview of Financial Interests

.01 If a covered member had or was committed to acquire any direct financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member's compliance with the "Independence Rule" [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards. Accordingly, independence would be impaired.

.02 If a covered member had or was committed to acquire any material indirect financial interest in an attest client during the period of the professional engagement, the self-interest threat to the covered member's compliance with the "Independence Rule" [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards. Accordingly, independence would be impaired.

.03 If a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than 5 percent of an attest client's outstanding equity securities or other ownership interests during the period of the professional engagement, the self-interest threat to compliance with the "Independence Rule" [1.200.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards. Accordingly, independence would be impaired.

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if:

1. An individual participating on the attest engagement team has a close relative who had:
   a) A key position with the client, or
   b) A financial interest in the client that:
      i. Was material to the close relative and of which the individual has knowledge; or
      ii. Enabled the close relative to exercise significant influence over the client.
2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had:
   a) A key position with the client, or
   b) A financial interest in the client that

i. Was material to the close relative and of which the individual or partner has knowledge; and

ii. Enabled the close relative to exercise significant influence over the client

Question and Answer

Q: A potential audit client is owned by the CPA's stepbrother. Would the CPA be independent with regard to the potential client? What if the CPA is closer to the stepbrother than to his own brother?

A: A stepbrother is not considered a close relative under the independence rules and normally would not impair independence. However, if the relationship between the CPA and stepbrother was close enough to lead a reasonable person, aware of all the facts, to conclude that the situation poses an unacceptable threat to the appearance of independence and the CPA's objectivity, then the relationship would impair independence.

1.300 General Standards

1.300.001 General Standards Rule

.01 A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council:

a) Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

b) Due Professional Care. Exercise due professional care in the performance of professional services.

c) Planning and Supervision. Adequately plan and supervise the performance of professional services.

d) Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

In general, these standards are applicable to all professional services rendered by an accounting firm. For example, an accountant who performs a consulting services engagement must properly plan and supervise the job.

Rule 1.300.001 requires that a firm have a certain level of expertise before an audit, tax, or consulting engagement is accepted. This does not suggest that an accounting firm must have complete knowledge in an area before the engagement is accepted -- a lack of competence is not apparent just because an accounting firm accepts a client knowing that additional research may be necessary to complete the job.

Case Study: Competency, Auditing Standards and Other Professional Standards

Licensee was subject to a Quality Assurance Review by the U.S. Department of Housing and Urban Development, Real Estate Assessment Center (HUD). This review included licensee's audit work for two county housing authorities. The opinion issued by HUD found that the licensee did not comply with all applicable audit standards while performing audits of HUD assisted properties. Documentation for the audit work was not of sufficient standard.

LIKELY DISCIPLINARY ACTION: Violation of 1.300.001 – General Standards Rule.

1.310 Compliance With Standards

1.310.001 Compliance With Standards Rule

.01 A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

1.310.001 requires members to observe technical standards promulgated by bodies designated by the AICPA Council. To date, the bodies designated by the Council are the Auditing Standards Board (ASB), Accounting and Review Services Committee (ARSC), Management Consulting Services Executive Committee (MCSEC), and Tax Executive Committee.

Observation

The Code of Professional Conduct does not refer to Audit and Accounting Guides that may be issued by a committee or task force established by the AICPA. Although each Audit Guide contains a preamble that states that a Guide does not have the authority of a pronouncement by the ASB, it does note that a member may be called upon to justify departures from the Guide if the member's work is challenged.

1.320 Accounting Principles

1.320.001 Accounting Principles Rule

.01 A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

Observation

The AICPA Council has designated the FASB, GASB, IASB, PCAOB, and FASAB as bodies to promulgate accounting principles. In addition, several AICPA committees have been designated to promulgate standards in their respective subject areas.

1.320.001 also provides flexibility in the application of accounting principles.

When the auditor concludes that a written accounting rule should not be followed, the auditor's standard report must be expanded to include an explanatory paragraph. The explanatory paragraph would describe the nature of the departure; however, the opinion expressed would be an unqualified opinion and no reference to the explanatory paragraph would be made in the opinion paragraph.

1.400 Acts Discreditable

1.400.001 Acts Discreditable Rule

.01 A member shall not commit an act discreditable to the profession.

> **NOTE:** 1.400.001 is very broad. It is basic to ethical conduct, and only through its observance can the profession expect to win the confidence of the public. What constitutes a discreditable act is highly judgmental. There has been no attempt to be specific about what constitutes a discreditable act; however, the AICPA bylaws (Section 7.3) state that the following actions will lead to membership suspension or termination, without the need for a disciplinary hearing:
>
> - If a member commits a crime punishable by imprisonment for more than one year.
> - If a member willfully fails to file an income tax return that he or she, as an individual taxpayer, is required by law to file.
> - If a member files a false or fraudulent income tax return on his or her behalf, or on a client's behalf.
> - If a member willfully aids in the preparation and presentation of a false and fraudulent income tax return of a client.
> - If a member's certificate as a certified public accountant, or license or permit to practice as such, is revoked by a governmental authority as a disciplinary measure.

In addition, interpretations under the Acts Discreditable Rule identify the following discreditable acts:

- Discrimination or harassment in employment practices.
- Solicitation or disclosure of CPA examination questions or answers.
- Failure to file a tax return of pay a tax liability.
- Negligence in the preparation of financial statements or records.
- Negligence in the preparation of reports to governmental bodies, commissions, or other regulatory agencies.
- Failure to follow applicable standards in conducting governmental audits.
- Use of prohibited indemnification agreements.
- Disclosure or use of confidential information obtained from employment or volunteer activities.
- Using the CPA credential in violation of state law.
- Failure to comply with the request to return client records.
- Removing client files or proprietary information from a former employer.
- Use of confidential information from nonclient services.

1.400.090 False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services

.01 A member would be in violation of the "Acts Discreditable Rule" [1.400.001] if the member promotes or markets the member's abilities to provide professional services or makes claims about the member's experience or qualifications in a manner that is false, misleading, or deceptive.

1.500 Fees and Other Types of Remuneration

1.510 Contingent Fees

1.510.001 Contingent Fees Rule

.01 A member in public practice shall not

a) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member's firm performs,

  i. an audit or review of a financial statement; or

  ii. a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

iii. an examination of prospective financial information; or

b) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

.02 The prohibition in a. above applies during the period in which the member or member's firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

.03 Except as stated in the next sentence, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

Question and Answer

Q: A CPA offers a new client a free one-hour consultation or a 10 percent discount on tax return preparation. Is this acceptable?

A: Yes. These are not prohibited transactions.

.04 A member's fees may vary depending, for example, on the complexity of services rendered.

Note

For example, charging a new client $500 for completing a tax return when a similar continuing client is charged only $300 for a similar tax return is permitted, since a first year engagement is more difficult than a repeat engagement.

The accounting profession has had a long-standing tradition that a contingent fee would infringe on the CPA's ability to be independent. A contingent fee is based on an arrangement whereby the client is not required to pay the CPA unless a specified finding or result is attained. For example, a contingent fee arrangement would exist if the auditor's fee is dependent on the net proceeds of a public stock offering. Engagement fees should be determined by such factors as the number of hours required to perform the engagement, the type of personnel needed for the engagement, and the complexity of the engagement.

Fees are not considered to be contingent if they are determined (1) by courts or other public authorities or (2) by judicial proceedings or governmental agencies in the case of tax matters.

The period of prohibition includes the date covered by the financial statements and the period during which the attestation service (and compilation service, as described above) is performed. For example, if the CPA is auditing a client's financial statements for the year ended December 31, 2014, and the date of the auditor's report is March 12, 2015, no services could be performed on a contingent fee basis by the auditor for the period from January 1, 2014, through March 12, 2015.

1.510.001 also prohibits the CPA from charging a contingent fee to prepare an original or amended tax return or claim for a refund. While independence is not an issue in performing tax services, the AICPA takes the position that it would be unprofessional to charge a fee, for example, based on the amount of refund that may be claimed on the tax return.

1.520 Commissions and Referral Fees

1.520.001 Commissions and Referral Fees Rule

.01 Prohibited commissions. A member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission, when the member or member's firm also performs for that client

a) an audit or review of a financial statement; or

b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

c) an examination of prospective financial information.

.02 This prohibition applies during the period in which the member is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in such listed services.

.03 Disclosure of permitted commissions. A member in public practice who is not prohibited by this rule from performing services for or receiving a commission and who is paid or expects to be paid a commission shall disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission relates.

.04 Referral fees. Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.

Note

A CPA cannot receive a commission for recommending a client's product or services if the CPA audits or reviews that client's financial statements or examines that client's prospective financial information. In addition, no commissions can be received when the CPA compiles a client's financial statements if the CPA believes that a third party will rely on the statements, unless any lack of independence is disclosed in the compilation report.

Observations

#1 - When a CPA sells products that the CPA has title to directly to clients, this is not considered a commission. However, care should be exercised to ensure that the arrangement does not impair independence.

#2 - As with contingent fees, the most important point for CPAs in public practice to remember is that although most Boards of Accountancy allow for commissions with varying requirements, some states continue to prohibit commissions altogether.

#3 - The Commissions and Referral Fee Rule has never prohibited calculating the price to be paid for the purchase of an accounting practice as a percentage of fees the purchaser receives from these new clients over some specified period of time such as one, two, three or more years. The AICPA Professional Ethics Executive Committee has stated that the Rule does not prohibit the purchase of a portion of a practice (such as the tax practice related to individual returns) or even the purchase of a single client. Further, the purchase may be made through a non-CPA broker who will receive a portion of the purchase price.

#4 - The Rule also does not prohibit the payment of bonuses to employees even though practice development efforts on the part of the employee are a factor in determining the amount of the bonus.

#5 - The markup of a subcontractor's fees is not considered a commission.

#6 - A member's spouse may receive a commission for referring a product to a client provided the spouse is not part of the member's firm. However, care must be taken to avoid any potential conflict of interest.

1.600 Advertising and Other Forms of Solicitation

1.600.001 Advertising and Other Forms of Solicitation Rule

.01 A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited.

Advertising or other forms of solicitation that are false, misleading, or deceptive are not in the public interest and are prohibited. Such activities include those that:

- Create false or unjustified expectations of favorable results
- Imply the ability to influence any court, tribunal, regulatory agency or similar body or official
- Contain a representation that specific professional services in current or future periods will be performed for a stated fee, estimated fee or fee range when it was likely at the time of the representation that such fees would be substantially increased and the prospective client was not advised of that likelihood
- Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

Case Study: Public Communications and Advertising

Smith CPA LLC circulated an advertisement in a local newspaper that stated the following:

> "Professional Service Warranty which guarantees you the largest refund possible with the lowest tax liability."

The advertisement guaranteed the reader the largest refund possible with the lowest tax liability. The advertisement did not state or explain how the services could be verified to provide the largest refund or the lowest tax liability.

1.700 Confidential Information

1.700.001 Confidential Client Information Rule

.01 A member in public practice shall not disclose any confidential client information without the specific consent of the client.

.02 This rule shall not be construed (1) to relieve a member of his or her professional obligations of the "Compliance With Standards Rule" [1.310.001] or the "Accounting Principles Rule" [1.320.001], (2) to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy. Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

Question and Answer

Q: The IRS requested that a CPA provide copies of documents relating to a prior client of the CPA. The CPA is not able to locate the client to obtain permission to release the documents. Should the CPA turn the information over to the IRS?

A: No. A CPA cannot release confidential client information without the specific consent of the client unless the CPA receives a validly issued and enforceable subpoena or summons. Information obtained by a licensee can be disclosed in response to an official inquiry from a federal or state government regulatory agency. However, the IRS is considered to be a taxing agency and not a government regulatory agency.

Practice Pointer: Your Laptop - Physical Security, Data Protection, and Tracking/Recovery

Adapted from an article in the North Carolina State Board of CPA Examiners Newsletter.

The theft of laptop computers and the sensitive data they contain is a growing problem for CPAs – in one week, three CPAs contacted the Board regarding the theft of laptops from their firms.

There are three major aspects to laptop security – physical security, data protection, and tracking/recovery.

One of the first things to do after purchasing a laptop is to make a copy of the purchase receipt, serial number, and description of the laptop and keep that information in a location separate from the laptop. This information will be invaluable if the laptop is lost or stolen.

In addition, asset tag or engrave the laptop. Engraving your firm name and phone number or address may increase the likelihood of getting the laptop returned if it is stolen and recovered. Tamper-proof asset tags may serve as a deterrent to a thief who must choose between stealing an unmarked laptop or a marked laptop. Why? Asset tags are difficult to remove and may hamper the thief's ability to sell the laptop on the open market.

Industry experts estimate that one in eight laptops is at risk of theft. With such a daunting statistic, laptop users may feel resigned to being the victim of theft. However, one of the cheapest and most cost-effective solutions to deter the theft of a laptop is to attach a security cable (similar to the locks used on bicycles) to the laptop.

With cable locks, a steel clip provided by the manufacturer is installed in a security slot on the back or side of the laptop and a steel cable is threaded through the clip and wrapped around a heavy object such as a desk leg or support pole. The two ends of the cable are then secured with a locking device. If the laptop does not contain a security slot or if the desk does not provide a location for suitable anchorage, special adhesive pads containing an anchorage slot are available. Although cable locks are not infallible, they will at least make the thief work a little harder to get the laptop.

Another effective method of protecting a laptop is to use a laptop safe. An advantage of a laptop safe is that when the laptop is locked in a safe, the PC cards and peripherals are secure, a protection that is not available with cable locks.

The two main types of safes available are portable safes that can safely attach to most work surfaces and car safes which are designed to protect valuables while they are stored in the trunk of a vehicle. (**NOTE:** Never leave a laptop in plain sight in a vehicle; doing so is inviting a thief to break in the vehicle and take the laptop.)

Whereas cable locks and safes are designed to stop (or at least slow down) an opportunistic thief, alarms and motion detectors are intended to make the potential robber so conspicuous that he or she aborts the crime.

Products range from simple motion detectors to sensors that detect the unplugging of cables. Some products are designed to lock down the laptop if it is moved out of a designated range. Other products rely on nothing more than movement of the object to which it is attached; if the laptop to which the sensor is attached is moved, an alarm will sound.

Let's assume that, despite taking the appropriate physical security measures, your laptop has been stolen. How worried would you be about the security of the data on the machine?

Safeguarding data when it is in unauthorized hands is a matter of controlling access and encrypting data. If the first thing a thief sees when turning on a laptop is, "please enter boot password," he or she knows that it will take some effort to access the information on the machine.

Many machines allow the owner to set a boot password and a user will be prompted three times to enter the correct password. If there are three password failures, the machine will refuse to boot. However, if the machine is restarted, the user will have three more chances to enter the right password.

Removing a password-protected BIOS (basic input output system) and boot sequence typically involves physically opening the computer and removing the CMOS (complementary metal oxide semiconductor) battery (which may clear the BIOS information) or shorting some jumpers to reset the BIOS to a default state.

If you are running an operating system that supports proper logins, setting a password is not only a good idea, it is required. To successfully login to the computer, the user must provide a login name and password. If the information entered is incorrect, the operating system will refuse to allow the user to become an active user.

When creating a password, make sure you create a strong password. For a password to be considered strong, it must be eight or more characters (14 characters or longer is ideal); it must combine letters, numbers, and symbols; it must use a mix of uppercase letters and lowercase letters; and it should use words and phrases that are easy for you to remember, but difficult for others to guess. (**NOTE:** Avoid using your login name, your name, your birthday, anniversary, social security number, telephone number, etc., as part of your password.) Don't forget to change your passwords on a regular basis.

Although applying strong passwords to your laptop will make it more difficult for a casual thief to log in as "you," and therefore gain access to the information on your machine, passwords should not be relied upon as the sole piece of security on a laptop.

Even if an unauthorized user gains access to your laptop, encryption will protect the information stored on your machine. When you encrypt a file or folder, you are converting it to a format that can't be read by another user. When a file or folder is encrypted, an encryption key is added to the files or folder that you selected to encrypt and the key is needed to read the file.

Therefore, most firms who go this route will seek a third-party product which relies on encryption techniques above and beyond the Windows operating system.

CPAs using encryption technology need assurances that application databases such as tax, audit automation, and time and billing will operate correctly from encrypted disks or folders. The major software vendors test their products under a variety of scenarios and will be able to advise their customers of encryption solutions which are fully compatible with their products.

While encryption will protect the sensitive information on your laptop, it does nothing to retrieve the data on a lost or stolen machine. To do that, you must back up your files and store them in a secure location. Ideally, files should be backed up on a network server, but if that is not possible, there are other options.

External drives, flash drives, and CDs are excellent choices for backing up your files.

While encryption strategies will help safeguard the data on a lost or stolen notebook computer, they do nothing to help recover the missing machine – the FBI estimates that just 3% of stolen or lost laptops are recovered.

Until recently, luck was the determining factor in recovering a lost or stolen machine, but new technology is providing users with the ability to track stolen or lost laptops.

With tracking programs, once a computer is reported lost or stolen, the tracking company will wait for the laptop to send a location signal (sent whenever the machine is connected to the Internet). When a signal is retrieved, the program will be instructed to broadcast as much information as it can about the current connection (originating phone number, IP address, service provider, etc.). When enough information has been collected, the tracking company will notify the appropriate law enforcement agency which may be able to recover the machine.

Other programs provide the user with the ability to execute commands remotely to the missing machine (if connected to the Internet), theoretically allowing the user to delete all of the important information on the hard drive.

If you haven't yet experienced the loss of a computer full of sensitive and confidential data, you are living on borrowed time. Plan ahead now to minimize the risk, reduce your exposure, and enhance your chances of recovery. Manage your risks through proactive strategies. Develop a security policy and implement it.

This is not an issue you can address once and have solved forever. Threats will change, risks will change, and requirements will change. Be sure your plans, your people, and your processes change along with them. Conduct periodic training updates, ensure software is kept up to date with the latest versions, and keep your emergency reaction checklists current.

Practice Pointer: The Ethics of Outsourcing Client Tax Returns

Business process outsourcing – contracting business processes to outside service vendors – is not a new concept, and the accounting industry has long taken advantage of the benefits of outsourcing. However, a growing trend among CPA firms is causing concern among regulators.

A number of CPA firms, both multi-state and local, have begun using the burgeoning outsourcing and technology markets in India to process client tax returns. Although the AICPA Code and Rules do not expressly prohibit the practice of outsourcing the preparation of client tax returns, there are several rules a CPA must consider when outsourcing services.

One prime concern is maintaining the confidentiality of client records. Pursuant to Rule 1.700.001, a CPA shall not disclose any confidential information except with the consent of the client.

To process the tax return, the preparer must have sensitive client information such as the client's Social Security Number, date of birth, bank and brokerage statements, credit card information, salary, etc. In short, much of the information can be used to perpetrate identity theft.

If your CPA firm has professional liability insurance coverage, you should check with your insurance carrier to see if your policy covers the firm when using an outsource center.

The accuracy of the tax return remains the ultimate responsibility of the CPA firm, and all returns prepared by an outsource center must be reviewed by the CPA firm and the signing CPA.

If your CPA firm is considering outsourcing the preparation of client tax returns, remember that a CPA is responsible for ensuring that any partner, shareholder, officer, director, unlicensed principal, proprietor, employee or agent, including outsource personnel, comply with the AICPAs rules on Professional Ethics and Conduct.

In addition, the IRS and most states impose criminal and civil penalties for the unauthorized disclosure of tax return data.

1.800 Form of Organization and Name

1.800.001 Form of Organization and Name Rule

.01 A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council.

.02 A member shall not practice public accounting under a firm name that is misleading.

.03 Names of one or more past owners may be included in the firm name of a successor organization.

.04 A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all its CPA owners are members of the AICPA.

Question and Answer

Q: Three CPA firms wish to form an association – not a partnership – to be known as "Smith, Jones, Nash and Assoc." Is there any impropriety in this?

A: The use of such a title is not permitted since it might mislead the public into thinking a true partnership exists. Instead, each firm is advised to use its own name on its letterhead, indicating the other two as correspondents.

Note

Over the past several decades, the character of the practice of accounting has broadened to include a variety of activities that are beyond the scope of accounting. These activities include, among others, environmental auditing, executive recruitment, and the design of sophisticated computer systems that are not part of the client's accounting system. With the expansion of the types of services provided by accounting firms, there is an obvious need to recruit personnel who do not have an accounting/auditing background. For many accounting firms, these nontraditional professionals are increasingly important to their growth and development.

Practice Pointer: Non-CPA Ownership of CPA Firms

The AICPA allows a CPA firm to be owned by non-CPAs if the form of ownership is sanctioned by the particular state and if the following guidelines are observed:

- Fifty-one percent of the ownership (as measured by financial interest and voting rights) must be held by CPAs.
- A non-CPA owner must be actively engaged in providing services to clients of the firm.
- A CPA must be ultimately responsible for all services provided by the firm that involve financial statement attestation, compilation services, and "other engagements governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services."
- A non-CPA may not hold him or herself out as a CPA, but may be referred to as a(n) principal, owner, officer, member, shareholder or other title allowed by state law.

While the resolution allows for accounting firm ownership by non-CPAs, those individuals are not eligible for membership in the AICPA.

Observation

Each state is responsible for determining what forms of ownership may be used to practice public accounting; however, the AICPA notes that a practitioner can practice only in a business organization form that conforms to resolutions of the AICPA Council.

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CHAPTER 2: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is found as the base of the AICPA Ethics Pyramid:**

A. Your behavior

B. Principles

C. Rules

D. Interpretations

2. **Which of the following is <u>not</u> one of the Principles of the AICPA Code of Professional Conduct:**

A. Honesty

B. Integrity

C. Responsibilities

D. Due care

3. **The AICPA codified the Code of Professional Conduct into three functional areas, including all of the following <u>except</u>:**

A. Members in Public Practice

B. Members in Business

C. Member in Public Practice and Business

D. Other Members (retired, unemployed, etc.)

4.	**The General Standards Rule [1.300.001] provides guidance on professional competence. Which of the following is true regarding a CPA accepting an engagement under 1.300.001:** **A.** a CPA may generally accept any engagement in which the CPA can meet the expectations of the client **B.** a CPA may accept an engagement only if, at the time of acceptance, the CPA possesses sufficient professional competence to complete the engagement **C.** 1.300.001 generally prohibits CPAs from representing taxpayers before the Internal Revenue Service unless the CPA has also earned the Enrolled Agent designation **D.** 1.300.001 allows a CPA to accept an engagement in which the CPA lacks professional competence provided the CPA can obtain the necessary competence prior to completing the engagement
5.	**The Acts Discreditable Rule [1.400.001] is purposely very broad and very non-specific as to exactly when a violation occurs. Which of the following would most likely be a violation of 1.400.001 "Acts Discreditable":** **A.** a CPA is convicted of a traffic offense and is fined $400 **B.** a CPA cuts his professional services fee by 80% for a client who is near bankruptcy and prepays the estimated fee **C.** a CPA files a false personal tax return but is not convicted of any crime due to the suppression of evidence that is inadmissible in court **D.** a CPA mistakenly fails to sign his personal tax return but does sign it when requested by the tax authorities

CHAPTER 2: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The Code, interpretations, and rulings are meaningless unless they impact your behavior. Therefore, your behavior is at the top of the pyramid. **B.** CORRECT. The six principles of the Code of Professional Conduct provide the conceptual framework for the Code, and they are the cornerstone of ethical behavior. **C.** Incorrect. The rules of the Code of Professional Conduct are more specific than the principles. **D.** Incorrect. The interpretations are issued by the AICPA to better explain the Code. The Interpretations explain the Code but are not part of it. *(See page 14 of the course material.)*
2.	**A.** CORRECT. The other Principles are the public interest, objectivity and independence, and scope and nature of services. **B.** Incorrect. Members should perform all professional responsibilities with the highest sense of integrity to maintain and broaden public confidence. **C.** Incorrect. Members should exercise sensitive professional and moral judgments in all their activities. **D.** Incorrect. Members should observe the profession's technical and ethical standards, continually strive to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability. *(See pages 15 to 16 of the course material.)*
3.	**A.** Incorrect. The groupings are based on the member's area of practice, including public practice. The term member relates to any CPA, whether or not he or she is a member of the AICPA. **B.** Incorrect. The groupings are based on the member's area of practice, including business. The term member relates to any CPA, whether or not he or she is a member of the AICPA. **C.** CORRECT. There is not a part that includes a combination of these groups. **D.** Incorrect. The groupings are based on the member's area of practice, including a grouping of other members that do not fall into the main two categories. *(See page 16 of the course material.)*

4.	**A.** Incorrect. Meeting client expectations is important. However, 1.300.001 relates to professional competence, not client expectations. **B.** Incorrect. The key period of time for determining professional competence is at the end of an engagement, not at the beginning of the engagement. **C.** Incorrect. 1.300.001 is more general in nature and does not prohibit CPAs from performing tax services for clients. **D.** CORRECT. A CPA that accepts an engagement while lacking professional competence could gain the required competence by taking a course on the topic or seeking the assistance of a colleague. *(See page 25 of the course material.)*
5.	**A.** Incorrect. Although committing a crime punishable by imprisonment for more than one year is a violation of 1.400.001, a relatively minor traffic violation is not a violation. **B.** Incorrect. Besides being a benevolent act, cutting one's fee may be a wise business move if billing the full fee in arrears resulted in no recovery due to bankruptcy. **C.** CORRECT. Filing a false or fraudulent tax return is a violation of 1.400.001, even if a criminal conviction is not obtained. **D.** Incorrect. An unintentional mistake is not generally a violation of 1.400.001, though a pattern of repeated material errors could potentially rise to that level. *(See page 27 of the course material.)*

CHAPTER 3: IRS CIRCULAR 230

Chapter Objective

After completing this chapter, you should be able to:

- Identify the Internal Revenue Service Requirements as outlined in Circular 230.

Introduction

The tax preparation and tax consulting industry has historically enjoyed less government regulation than the practice of accountancy. In 1995, the IRS proposed studying the concept of tax preparer registration in order to combat rising fraud in the earned income credit program. This proposal was dropped because of widespread industry opposition. Instead, the IRS increased the scrutiny applied to firms applying to file tax returns electronically. In 2010, the IRS issued regulations requiring the registration of tax preparers. Effective January 1, 2011, all paid tax return preparers are required to have a Preparer Tax Identification Number (PTIN).

The tax practice field has had less ethical guidance because of the unique relationship between the CPA and client. In an attest engagement, the CPA is ultimately responsible to the users of the client financial statements as well as to the client. In a tax engagement, the CPA is an "advocate of the taxpayer." The courts have held that there is nothing illegal or sinister in a taxpayer arranging one's affairs so as to pay the lowest tax legally available.

Nevertheless, CPAs in tax practice do have two sets of ethical and legal guidance which governs their tax practice. Circular 230 governs practice before the Internal Revenue Service. The AICPA has issued statements on standards for tax services. We will examine both of these items, pointing out the differences wherever relevant.

I. CIRCULAR 230

Circular 230 is published by the Treasury Department. It prescribes regulations governing the practice of attorneys, CPAs, EAs, Enrolled Actuaries, appraisers, and others before the Internal Revenue Service. Circular 230 has been amended several times recently, and more changes are proposed. The IRS is currently revising Circular 230 to extend its application to cover unenrolled tax return preparers. This course reprints and discusses most, but not all, of Circular 230.

A. EXPLANATIONS OF PROVISIONS

Tax advisors play an increasingly important role in the federal tax system, which is founded on principles of voluntary compliance. The tax system is best served when the public has confidence in the honesty and integrity of the professionals providing tax advice. To restore, promote, and maintain the public's confidence in those individuals and firms, Circular 230 sets forth regulations and best practices applicable to all tax advisors. Circular 230 regulations are limited to practice before the IRS and do not alter or supplant other ethical standards applicable to practitioners.

B. WHAT IS NOT CONSIDERED "PRACTICE BEFORE THE IRS"

Section 10.7 of Circular 230 provides a long list of exceptions and exclusions to Circular 230. The following persons and situations are not considered "practicing before the IRS" and therefore are generally exempt from the rules we will discuss later in this course.

(a) Representing oneself – individuals may appear on their own behalf before the IRS, provided they present satisfactory identification.

(b) Participating in rulemaking – individuals may participate in rule making.

(c) Limited practice –

> (1) In general. Subject to the limitations in paragraph (c)(2) of this section, an individual who is not a practitioner may represent a taxpayer before the Internal Revenue Service in the circumstances described in this paragraph (c)(1), even if the taxpayer is not present, provided the individual presents satisfactory identification and proof of his or her authority to represent the taxpayer. The circumstances described in this paragraph (c)(1) are as follows:
>
> > (i) An individual may represent a member of his or her immediate family.
> >
> > (ii) A regular full-time employee of an individual employer may represent the employer
> >
> > (iii) A general partner or regular full-time employee of a partnership may represent the partnership
> >
> > (iv) A bona fide officer or a regular full-time employee of a corporation, association, or organized group may represent the corporation, association, or organized group
> >
> > (v) A regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate
> >
> > (vi) An officer or a regular employee of a governmental unit, agency, or authority may represent the governmental unit, agency, or authority in the course of his or her official duties.

(vii) An individual may represent any individual or entity, who is outside the United States, before personnel of the Internal Revenue Service when such representation takes place outside the United States.

(2) Limitations.

(i) An individual who is under suspension or disbarment from practice before the Internal Revenue Service may not engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section.

(ii) The Commissioner, or delegate, may, after notice and opportunity for a conference, deny eligibility to engage in limited practice before the Internal Revenue Service under paragraph (c)(1) of this section to any individual who has engaged in conduct that would justify a sanction under §10.50.

(iii) An individual who represents a taxpayer under the authority of paragraph (c)(1) of this section is subject, to the extent of his or her authority, to such rules of general applicability regarding standards of conduct and other matters as prescribed by the Internal Revenue Service.

(d) Special appearances. The Commissioner, or delegate, may, subject to conditions deemed appropriate, authorize an individual who is not otherwise eligible to practice before the Internal Revenue Service to represent another person in a particular matter.

(e) Fiduciaries. For purposes of this part, a fiduciary (for example, a trustee, receiver, guardian, personal representative, administrator, or executor) is considered to be the taxpayer and not a representative of the taxpayer.

(f) Effective/applicability date. This section is applicable beginning August 2, 2011.

Observation

None of the items above in (a)-(e) are considered to be practicing before the IRS.

Section 10.8 of Circular 230 discusses the application of Circular 230 on those that prepare tax returns and the application of the rules to other individuals as follows:

(a) Preparing all or substantially all of a tax return. Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund must have a preparer tax identification number. Except as otherwise prescribed in forms, instructions, or other appropriate guidance, an individual must be an attorney, certified public accountant, enrolled agent, or registered tax return preparer to obtain a preparer tax identification number. Any individual who for compensation prepares or assists with the preparation of all or substantially all of a tax return or claim for refund is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C.

(b) Preparing a tax return and furnishing information. Any individual may for compensation prepare or assist with the preparation of a tax return or claim for refund (provided the individual prepares less than substantially all of the tax return or claim for refund), appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Internal Revenue Service or any of its officers or employees.

(c) Application of rules to other individuals. Any individual who for compensation prepares, or assists in the preparation of, all or a substantial portion of a document pertaining to any taxpayer's tax liability for submission to the Internal Revenue Service is subject to the duties and restrictions relating to practice in subpart B, as well as subject to the sanctions for violation of the regulations in subpart C. Unless otherwise a practitioner, however, an individual may not for compensation prepare, or assist in the preparation of, all or substantially all of a tax return or claim for refund, or sign tax returns and claims for refund. For purposes of this paragraph, an individual described in 26 CFR 301.7701-15(f) is not treated as having prepared all or a substantial portion of the document by reason of such assistance.

(d) Effective/applicability date. This section is applicable beginning August 2, 2011.

A CPA who is practicing before the IRS and does not fall into one of the exception categories above is subject to subpart B of Circular 230 – Duties and Restrictions relating to practice before the IRS. It is reproduced below and should be read in its entirety.

C. CIRCULAR 230: SUBPART B -- DUTIES AND RESTRICTIONS RELATING TO PRACTICE BEFORE THE INTERNAL REVENUE SERVICE

Table of Contents (this subpart)

<u>**Section**</u>

10.29 Conflicting interests

10.30 Solicitation

10.31 Negotiation of taxpayer checks

10.32 Practice of law

10.33 Best practices for tax advisors

10.34 Standards with respect to tax returns and documents, affidavits, and other papers

10.35 Competence

10.36 Procedures to ensure compliance

10.37 Requirements for written advice

10.38 Establishment of advisory committees

SECTION 10.20 Information to be furnished.

(a) To the Internal Revenue Service.

(1) A practitioner must, on a proper and lawful request by a duly authorized officer or employee of the Internal Revenue Service, promptly submit records or information in any matter before the Internal Revenue Service unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

(2) Where the requested records or information are not in the possession of, or subject to the control of, the practitioner or the practitioner's client, the practitioner must promptly notify the requesting Internal Revenue Service officer or employee and the practitioner must provide any information that the practitioner has regarding the identity of any person who the practitioner believes may have possession or control of the requested records or information. The practitioner must make reasonable inquiry of his or her client regarding the identity of any person who may have possession or control of the requested records or information, but the practitioner is not required to make inquiry of any other person or independently verify any information provided by the practitioner's client regarding the identity of such persons.

Observation

The paragraph above should be read in light of the enacted accountant-client privilege.

Observation

Section 10.20 requires a practitioner to respond promptly to a proper and lawful request for records and information, unless the practitioner believes in good faith and on reasonable grounds that the records or information are privileged.

When a proper and lawful request is made by a duly authorized officer or employee of the Internal Revenue Service, concerning an inquiry into an alleged violation of the regulations in this part, a practitioner must provide any information the practitioner has concerning the alleged violation and testify regarding this information in any proceeding instituted under this part, unless the practitioner believes in good faith and on reasonable grounds that the information is privileged.

Observation

Sometimes referred to as "snitch laws," these provisions require the cooperation of those practicing before the IRS. Failure to cooperate could result in the loss of the right to practice before the IRS.

(b) Interference with a proper and lawful request for records or information.

A practitioner may not interfere, or attempt to interfere, with any proper and lawful effort by the Internal Revenue Service, its officers or employees, to obtain any record or information unless the practitioner believes in good faith and on reasonable grounds that the record or information is privileged.

SECTION 10.21 Knowledge of client's omission.

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance, error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Observation

When you sign a tax return as a paid preparer, your signature is based not only on what is presented in the return but any item that you have knowledge of.

SECTION 10.22 Diligence as to accuracy.

(a) In general.

A practitioner must exercise due diligence:

(1) In preparing or assisting in the preparation of, approving, and filing tax returns, documents, affidavits, and other papers relating to Internal Revenue Service matters;

(2) In determining the correctness of oral or written representations made by the practitioner to the Department of the Treasury; and

(3) In determining the correctness of oral or written representations made by the practitioner to clients with reference to any matter administered by the Internal Revenue Service.

(b) Reliance on others.

Except as modified in §§10.34 and 10.37, a practitioner will be presumed to have exercised due diligence for purposes of this section if the practitioner relies on the work product of another person and the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking proper account of the nature of the relationship between the practitioner and the person.

Practice Pointer: Professional Responsibility and the Report of Foreign Bank and Financial Accounts

Practitioners who prepare Form 1040 must inquire of their clients with sufficient detail to prepare correct responses for the two questions at the bottom of Schedule B. Penalties of up to $10,000 can apply for a simple failure to file the required forms.

(c) Effective/applicability date. Paragraph (a) of this section is applicable on September 26, 2007. Paragraph (b) of this section is applicable June 12, 2014.

SECTION 10.23 Prompt disposition of pending matters.

A practitioner may not unreasonably delay the prompt disposition of any matter before the Internal Revenue Service.

Example

Nash, CPA is representing a client under audit by the IRS. Nash believes all the factual matters of the audit could be resolved in 6-8 weeks. Nash learns that the auditor assigned to the audit is planning to retire in six months. Nash believes that if he could delay the audit by raising unreasonable objections until after the IRS agent retires, he could possibly get a better result from the new agent. Purposely delaying the conclusion of the audit until after the IRS agent retires would be a violation of Section 10.23.

Observation

The following two sections seek to ensure that all persons will be treated equally by the IRS and that none will receive preferential treatment.

SECTION 10.24 Assistance from disbarred or suspended persons and former Internal Revenue Service employees.

A practitioner may not, knowingly and directly or indirectly:

(a) Accept assistance from or assist any person who is under disbarment or suspension from practice before the Internal Revenue Service if the assistance relates to a matter or matters constituting practice before the Internal Revenue Service.

(b) Accept assistance from any former government employee where the provisions of §10.25 or any federal law would be violated.

SECTION 10.25 Practice by former Government employees, their partners and their associates.

(a) Definitions.

For purposes of this section:

(1) Assist means to act in such a way as to advise, furnish information to, or otherwise aid another person, directly or indirectly.

(2) Government employee is an officer or employee of the United States or any agency of the United States, including a special Government employee as defined in 18 U.S.C. 202(a), or of the District of Columbia, or of any State, or a member of Congress or of any State legislature.

(3) Member of a firm is a sole practitioner or an employee or associate thereof, or a partner, stockholder, associate, affiliate or employee of a partnership, joint venture, corporation, professional association or other affiliation of two or more practitioners who represent nongovernmental parties.

(4) Particular matter involving specific parties is defined at 5 CFR 2637.201(c), or superseding post-employment regulations issued by the U.S. Office of Government Ethics.

(5) Rule includes Treasury regulations, whether issued or under preparation for issuance as notices of proposed rulemaking or as Treasury decisions, revenue rulings, and revenue procedures published in the Internal Revenue Bulletin (see 26 CFR 601.601(d)(2)(ii)(b)).

(b) General rules

(1) No former Government employee may, subsequent to Government employment, represent anyone in any matter administered by the Internal Revenue Service if the representation would violate 18 U.S.C. 207 or any other laws of the United States.

(2) No former Government employee who personally and substantially participated in a particular matter involving specific parties may, subsequent to Government employment, represent or knowingly assist, in that particular matter, any person who is or was a specific party to that particular matter.

(3) A former Government employee who within a period of one year prior to the termination of Government employment had official responsibility for a particular matter involving specific parties may not, within two years after Government employment is ended, represent in that particular matter any person who is or was a specific party to that particular matter.

(4) No former Government employee may, within one year after Government employment is ended, communicate with or appear before, with the intent to influence, any employee of the Treasury Department in connection with the publication, withdrawal, amendment, modification, or interpretation of a rule the development of which the former Government employee participated in, or for which, within a period of one year prior to the termination of Government employment, the former government employee had official responsibility. This paragraph (b)(4) does not, however, preclude any former employee from appearing on one's own behalf or from representing a taxpayer before the Internal Revenue Service in connection with a particular matter involving specific parties involving the application or interpretation of a rule with respect to that particular matter, provided that the representation is otherwise consistent with the other provisions of this section and the former employee does not utilize or disclose any confidential information acquired by the former employee in the development of the rule.

(c) Firm representation.

(1) No member of a firm of which a former Government employee is a member may represent or knowingly assist a person who was or is a specific party in any particular matter with respect to which the restrictions of paragraph (b)(2) of this section apply to the former Government employee, in that particular matter, unless the firm isolates the former Government employee in such a way to ensure that the former Government employee cannot assist in the representation.

(2) When isolation of a former Government employee is required under paragraph (c)(1) of this section, a statement affirming the fact of such isolation must be executed under oath by the former Government employee and by another member of the firm acting on behalf of the firm. The statement must clearly identify the firm, the former Government employee, and the particular matter(s) requiring isolation. The statement must be retained by the firm and, upon request, provided to the office(s) of the Internal Revenue Service administering or enforcing this part.

(d) Pending representation. The provisions of this regulation will govern practice by former Government employees, their partners and associates with respect to representation in particular matters involving specific parties where actual representation commenced before the effective date of this regulation.

(e) Effective/applicability date. This section is applicable beginning August 2, 2011.

Observation

This section reflects changes to federal statutes governing post-employment restrictions applicable to former government employees.

Observation

The section above may impose obligations on the firms of former government employees that exceed the obligations of other practitioners.

SECTION 10.26 Notaries.

A practitioner may not take acknowledgments, administer oaths, certify papers, or perform any official act as a notary public with respect to any matter administered by the Internal Revenue Service and for which he or she is employed as counsel, attorney, or agent, or in which he or she may be in any way interested.

Observation

Obviously, a notary may not be a party to the transaction, benefit from the transaction, or have a conflict of interest.

SECTION 10.27 Fees.

(a) In general.

A practitioner may not charge an unconscionable fee in connection with any matter before the Internal Revenue Service

Observation

A practitioner may charge different rates depending upon the complexity of the issue.

(b) Contingent fees.

(1) Except as provided in paragraphs (b)(2), (3), and (4) of this section, a practitioner may not charge a contingent fee for services rendered in connection with any matter before the Internal Revenue Service.

(2) A practitioner may charge a contingent fee for services rendered in connection with the Service's examination of, or challenge to—

(i) An original tax return; or

(ii) An amended return or claim for refund or credit where the amended return or claim for refund or credit was filed within 120 days of the taxpayer receiving a written notice of the examination of, or a written challenge to the original tax return

Observation

Contrary to AICPA standards, a contingent fee may not be charged on an original return even when the practitioner reasonably anticipates that the return position will be substantively reviewed by the IRS prior to filing of the return.

(3) A practitioner may charge a contingent fee for services rendered in connection with a claim for credit or refund filed solely in connection with the determination of statutory interest or penalties assessed by the Internal Revenue Service.

(4) A practitioner may charge a contingent fee for services rendered in connection with any judicial proceeding arising under the Internal Revenue Code.

(c) Definitions. For purposes of this section—

(1) Contingent fee is any fee that is based, in whole or in part, on whether or not a position taken on a tax return or other filing avoids challenge by the Internal Revenue Service or is sustained either by the Internal Revenue Service or in litigation. A contingent fee includes a fee that is based on a percentage of the refund reported on a return, that is based on a percentage of the taxes saved, or that otherwise depends on the specific result attained. A contingent fee also includes any fee arrangement in which the practitioner will reimburse the client for all or a portion of the client's fee in the event that a position taken on a tax return or other filing is challenged by the Internal Revenue Service or is not sustained, whether pursuant to an indemnity agreement, a guarantee, rescission rights, or any other arrangement with a similar effect.

(2) Matter before the Internal Revenue Service includes tax planning and advice, preparing or filing or assisting in preparing or filing returns or claims for refund or credit, and all matters connected with a presentation to the Internal Revenue Service or any of its officers or employees relating to a taxpayer's rights, privileges, or liabilities under laws or regulations administered by the Internal Revenue Service. Such presentations include, but are not limited to, preparing and filing documents, corresponding and communicating with the Internal Revenue Service, rendering written advice with respect to any entity, transaction, plan or arrangement, and representing a client at conferences, hearings, and meetings.

(d) Effective/applicability date. This section is applicable for fee arrangements entered into after March 26, 2008.

SECTION 10.28 Return of client's records.

(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client's records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer's return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her federal tax obligations.

Observation

The records that must be returned are limited to those records necessary for the client to comply with his or her federal tax obligations. This rule does not apply to other records the practitioner may have.

(b) For purposes of this section – Records of the client include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner's representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner's firm, employees or agents if the practitioner is withholding such document pending the client's performance of its contractual obligation to pay fees with respect to such document.

Observation

A practitioner may withhold the client's current year completed tax return pending payment of fees.

AICPA and State Law Comparison

This section is more restrictive than AICPA rules. However, most state accountancy laws require the immediate return of all client records while the IRS rule pertains only to tax related records.

SECTION 10.29 Conflicting interests.

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

(1) The representation of one client will be directly adverse to another client; or

(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if:

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;

(2) The representation is not prohibited by law;

(3) Each affected client waives the conflict of interest and gives informed consent, confirmed in writing by each affected client, at the time the existence of the conflict of interest is known by the practitioner. The confirmation may be made within a reasonable period after the informed consent, but in no event later than 30 days.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(d) Effective/applicability date. This section is applicable on September 26, 2007.

Practice Pointer

Consents must be in writing and must be retained for at least 36 months after the conclusion of the engagement.

SECTION 10.30 Solicitation.

(a) Advertising and solicitation restrictions.

(1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim. Enrolled agents or enrolled retirement plan agents, in describing their professional designation, may not utilize the term of art "certified" or imply an employer/employee relationship with the Internal Revenue Service. Examples of acceptable descriptions for enrolled agents are "enrolled to represent taxpayers before the Internal Revenue Service," "enrolled to practice before the Internal Revenue Service," and "admitted to practice before the Internal Revenue Service." Similarly, examples of acceptable descriptions for enrolled retirement plan agents are "enrolled to represent taxpayers before the Internal Revenue Service as a retirement plan agent" and

"enrolled to practice before the Internal Revenue Service as a retirement plan agent." An example of an acceptance description for registered tax return preparers is "designated as a registered tax return preparer by the Internal Revenue Service."

Observation

Most Boards of Accountancy have similar laws banning false and misleading statements.

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) Fee information.

(1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information:

(A) Fixed fees for specific routine services.

(B) Hourly rates.

(C) Range of fees for particular services.

(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

Practice Pointer

When practitioners send their clients annual income tax organizers, it is appropriate to include an engagement letter. The engagement letter should specify the responsibilities of both the practitioner and client as well as the responsibility for fees and costs.

(2) A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.

(c) Communication of fee information.

Fee information may be communicated in professional lists, telephone directories, print media, mailings, electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.

Practice Pointer

Practitioners must keep a copy of all mailers for at least 36 months.

(d) Improper associations.

A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.

(e) Effective/applicability date. This section is applicable beginning August 2, 2011.

SECTION 10.31 Negotiation of taxpayer checks.

(a) A practitioner may not endorse or otherwise negotiate any check (including directing or accepting payment by any means, electronic or otherwise, into an account owned or controlled by the practitioner or any firm or other entity with whom the practitioner is associated) issued to a client by the government in respect of a Federal tax liability.

(b) Effective/applicability date. This section is applicable beginning June 12, 2014.

Observation

The prohibition on negotiating taxpayer refund checks applies to all persons representing the taxpayer, not just the tax return preparer. The rule was modified to include the current practice of direct deposit as opposed to only applying to the endorsement of a physical check.

Example 1

Bob and John own a used car dealership that advertises “No car over $6,000” and “We finance anyone.” One technique Bob and John have used for many years is to use a customer’s tax refund as the down payment or even the bulk of the payment on a car purchase and loan. Bob offers to prepare a customer’s tax return at no cost if the refund is used towards the purchase of a qualified car. Most of the returns Bob prepares claim a large earned income credit. In order to ensure payment for the car, Bob directs the customer’s refund to be sent via direct deposit to the dealership’s business checking account that John oversees.

Although, you can probably spot numerous potential ethical issues in this scenario, the updated rule on negotiating tax refund checks would prohibit the direct deposit of the client’s tax refund into the car dealer/tax preparer’s bank account.

Example 2

Bill is representing a client before the IRS for the audit of a prior year tax return. Bill did not prepare the original tax return. The audit results in a refund as the original return omitted a large tax credit. Bill wants to ensure that he gets paid for all the time representing the client. Under the old Section 10.31, Bill could have argued that the prohibition on endorsing refund checks did not apply to him since he did not prepare the original tax return. The revised rule clarifies that Bill may not negotiate the client’s refund check.

Practice Pointer

By completing Form 2848 “Power of Attorney and Declaration of Representative,” a taxpayer may authorize their representative to receive refund checks. However, even the power of attorney specifically forbids the representative from endorsing refund checks.

SECTION 10.32 Practice of law.

Nothing in the regulations in this part may be construed as authorizing persons not members of the bar to practice law.

SECTION 10.33 Best practices for tax advisors.

(a) Best practices. Tax advisors should provide clients with the highest quality representation concerning federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

(1) Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client's expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

(2) Establishing the facts, determining which facts are relevant, and evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

(3) Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

(4) Acting fairly and with integrity in practice before the Internal Revenue Service.

(b) Procedures to ensure best practices for tax advisors. Tax advisors with responsibility for overseeing a firm's practice of providing advice concerning federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.

(c) Applicability date. This section is effective after June 20, 2005.

SECTION 10.34 Standards with respect to tax returns and documents, affidavits and other papers.

(a) Tax returns.

(1) A practitioner may not willfully, recklessly, or through gross incompetence —

(i) Sign a tax return or claim for refund that the practitioner knows or reasonably should know contains a position that —

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in Section 6694(a)(2) of the Internal Revenue Code (Code) (including the related regulations and other published guidance); or

(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in Section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(ii) Advise a client to take a position on a tax return or claim for refund, or prepare a portion of a tax return or claim for refund containing a position, that—

(A) Lacks a reasonable basis;

(B) Is an unreasonable position as described in Section 6694(a)(2) of the Code (including the related regulations and other published guidance); or

(C) Is a willful attempt by the practitioner to understate the liability for tax or a reckless or intentional disregard of rules or regulations by the practitioner as described in Section 6694(b)(2) of the Code (including the related regulations and other published guidance).

(2) A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted willfully, recklessly, or through gross incompetence.

(b) Documents, affidavits and other papers

(1) A practitioner may not advise a client to take a position on a document, affidavit or other paper submitted to the Internal Revenue Service unless the position is not frivolous.

(2) A practitioner may not advise a client to submit a document, affidavit or other paper to the Internal Revenue Service

(i) The purpose of which is to delay or impede the administration of the federal tax laws;

(ii) That is frivolous; or

(iii) That contains or omits information in a manner that demonstrates an intentional disregard of a rule or regulation unless the practitioner also advises the client to submit a document that evidences a good faith challenge to the rule or regulation.

(c) Advising clients on potential penalties.

(1) A practitioner must inform a client of any penalties that are reasonably likely to apply to the client with respect to

(i) A position taken on a tax return if—

(A) The practitioner advised the client with respect to the position; or

(B) The practitioner prepared or signed the tax return; and

(ii) Any document, affidavit or other paper submitted to the Internal Revenue Service.

(2) The practitioner also must inform the client of any opportunity to avoid any such penalties by disclosure, if relevant, and of the requirements for adequate disclosure.

(3) This paragraph (c) applies even if the practitioner is not subject to a penalty under the Internal Revenue Code with respect to the position or with respect to the document, affidavit or other paper submitted.

(d) Relying on information furnished by clients. A practitioner advising a client to take a position on a tax return, document, affidavit or other paper submitted to the Internal Revenue Service, or preparing or signing a tax return as a preparer, generally may rely in good faith without verification upon information furnished by the client. The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete.

(e) Effective/applicability date. Paragraph (a) of this section is applicable for returns or claims for refund filed or advice provided beginning August 2, 2011. Paragraphs (b) through (d) of this section are applicable to tax returns, documents, affidavits and other papers filed on or after September 26, 2007.

SECTION 10.35 Competence.

(a) A practitioner must possess the necessary competence to engage in practice before the Internal Revenue Service. Competent practice requires the appropriate level of knowledge, skill, thoroughness, and preparation necessary for the matter for which the practitioner is engaged. A practitioner may become competent for the matter for which the practitioner has been engaged through various methods, such as consulting with experts in the relevant area or studying the relevant law.

(b) Effective/applicability date. This section is applicable beginning June 12, 2014.

Observation

Whether consultation and/or research are adequate to make a practitioner competent in a particular situation depends on the facts and circumstances of the particular situation. Although not binding on the IRS, the IRS has stated that the AICPA competency standard is generally informative on the standard of competency expected of practitioners under Circular 230.

SECTION 10.36 Procedures to ensure compliance.

(a) Any individual subject to the provisions of this part who has (or individuals who have or share) principal authority and responsibility for overseeing a firm's practice governed by this part, including the provision of advice concerning Federal tax matters and preparation of tax returns, claims for refund, or other documents for submission to the Internal Revenue Service, must take reasonable steps to ensure that the firm has adequate procedures in effect for all members, associates, and employees for purposes of complying with subparts A, B, and C of this part, as applicable. In the absence of a person or persons identified by the firm as having the principal authority and responsibility described in this paragraph, the Internal Revenue Service may identify one or more individuals subject to the provisions of this part responsible for compliance with the requirements of this section.

(b) Any such individual who has (or such individuals who have or share) principal authority as described in paragraph (a) of this section will be subject to discipline for failing to comply with the requirements of this section if--

> (1) The individual through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with this part, as applicable, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with this part, as applicable;
>
> (2) The individual through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that firm procedures in effect are properly followed, and one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, of failing to comply with this part, as applicable; or
>
> (3) The individual knows or should know that one or more individuals who are members of, associated with, or employed by, the firm are, or have, engaged in a pattern or practice, in connection with their practice with the firm, that does not comply with this part, as applicable, and the individual, through willfulness, recklessness, or gross incompetence fails to take prompt action to correct the noncompliance.

(c) Effective/applicability date. This section is applicable beginning June 12, 2014.

Observation

This provision is important for a number of reasons. First, it places the first layer of responsibility on the firm as part of a “self-regulatory” environment. Second, it puts certain individuals on notice that they could be subject to individual disciplinary actions based on the actions of others in the firm. The individual will be responsible to ensure:

1. The firm has procedures in place to ensure compliance with Circular 230;
2. The firm follows the requisite procedures; and
3. Individuals in the firm do not engage in a pattern and practice of disregarding the provisions of Circular 230.

In essence, the IRS is making certain individuals at the firm into enforcers.

SECTION 10.37 Requirements for written advice.

(a) Requirements. (1) A practitioner may give written advice (including by means of electronic communication) concerning one or more Federal tax matters subject to the requirements in paragraph (a)(2) of this section. Government submissions on matters of general policy are not considered written advice on a Federal tax matter for purposes of this section. Continuing education presentations provided to an audience solely for the purpose of enhancing practitioners’ professional knowledge on Federal tax matters are not considered written advice on a Federal tax matter for purposes of this section. The preceding sentence does not apply to presentations marketing or promoting transactions.

(2) The practitioner must--

(i) Base the written advice on reasonable factual and legal assumptions (including assumptions as to future events);

(ii) Reasonably consider all relevant facts and circumstances that the practitioner knows or reasonably should know;

(iii) Use reasonable efforts to identify and ascertain the facts relevant to written advice on each Federal tax matter;

(iv) Not rely upon representations, statements, findings, or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance on them would be unreasonable;

(v) Relate applicable law and authorities to facts; and

(vi) Not, in evaluating a Federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit.

(3) Reliance on representations, statements, findings, or agreements is unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based are incorrect, incomplete, or inconsistent.

(b) Reliance on advice of others. A practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances. Reliance is not reasonable when--

(1) The practitioner knows or reasonably should know that the opinion of the other person should not be relied on;

(2) The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or

(3) The practitioner knows or reasonably should know that the other person has a conflict of interest in violation of the rules described in this part.

(c) Standard of review. (1) In evaluating whether a practitioner giving written advice concerning one or more Federal tax matters complied with the requirements of this section, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, including, but not limited to, the scope of the engagement and the type and specificity of the advice sought by the client.

(2) In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) in promoting, marketing, or recommending to one or more taxpayers a partnership or other entity, investment plan or arrangement a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code, the Commissioner, or delegate, will apply a reasonable practitioner standard, considering all facts and circumstances, with emphasis given to the additional risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances, when determining whether a practitioner has failed to comply with this section.

(d) Federal tax matter. A Federal tax matter, as used in this section, is any matter concerning the application or interpretation of---

(1) A revenue provision as defined in Section 6110(i)(1)(B) of the Internal Revenue Code;

(2) Any provision of law impacting a person's obligations under the internal revenue laws and regulations, including but not limited to the person's liability to pay tax or obligation to file returns; or

(3) Any other law or regulation administered by the Internal Revenue Service.

(e) Effective/applicability date. This section is applicable to written advice rendered after June 12, 2014.

Observations

#1 - The new rule relies on much more of a "facts and circumstances" approach.

#2 - The new rule no longer requires written advice to describe any particular piece of information or analysis. However, the IRS encourages practitioners to describe all relevant facts, law, analysis, and assumptions in appropriate circumstances. The determination of whether a practitioner complied with this rule will be based on all facts and circumstances, including whether it was appropriate to describe all relevant facts, law, analysis, and assumptions in a piece of written tax advice.

Goodbye Circular 230 Disclaimers

Many practitioners currently use a Circular 230 disclaimer at the conclusion of every email to remove the communication from the covered opinion rules in former §10.35. This disclaimer was included whether or not the email contained any tax advice. The removal of former §10.35 eliminates the detailed provisions concerning covered opinions and disclosures in written opinions. Because the new §10.37 does not include a disclosure provision, the Circular 230 disclaimer is simply not needed.

SECTION 10.38 Establishment of Advisory Committees.

(a) Advisory committees.

To promote and maintain the public's confidence in tax advisors, the Internal Revenue Service is authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. Membership of an advisory committee must be balanced among those who practice as attorneys, accountants, enrolled agents, enrolled actuaries, enrolled retirement plan agents, and registered tax return preparers. Under procedures prescribed by the Internal Revenue Service, an advisory committee may review and make general recommendations regarding the practices, procedures, and policies of the offices described in §10.1.

(b) Effective date.

This section is applicable beginning August 2, 2011.

D. CIRCULAR 230: SUBPART C – SANCTIONS FOR VIOLATION OF THE REGULATIONS

Table of Contents (this subpart)

10.52 Violations subject to sanction

10.53 Receipt of information concerning practitioner

SECTION 10.50 Sanctions.

(a) Authority to censure, suspend, or disbar.

The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may censure, suspend or disbar any practitioner from practice before the Internal Revenue Service if the practitioner is shown to be incompetent or disreputable (within the meaning of Sec. 10.51), fails to comply with any regulation in this part (under the prohibited conduct standards of Sec. 10.52), or with intent to defraud, willfully and knowingly misleads or threatens a client or prospective client. Censure is a public reprimand.

Observation

The new regulations add "censure" as a possible sanction.

(b) Authority to disqualify.

The Secretary of the Treasury, or delegate, after due notice and opportunity for hearing, may disqualify any appraiser for a violation of these rules as applicable to appraisers.

(1) If any appraiser is disqualified pursuant to this subpart C, the appraiser is barred from presenting evidence or testimony in any administrative proceeding before the Department of Treasury or the Internal Revenue Service, unless and until authorized to do so by the Internal Revenue Service pursuant to §10.81, regardless of whether the evidence or testimony would pertain to an appraisal made prior to or after the effective date of disqualification.

(2) Any appraisal made by a disqualified appraiser after the effective date of disqualification will not have any probative effect in any administrative proceeding before the Department of the Treasury or the Internal Revenue Service. An appraisal otherwise barred from admission into evidence pursuant to this section may be admitted into evidence solely for the purpose of determining the taxpayer's reliance in good faith on such appraisal.

(c) Authority to impose monetary penalty

(1) In general

(i) The Secretary of the Treasury, or delegate, after notice and an opportunity for a proceeding, may impose a monetary penalty on any practitioner who engages in conduct subject to sanction under paragraph (a) of this section.

(ii) If the practitioner described in paragraph (c)(1)(i) of this section was acting on behalf of an employer or any firm or other entity in connection with the conduct giving rise to the penalty, the Secretary of the Treasury, or delegate, may impose a monetary penalty on the employer, firm, or entity if it knew, or reasonably should have known, of such conduct.

(2) Amount of penalty. The amount of the penalty shall not exceed the gross income derived (or to be derived) from the conduct giving rise to the penalty.

(3) Coordination with other sanctions. Subject to paragraph (c)(2) of this section

(i) Any monetary penalty imposed on a practitioner under this paragraph (c) may be in addition to or in lieu of any suspension, disbarment or censure and may be in addition to a penalty imposed on an employer, firm or other entity under paragraph (c)(1)(ii) of this section.

(ii) Any monetary penalty imposed on an employer, firm or other entity may be in addition to or in lieu of penalties imposed under paragraph (c)(1)(i) of this section.

(d) Authority to accept a practitioner's consent to sanction. The Internal Revenue Service may accept a practitioner's office of consent to be sanctioned under §10.50 in lieu of instituting or continuing a proceeding under §10.60(a).

(e) Sanctions to be imposed. The sanctions imposed by this section shall take into account all relevant facts and circumstances.

(f) Effective/applicability date. This section is applicable to conduct occurring on or after August 2, 2011, except that paragraphs (a), (b)(2), and (e) apply to conduct occurring on or after September 26, 2007, and paragraph (c) applies to prohibited conduct that occurs after October 22, 2004.

SECTION 10.51 Incompetence and disreputable conduct.

(a) Incompetence and disreputable conduct. Incompetence and disreputable conduct for which a practitioner may be sanctioned under §10.50 includes, but is not limited to--

(1) Conviction of any criminal offense under the Federal tax laws.

(2) Conviction of any criminal offense involving dishonesty or breach of trust.

(3) Conviction of any felony under Federal or State law for which the conduct involved renders the practitioner unfit to practice before the Internal Revenue Service.

(4) Giving false or misleading information, or participating in any way in the giving of false or misleading information to the Department of the Treasury or any officer or employee thereof, or to any tribunal authorized to pass upon Federal tax matters, in connection with any matter pending or likely to be pending before them, knowing the information to be false or misleading. Facts or other matters contained in testimony, Federal tax

returns, financial statements, applications for enrollment, affidavits, declarations, and any other document or statement, written or oral, are included in the term "information."

(5) Solicitation of employment as prohibited under §10.30, the use of false or misleading representations with intent to deceive a client or prospective client in order to procure employment, or intimating that the practitioner is able improperly to obtain special consideration or action from the Internal Revenue Service or any officer or employee thereof.

(6) Willfully failing to make a Federal tax return in violation of the Federal tax laws, or willfully evading, attempting to evade, or participating in any way in evading or attempting to evade any assessment or payment of any Federal tax.

(7) Willfully assisting, counseling, encouraging a client or prospective client in violating, or suggesting to a client or prospective client to violate, any Federal tax law, or knowingly counseling or suggesting to a client or prospective client an illegal plan to evade Federal taxes or payment thereof.

(8) Misappropriation of, or failure properly or promptly to remit, funds received from a client for the purpose of payment of taxes or other obligations due the United States.

(9) Directly or indirectly attempting to influence, or offering or agreeing to attempt to influence, the official action of any officer or employee of the Internal Revenue Service by the use of threats, false accusations, duress or coercion, by the offer of any special inducement or promise of an advantage, or by the bestowing of any gift, favor or thing of value.

(10) Disbarment or suspension from practice as an attorney, certified public accountant, public accountant or actuary by any duly constituted authority of any State, territory, or possession of the United States, including a Commonwealth, or the District of Columbia, any Federal court of record or any Federal agency, body or board.

(11) Knowingly aiding and abetting another person to practice before the Internal Revenue Service during a period of suspension, disbarment or ineligibility of such other person.

(12) Contemptuous conduct in connection with practice before the Internal Revenue Service, including the use of abusive language, making false accusations or statements, knowing them to be false or circulating or publishing malicious or libelous matter.

(13) Giving a false opinion, knowingly, recklessly, or through gross incompetence, including an opinion which is intentionally or recklessly misleading, or engaging in a pattern of providing incompetent opinions on questions arising under the Federal tax laws. False opinions described in this paragraph (a)(13) include those which reflect or result from a knowing misstatement of fact or law, from an assertion of a position known to be unwarranted under existing law, from counseling or assisting in conduct known

to be illegal or fraudulent, from concealing matters required by law to be revealed, or from consciously disregarding information indicating that material facts expressed in the opinion or offering material are false or misleading. For purposes of this paragraph (a)(13), reckless conduct is a highly unreasonable omission or misrepresentation involving an extreme departure from the standards of ordinary care that a practitioner should observe under the circumstances. A pattern of conduct is a factor that will be taken into account in determining whether a practitioner acted knowingly, recklessly, or through gross incompetence. Gross incompetence includes conduct that reflects gross indifference, preparation which is grossly inadequate under the circumstances, and a consistent failure to perform obligations to the client.

(14) Willfully failing to sign a tax return prepared by the practitioner when the practitioner's signature is required by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.

(15) Willfully disclosing or otherwise using a tax return or tax return information in a manner not authorized by the Internal Revenue Code, contrary to the order of a court of competent jurisdiction, or contrary to the order of an administrative law judge in a proceeding instituted under §10.60.

(16) Willfully failing to file on magnetic or other electronic media a tax return prepared by the practitioner when the practitioner is required to do so by the Federal tax laws unless the failure is due to reasonable cause and not due to willful neglect.

(17) Willfully preparing all or substantially all of, or signing, a tax return or claim for refund when the practitioner does not possess a current or otherwise valid preparer tax identification number or other prescribed identifying number.

(18) Willfully representing a taxpayer before an officer or employee of the Internal Revenue Service unless the practitioner is authorized to do so pursuant to this part.

(b) Effective/applicability date. This section is applicable beginning August 2, 2011.

DISREPUTABLE CONDUCT

The following are actual examples of disreputable conduct taken from IRS disciplinary cases:

- Failure to file a U.S. individual income tax return for the tax years 2001 through 2006.
- Preparing 2013 tax returns without a Preparer Tax Identification Number (PTIN).
- Failure to respond to a June 27, 2012 Request for Information.
- Respondent used a contingent fee structure based upon the expected income tax refunds for client returns prepared using the Form 2555 Position.

- Respondent charged unconscionable fees for preparation of tax returns using the Form 2555 Position.
- Respondent represented as facts to IRS Criminal Agents items that he knew to be false.
- Respondent threatened lawsuits for damages, and lawsuits against IRS employees, personally, for unauthorized collection actions that Respondent alleged would be avoided if the IRS accepted the taxpayer's settlement offer to pay 20% of the assessed tax.
- Respondent signed, and submitted to the IRS, a Power of Attorney ("Form 2848") for taxpayer clients that listed both the Respondent and an unenrolled individual as the two representatives.
- Respondent obstructed the IRS examination and collection activities for clients whose returns were prepared with the Form 2555 Position.
- Respondent sold and implemented a number of tax shelters and executed a number of tax opinion letters on behalf of respondent's firm, which contributed to the failure of providing the respondent's clients with competent tax guidance.
- Between 2002 and 2009, respondent committed 5 counts of bank fraud and 3 counts of mail fraud for over $2 million.

Case Study: Disreputable Conduct

While employed by CPA firm, CPA prepared 17 income tax returns for clients who were not clients of the CPA firm. CPA used the employer's tax return preparation software and computer equipment to prepare these tax returns. CPA did not remove the employer's name from the paid preparer section of the tax returns prior to issuing these tax returns to clients. CPA billed the clients using invoices with CPA's name only and kept the fees received for these services.

CPA believed that these clients knew the CPA firm was not responsible for the tax returns even though the employer's name was displayed in the paid preparer section of the tax return.

Practice Pointer: Revised Regulations on Releasing Taxpayer Information

In 2008, the IRS released revised regulations concerning taxpayer privacy and the release of taxpayer information with an effective date of January 1, 2009. In 2013, Revenue Procedure 2013-14 was released, supplementing the regulations and providing additional guidance to tax return preparers regarding the form and content of taxpayer consents to disclose and consents to use tax return information, effective as of January 14, 2013. The effective date was extended to January 1, 2014 by Revenue Procedure 2013-19.

In general terms, a taxpayer's consent to each separate disclosure or separate use of tax return information must be contained on a separate written document, which can be furnished on paper or electronically. The consent may be included as an attachment to an engagement letter.

SECTION 10.52 Violation subject to sanction.

(a) A practitioner may be sanctioned under Sec. 10.50 if the practitioner

(1) Willfully violates any of the regulations (other than §10.33) contained in this part; or

(2) Recklessly or through gross incompetence (within the meaning of §10.51(a)(13)) violates §§10.34, 10.35, 10.36 or 10.37.

(b) Effective/applicability date. This section is applicable to conduct occurring on or after September 26, 2007.

SECTION 10.53 Receipt of information concerning practitioner.

(a) Officer or employee of the Internal Revenue Service.

If an officer or employee of the Internal Revenue Service has reason to believe that a practitioner has violated any provision of this part, the officer or employee will promptly make a written report of the suspected violation. The report will explain the facts and reasons upon which the officer's or employee's belief rests, and must be submitted to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part.

Practice Pointer

Be very careful what you say and do when meeting with IRS personnel. As detailed above, IRS employees are required to report any violation by a practitioner.

(b) Other persons.

Any person other than an officer or employee of the Internal Revenue Service having information of a violation of any provision of this part may make an oral or written report of the alleged violation to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part or any officer or employee of the Internal Revenue Service. If the report is made to an officer or employee of the Internal Revenue Service, the officer or employee will make a written report of the suspected violation, and submit the report to the office(s) of the Internal Revenue Service responsible for administering or enforcing this part.

(c) Destruction of report.

No report made under paragraph (a) or (b) of this section shall be maintained unless retention of such record is permissible under the applicable records control schedule as approved by the National Archives and Records Administration and designated in the Internal Revenue Manual. Reports must be destroyed as soon as permissible under the applicable records control schedule.

(d) Effect on proceedings under subpart D.

The destruction of any report will not bar any proceeding under subpart D of this part, but precludes the Director of the Office of Professional Responsibility's use of a copy of such report in a proceeding under subpart D of this part.

(e) Effective/applicability date. This section is applicable beginning August 2, 2011.

RECENT CHANGES TO CIRCULAR 230

On June 12, 2014 the following changes to Circular 230 became effective:

- The complex rule governing "Covered Opinions" under §10.35 has been eliminated, while the rule on written opinions under §10.37 has been expanded.
- Under §10.36, an individual with principal authority for overseeing a firm's federal tax practice must take reasonable steps to ensure that the firm has adequate procedures in place to comply with Circular 230.
- Practitioners must exercise competence when representing persons before the IRS. Competence may be obtained in a number of ways.
- The rule on the expedited suspension of a practitioner's IRS practice rights has been expanded to include the failure of a practitioner to file a return in four of the previous five years.
- The prohibition on practitioners negotiating taxpayer refund checks is expanded to include electronic payments, including the direct deposit of tax refunds into a practitioner's account.
- The Office of Professional Responsibility has exclusive responsibility with the IRS for matters related to practitioner discipline.

THE TAXPAYER BILL OF RIGHTS

For some time now, some members of Congress have been advocating for a Taxpayer Bill of Rights. Although Congress has not acted on this matter, the IRS has. In 2014, the IRS took administrative action to issue a Taxpayer Bill of Rights. While impressive looking on its face, the new Bill of Rights is simply a restatement of previously existing rights into a single document. The IRS has issued Publication 1 that is summarized as follows.

- The right to be informed.
- The right to quality service.
- The right to pay no more than the correct amount of tax.
- The right to challenge the IRS's position and be heard.
- The right to appeal an IRS decision in an independent forum.
- The right to finality.
- The right to privacy.
- The right to confidentiality.
- The right to retain representation.
- The right to a fair and just tax system.

Although, these rights are not new, they merit attention here since taxpayers may perceive them as new rights.

CHAPTER 3: TEST YOUR KNOWLEDGE

The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). They are included as an additional tool to enhance your learning experience and do not need to be submitted in order to receive CPE credit.

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is correct regarding ethical guidance and the tax professional:**

   A. the tax practice field has significantly more ethical guidance than that of attest engagements

   B. taxpayers may not arrange one's affairs to pay the lowest tax legally available

   C. CPAs in tax practice do not have any specific guidance that governs their tax practice

   D. tax preparers have registration requirements

2. **Bob Jones, Inc. is a new small business client that has asked you to prepare its current year tax return. Upon interviewing the client, you determine that the client has not filed several prior year tax returns. According to Circular 230, what should you do:**

   A. notify the IRS of this failure

   B. advise the client promptly of the fact of noncompliance and notify the IRS if the client refuses to file

   C. advise the client promptly of the fact of noncompliance

   D. ignore the fact of non-filing provided the current year return is filed timely

3. **Which of the following is true regarding when a contingent fee is permitted by the IRS:**

   A. contingent fees are permitted as long as AICPA standards are followed

   B. contingent fees are allowed on original tax returns

   C. contingent fees are allowed when representing a client under audit

   D. contingent fees are never allowed

4.	**According to Circular 230, Section 10.36, which of the following is correct regarding procedures to ensure compliance:** **A.** it places the first layer of responsibility on the individual as part of a "self-regulatory" environment **B.** it makes an individual of a firm into an enforcer of Circular 230 **C.** it provides that only firms, and not individuals of a firm, can be subject to disciplinary action for failing to comply with Circular 230 **D.** the provision is ineffective

CHAPTER 3: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The opposite is true. The CPA in an attest engagement is ultimately responsible to the users of the client financial statements as well as to the client. In a tax engagement, the CPA is an "advocate of the taxpayer." **B.** Incorrect. The courts have held that there is nothing illegal or sinister in a taxpayer arranging one's affairs so as to pay the lowest tax legally available. **C.** Incorrect. CPAs in tax practice have two sets of ethical and legal guidance which govern their tax practice: (1) IRS Circular 230, and (2) AICPA Statements on Standards for Tax Services. **D.** CORRECT. All paid tax return preparers are required to have a Preparer Tax Identification Number (PTIN) as of January 1, 2011. *(See page 45 of the course material.)*
2.	**A.** Incorrect. Practitioners have no obligation to notify the IRS. **B.** Incorrect. Practitioners are prohibited from notifying the IRS even if the client refuses to take corrective action. **C.** CORRECT. A practitioner must notify the client of the noncompliance. **D.** Incorrect. A practitioner may not ignore the noncompliance. *(See page 50 of the course material.)*
3.	**A.** Incorrect. The AICPA and IRS have vastly different rules relating to contingent fees. CPAs will generally be bound by more than one set of rules and must adhere to the strictest rule that applies to any given situation. **B.** Incorrect. Contingent fees for preparing original tax returns are never permitted by the IRS. **C.** CORRECT. When representing a client under audit, there is little incentive for the practitioner to misstate income and play the "audit lottery." **D.** Incorrect. The IRS prohibits contingent fees on original tax returns and most amended returns while permitting contingent fee arrangements in many other situations. *(See pages 55 to 56 of the course material.)*

4.	**A.** Incorrect. Section 10.36 places the first layer of responsibility on the firm, not the individual, as part of a "self-regulatory" environment. **B.** CORRECT. An individual of a firm is responsible to ensure the firm has procedures in place to ensure compliance with Circular 230, the firm follows the requisite procedures, and individuals in the firm do not engage in a pattern and practice of disregarding the provisions of Circular 230. **C.** Incorrect. The provision puts certain individuals on notice that they could be subject to individual disciplinary actions based on the action of others in the firm. **D.** Incorrect. The provision became effective on June 12, 2014. *(See pages 65 to 66 of the course material.)*

CHAPTER 4: ETHICS FOR INDUSTRY CPAS

Chapter Objectives

After completing this chapter, you should be able to:

- Recognize AICPA guidance for Management Accountants.
- Identify ethical guidance promulgated by the Institute of Management Accountants (IMA).
- Recognize the similarities and differences of the guidance issued by the IMA and the AICPA.

I. INTRODUCTION

Although many CPAs begin their careers in public practice, many soon migrate to positions in industry. Many will join the Institute of Management Accountants (IMA). Some of those who join the IMA will also get the Certified Management Accountant (CMA) designation. Many will retain their membership in the AICPA. Both the AICPA and IMA are voluntary member organizations – only members are required to follow their respective ethical guidelines. However, these guidelines were designed in furtherance of the CPA's role as trusted business advisers. Accordingly, these guidelines should be followed by members and non-members alike.

II. NEW CODIFIED CODE OF PROFESSIONAL CONDUCT EFFECTIVE 12/15/14

The AICPA has codified the Code of Professional Conduct to be more logical and user friendly. The code, rules, interpretations and rulings are essentially the same, but they have been grouped into functional areas based on the member's area of practice plus a preface that is applicable to all members. (Note: Throughout the AICPA Code of Professional Conduct you will see the term "Member." This term relates to you, the CPA, whether or not you are a member of the AICPA.) The three functional areas are:

Part 1: Members in Public Practice

Part 2: Members in Business

Part 3: Other Members (retired, unemployed, etc.)

The part number is followed by two sets of three digit numbers to identify the topic and, when applicable, the subtopic. For example, 1.100.001 relates to Part 1 (Members in Public Practice); Topic 100 (Integrity and Objectivity); and Subtopic 001 (the Integrity and Objectivity rule).

By grouping all of the guidance for a particular type of member in one place, the CPA will save much time in researching a situation as well as (hopefully) reach a more accurate conclusion. However, bear in mind that a member may be covered by more than one category. For example, one could work full time for an employer in industry and work part time during busy season preparing tax returns.

This course will focus on Part 2 of the Code of Professional Conduct: Members in Business. Below is a listing of the topics covered in Part 2, followed by a discussion of each topic and selected corresponding interpretations, rulings, and other guidance by topic.

- 2.0 Conceptual Framework for Members in Business
- 2.100 Integrity and Objectivity
- 2.300 General Standards
- 2.400 Acts Discreditable

Throughout this course, we will attempt to use the actual AICPA code section references whenever possible. This will allow you to conduct further research on topics of interest to you. However, the source material is very voluminous, and in many instances, we have omitted entire sections of the Code. In other instances, we have greatly summarized the material – sometimes condensing several pages of material into a few bullet points or a single paragraph. We believe this approach is both appropriate and beneficial for the CPA seeking an overview or refresher course.

Part 2

Members in Business

2.000 Introduction

.01 Part 2 of the Code of Professional Conduct (the code) applies to members in business. Accordingly, when the term member is used in part 2 of the code, the requirements apply only to members in business. When a member in business is also a member in public practice (for example, a member has a part-time tax practice), the member should also consult part 1 of the code, which applies to members in public practice.

2.000.010 Conceptual Framework for Members in Business

Introduction

.01 Members may encounter various relationships or circumstances that create threats to the member's compliance with the rules. The rules and interpretations seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to the member's compliance with the rules that is not at an acceptable level. When making that evaluation, the member should apply the conceptual framework approach as outlined in this interpretation.

.02 The code specifies that in some circumstances, no safeguards can reduce a threat to an acceptable level. For example, the code specifies that a member may not subordinate the member's professional judgment to others without violating the "Integrity and Objectivity Rule" [2.100.001].

Conceptual Framework Approach

.06 Under the conceptual framework approach, members should identify threats to compliance with the rules and evaluate the significance of those threats. Members should evaluate identified threats both individually and in the aggregate because threats can have a cumulative effect on a member's compliance with the rules.

2.000.020 Ethical Conflicts

.01 An ethical conflict arises when a member encounters one or both of the following:

a) Obstacles to following an appropriate course of action due to internal or external pressures

b) Conflicts in applying relevant professional and legal standards.

For example, a member suspects a fraud may have occurred, but reporting the suspected fraud would violate the member's responsibility to maintain the confidentiality of his or her employer's confidential information.

.02 Once an ethical conflict is encountered, a member may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the member should consider factors such as the following:

a) Relevant facts and circumstances, including applicable rules, laws, or regulations

b) Ethical issues involved

c) Established internal procedures

2.100 Integrity and Objectivity

2.100.001 Integrity and Objectivity Rule

.01 In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

2.110 Conflicts of Interest

2.110.010 Conflicts of Interest

.01 In performing a professional service for an employer, a conflict of interest may occur if a member or the member's employer has a relationship with another person, entity, product, or service that, in the member's professional judgment, the employer or other appropriate parties may view as impairing the member's objectivity. In such situations, adverse interest or self-interest threats to the member's compliance with the "Integrity and Objectivity Rule" [2.100.001] may exist.

.02 A member should evaluate the significance of the threats to determine if they are at an acceptable level. If, after evaluating the threats, the member determines that the threats are so significant that no safeguards could eliminate or reduce the threats to an acceptable level, therefore impairing the member's objectivity, the member should either not perform the professional service or terminate one or more of the relationships that are causing the conflict.

2.120.010 Offering or Accepting Gifts or Entertainment

.01 For purposes of this interpretation, a customer or vendor of the member's employer includes a representative of the customer or vendor.

.02 When a member offers to, or accepts gifts or entertainment from, a customer or vendor of the member's employer, self-interest, familiarity, or undue influence threats to the member's compliance with the "Integrity and Objectivity Rule" [2.100.001] may exist.

.03 Threats to compliance with the "Integrity and Objectivity Rule" [2.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and the member would be presumed to lack integrity in violation of the "Integrity and Objectivity Rule" in the following circumstances:

a) The member offers to, or accepts gifts or entertainment from, a customer or vendor of the member's employer that violate applicable laws, rules, or regulations or the policies of the member's employer or the customer or vendor.

b) The member knows of the violation or demonstrates recklessness in not knowing.

.04 A member should evaluate the significance of any threats to determine if they are at an acceptable level. Threats are at an acceptable level when gifts or entertainment are reasonable in the circumstances. The member should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. The following are examples of relevant facts and circumstances:

a) The nature of the gift or entertainment

b) The occasion giving rise to the gift or entertainment

c) The cost or value of the gift or entertainment

d) The nature, frequency, and value of other gifts and entertainment offered or accepted

e) Whether the entertainment was associated with the active conduct of business directly before, during, or after the entertainment

f) Whether other customers or vendors also participated in the entertainment

g) The individuals from the customer or vendor and a member's employer who participated in the entertainment

2.130 Preparing and Reporting Information

2.130.010 Knowing Misrepresentations in the Preparation of Financial Statements or Records

.01 Threats to compliance with the “Integrity and Objectivity Rule” [2.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards, and the member would be considered to have knowingly misrepresented facts in violation of the “Integrity and Objectivity Rule,” if the member

a) makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records;

b) fails to correct an entity’s financial statements or records that are materially false and misleading when the member has the authority to record the entries; or

c) signs, or permits or directs another to sign, a document containing materially false and misleading information.

2.130.020 Subordination of Judgment

.01 The “Integrity and Objectivity Rule” [2.100.001] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services for an employer or on a volunteer basis. This interpretation addresses differences of opinion between a member and his or her supervisor or any other person within the member’s organization.

.02 Self-interest, familiarity, and undue influence threats to the member’s compliance with the “Integrity and Objectivity Rule” [2.100.001] may exist when a member and his or her supervisor or any other person within the member’s organization have a difference of opinion relating to the application of accounting principles; auditing standards; or other relevant professional standards, including standards applicable to tax and consulting services or applicable laws or regulations.

.03 A member should evaluate the significance of any threats to determine if they are at an acceptable level. Threats are at an acceptable level if the member concludes that the position taken does not result in a material misrepresentation of fact or a violation of applicable laws or regulations. If threats are not at an acceptable level, the member should apply the safeguards in paragraphs .05–.07 to eliminate or reduce the threat(s) to an acceptable level so that the member does not subordinate his or her judgment.

Question and Answer

Q: Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended September 30, 200X, Steffen proposes to reduce obsolete inventory to net realizable value. The obsolete items represent a significant amount of total inventory. The CFO concurs with Steffen's position. However, he decides not to go against the CEO whose position is that reducing the inventory this quarter is a discretionary decision and the CEO would prefer to record any such reduction at year end, after Company X completes its anticipated public offering of stock later this year. What are the ethical obligations of Steffen's in this situation?

A: To avoid subordinating her judgment, Steffen should first determine whether the inventory writedown is material. If so, she should restate her concerns to the CFO and CEO and, if the latter persists in not supporting the writedown, Steffen should bring the matter to the attention of the audit committee of the board of directors. She should document the understanding of the facts, the accounting principles involved, the application of the principles to the facts, and the parties with whom discussions were held. Steffen should consider any responsibility that may exist to go outside the company, although legal counsel should be sought on this matter.

Case Study: Unexplained Prosperity

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Henry Monterrey, a CPA employed as part-time controller by a small public accounting firm, prepared the financial statements and related tax returns during the first four years of operation for Thick-N-Chewy, Inc. This closely held company owns a chain of three candy stores located throughout the city. Aggregate annual revenues are 65 percent from delivery sales and 35 percent from in-store sales. Revenues increased by 12 percent in year two and 9 percent in year three. While preparing the annual statements and tax return for the current year, Monterrey noticed revenues were up 34 percent while costs of goods sold increased only 5 percent over the previous year. Taking note of this large increase, Monterrey began to investigate possible causes.

The CPA recalculated his original computations and found them to be correct. He then reviewed invoices for the goods purchased, thinking the cost of goods purchased could have decreased on a per-unit basis, thus explaining the disproportionate increase in revenues and cost of goods sold. He knew that he would need to check any changes in volume and price as well. Monterrey, believing he needed an answer to his question before he could publish the financial statements and sign the tax return, called a meeting to discuss the issue with the three brothers who worked as store managers and who were also majority shareholders.

After showing the brothers his unusual findings and inquiring about possible explanations, one of the brothers responded by saying that they had initiated cost saving measures to reduce the materials cost expense. The brother added that he did not appreciate being called into a meeting to answer unimportant questions about why they are making more money. On his way out, another brother said, “Rather than questioning our good business sense, you should be glad that we are making more money because you might now be able to get a larger bonus or a raise.”

Sensing that he had received a less than truthful answer, Monterrey began talking with some of the long-time employees of the stores to determine if any changes had occurred during the past year that would account for the dramatic increase in revenues. Did volume go up substantially while costs were held fairly constant: Was there a major price increase with volume holding steady? The consistent answer was that they had been making candy the same way since the parlors opened and that there had been no significant change in price and only a modest increase in volume.

When he was back at his office, Monterrey was looking through the Thick-N-Chewy file when he came across a newspaper article indicating that two sales clerks had been arrested for selling a controlled substance in one of the stores. Although there was no suggestion in the article that store management had been involved in the drug sales, Monterrey realized that if the candy stores were laundering drug money, it could explain the large increase in revenues while price and volume remained steady.

What are the ethical issues?

What should Monterrey do?

Suggested Answer

First, the CPA should assess the consequences of differing alternatives, some of which are:

Resign from the company

- Accountant’s integrity preserved
- Successor accountant may pursue problem
- Owners’ possible illegal activity not uncovered, at least at this time
- Drug peddling may continue
- Accountant’s income decreases

Report suspicions to law enforcement officers

- Accountant violates obligation to client, (employer) exceeds approved limits of actions
- Owners’ possible illegal activity may be uncovered
- Drug peddling may be stopped
- Candy stores may close, employees lose jobs

- Accountant may be sued by owner, censured by state Board
- Accountant's income decreases

Accept the owners' explanation, prepare the report

- Accountant's integrity compromised
- Illegal drug peddling, if real, continues
- Owners' reputation maintained
- Accountant's reputation may be harmed if drug activity subsequently discovered
- Accountant's income may increase

After assessing the possible consequences, the CPA should consider quitting his job. The CPA should talk candidly with a successor controller as to why he quit if the client permits the successor controller to speak candidly with the prior CPA.

.09 If the member concludes that no safeguards can eliminate or reduce the threats to an acceptable level or if the member concludes that appropriate action was not taken, then he or she should consider the continuing relationship with the member's organization and take appropriate steps to eliminate his or her exposure to subordination of judgment.

2.130.030 Obligation of a Member to His or Her Employer's External Accountant

.01 The "Integrity and Objectivity Rule" [2.100.001] requires a member to maintain objectivity and integrity in the performance of a professional service. When dealing with an employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which the employer's external accountant requests written representation.

2.160 Educational Services

2.160.010 Educational Services

.01 Members who perform educational services, such as teaching full or part time at a university, teaching a continuing professional education course, or engaging in research and scholarship, are performing professional services and, therefore, are subject to the "Integrity and Objectivity Rule" [2.100.001].

2.300 General Standards

2.300.001 General Standards Rule

.01 A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

a) Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

b) Due Professional Care. Exercise due professional care in the performance of professional services.

c) Planning and Supervision. Adequately plan and supervise the performance of professional services.

d) Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

2.400 Acts Discreditable

2.400.001 Acts Discreditable Rule

.01 A member shall not commit an act discreditable to the profession.

Interpretations Under the Acts Discreditable Rule

Interpretations under the Acts Discreditable Rule identify the following discreditable acts:

- Discrimination or harassment in employment practices.
- Solicitation or disclosure of CPA examination questions or answers.
- Failure to file a tax return or pay a tax liability.
- Negligence in the preparation of financial statements or records.
- Negligence in the preparation of reports to governmental bodies, commissions, or other regulatory agencies.
- Use of prohibited indemnification agreements.
- Disclosure or use of confidential information obtained from employment or volunteer activities.
- False, misleading, or deceptive acts in promoting or marketing professional services.
- Using the CPA credential in violation of state law.

Observation

While the AICPA guidance on using the CPA title is useful, the most important source of information on using the CPA title comes from your state Board of Accountancy. For example, both New York and California now severely restrict the use of the CPA title by inactive CPAs. Previously, many states allowed inactive CPAs to use the CPA title on business cards as long as it was clear that the CPA was not practicing public accounting. Most states have rules on who can use the CPA title and in what circumstances.

Example

John was an experienced CPA when he went to work for XYZ Industries, Inc. (XYZ) as CFO. XYZ was rapidly growing and hoping to go public within a year. XYZ did not have a true CFO prior to hiring John, and the accounting department was in disarray. Eighteen months later, XYZ had a successful IPO after which John said, “I have been so busy with the IPO that I did not file my tax returns for the prior two years.”

John may not realize it, but he has a responsibility under this rule to timely file all tax returns and to pay all applicable taxes. More importantly, most state boards of accountancy have similar rules, and the states have the ability to discipline their licensees.

Members in Business and Industry - Examples of Violations Adapted from the AICPA website

All members of the AICPA are required to follow the AICPA Code of Professional Conduct (Code). Members must be knowledgeable of their responsibilities under the Code. Below are a couple of fictitious examples of business and industry member violations prepared by the AICPA that show how the Rules and related interpretations could be applied. Some situations may result in more than one violation.

Integrity and Objectivity Rule

Member Linda Chambers is a CPA and the Chief Financial Officer for Brookings Incorporated. At the request of the external auditors, Linda signed the client representation letter stating that, there has been no communications from regulatory agencies concerning noncompliance with or deficiencies in financial reporting practices. Earlier that month she had received an inquiry from the Securities and Exchange Commission (SEC) concerning the company’s revenue recognition policy.

As a member, Linda has a responsibility to the company’s external accountants. She is required to be candid in disclosing the communication received from the SEC. In addition, Linda may not sign documents containing materially false and misleading information. Linda could potentially be in violation of “Integrity and Objectivity Rule” (AICPA, *Professional Standards*, ET sec. 2.100.001) as supported by the “Knowing Misrepresentations in the Preparation of Financial Statements or Records” interpretation (AICPA, *Professional Standards*, ET sec. 2.130.010), and Obligations of a Member to His or Her Employer’s External Accountants” interpretation (AICPA, *Professional Standards*, ET sec. 2.130.030).

Members in Business and Industry - Examples of Violations Adapted from the AICPA website (continued)

General Standards Rule

The controller, member Dale Weinstein, CPA, of Brookings Incorporated recorded a material sale of merchandise on the last day of the first quarter. Dale never received notification of a sales invoice or received any shipping documentation to ascertain that the sales transaction had actually occurred. Although this was a departure from company policy, Dale recorded the transaction.

Dale did not exercise due processional care and had a responsibility to obtain sufficient relevant data that would provide him with a reasonable basis for his conclusion. Dale could potentially be in violation of the "General Standards Rule" (AICPA, *Professional Standards*, ET sec. 2.300.001) of the AICPA *Code of Professional Conduct*.

Accounting Principles Rule

In a response to an SEC inquiry, member John Sterling, the CEO of Brookings Incorporated, writes: The Company's financial statements are presented in conformity with generally accepted accounting principles, and I am not aware of any material misstatements. Earlier that morning, John had been present at a meeting with the company's external accountants discussing a material error in those same financial statements.

John cannot express, in the written communication with the SEC that the financial statements are in accordance with generally accepted accounting principles and are free of material errors when he knows that his statement is false. As a member, John could be potentially in violation of the "Accounting Principles Rule" AICPA, *Professional Standards*, ET sec. 2.320.001) of the AICPA Code of Professional Conduct.

Acts Discreditable Rule

I have been so busy with the company's initial public offering that I have failed to file my personal income tax returns for the last two years, said member Susan Allen.

Susan may not realize it, but she has a responsibility to comply with applicable federal, state or local laws regarding the timely filing of her personal tax returns. She could now also be potentially in violation of the "Acts Discreditable Rule" as supported by the "Failure to File a Tax Return or Pay a Tax Liability" interpretation (AICPA, *Professional Standards*, ET sec. 2.400.030).

III. IMA STATEMENT OF ETHICAL PROFESSIONAL PRACTICE[1]

Members of IMA shall behave ethically. A commitment to ethical professional practice includes overarching principles that express our values, and standards that guide our conduct.

PRINCIPLES

IMA's overarching ethical principles include: Honesty, Fairness, Objectivity, and Responsibility. Members shall act in accordance with these principles and shall encourage others within their organizations to adhere to them.

STANDARDS

A member's failure to comply with the following standards may result in disciplinary action.

I. COMPETENCE

Each member has a responsibility to:

1. Maintain an appropriate level of professional expertise by continually developing knowledge and skills.
2. Perform professional duties in accordance with relevant laws, regulations, and technical standards.
3. Provide decision support information and recommendations that are accurate, clear, concise, and timely.
4. Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.

II. CONFIDENTIALITY

Each member has a responsibility to:

1. Keep information confidential except when disclosure is authorized or legally required.
2. Inform all relevant parties regarding appropriate use of confidential information, and monitor subordinates' activities to ensure compliance.
3. Refrain from using confidential information for unethical or illegal advantage.

III. INTEGRITY

Each member has a responsibility to:

1. Mitigate actual conflicts of interest, regularly communicate with business associates to avoid apparent conflicts of interest, and advise all parties of any potential conflicts.

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2. Refrain from engaging in any conduct that would prejudice carrying out duties ethically.
3. Abstain from engaging in or supporting any activity that might discredit the profession.

IV. CREDIBILITY

Each member has a responsibility to:

1. Communicate information fairly and objectively.
2. Disclose all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, analyses, or recommendations.
3. Disclose delays or deficiencies in information, timeliness, processing, or internal controls in conformance with organization policy and/or applicable law.

RESOLUTION OF ETHICAL CONFLICT

In applying the Standards of Ethical Professional Practice, you may encounter problems identifying unethical behavior or resolving an ethical conflict. When faced with ethical issues, you should follow your organization's established policies on the resolution of such conflict. If these policies do not resolve the ethical conflict, you should consider the following courses of action:

1. Discuss the issue with your immediate supervisor except when it appears that the supervisor is involved. In that case, present the issue to the next level. If you cannot achieve a satisfactory resolution, submit the issue to the next management level. If your immediate superior is the chief executive office or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with your superior's knowledge, assuming he or she is not involved. Communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate, unless you believe there is a clear violation of the law.
2. Clarify relevant ethical issues by initiating a confidential discussion with an IMA Ethics Counselor or other impartial advisor to obtain a better understanding of possible courses of action.
3. Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

Note

The author believes that all CPAs in industry should adhere to both the AICPA and IMA guidelines regardless of membership.

Case Study: Integrity and Objectivity

CPA, Director of Finance for a publicly owned company, made journal entries to adjust second and third quarter 200X financial statements according to a model developed and used by the company. When CPA made the adjustments to the second and third quarter financial statements, CPA did not report to senior management or to the external auditors that the adjustments could result in a misstatement of the financial statements. CPA reported the unsupported journal entries on the fourth quarter financial statements.

CPA made journal entries that were not in compliance with Generally Accepted Accounting Principles. CPA did not discharge the duty owed to the general public when CPA allowed incorrect second and third quarter financial statements to be issued.

IV. FOREIGN CORRUPT PRACTICES ACT

Congress enacted the Foreign Corrupt Practices Act in 1977. This Act was passed because of disclosures by the Office of the Watergate Special Prosecutor and the Securities and Exchange Commission (SEC) of the use of U.S. corporate funds for domestic political contributions and for the bribery of foreign government officials. Some of these payments were clearly illegal and others questionable, while some payments appeared to have been made by avoiding internal control systems. To prevent these problems from occurring in the future, the Act requires a publicly traded company (it does not apply to privately held companies) to keep in reasonable detail "books, records and accounts" that accurately and fairly reflect its transactions and disposition of assets, and maintain an adequate system of internal controls. The control system must have the following attributes:

- Transactions must occur under the authorization of management
- Transactions must be properly recorded
- There must be reasonable controls over access to assets
- There must be periodic reconciliations of recorded to actual assets, with an investigation of any differences.

This Act is particularly applicable to multinational organizations, so the controllers of these organizations must be aware of it and its ramifications for enhanced control systems. To be in compliance with the Act, a controller should be particularly mindful of the adequacy of company control systems, as well as of subtle changes in financial results that may indicate the presence of control problems.

The penalties for violation of this act are fines of up to $2,000,000 for any concern convicted of the violation. In addition, individuals involved in such illegal payoffs are subject personally to fines up to $100,000 and prison for up to five years.

V. COOK THE BOOKS & GO TO JAIL

In a sign of a widening crackdown, the Securities and Exchange Commission said it plans to work more closely with criminal prosecutors to attack corporate accounting fraud.

Case Study: NextCard, Inc.

Mr. Wachtel served as the Controller of NextCard, Inc. from 1998 to 2003.The Securities and Exchange Commission (SEC) filed a civil suit in 2004.

The SEC's Complaint alleged that Mr. Wachtel and the other defendents, all former officers of NextCard, engaged in a fraudulent scheme which resulted in NextCard filing materially false and misleading financial statements in the company's annual report on Form 10-K for the fiscal year ended December 31, 2000, and in the company's quarterly reports on Form 10-Q for the first two quarters of fiscal year 2001. The Complaint alleged that Wachtel and the other defendants failed to disclose several changes in NextCard's accounting policies, including: (1) the reclassification of certain credit losses as fraud losses; and (2) changes in NextCard's policy for calculating its loan loss reserve. According to the Complaint, as a result of these undisclosed accounting policy changes, investors were misled and denied material information concerning the rising levels of losses on NextCard's credit card portfolio.

Mr. Wachtel consented to the entry of a Final Judgment, in which he, without admitting or denying the allegations of the Complaint, agreed to the imposition of a permanent injunction for violating sections of the Securities Act and the Exchange Act; his disgorgement of $21,000, representing his sale of NextCard common stock, together with prejudgment interest in the amount of $1,223; and payment of civil penalties in the amount of $71,000. Mr. Wachtel was also prohibited for five years from acting as an officer or director of any issuer that has a class of securities registered pursuant to Section 12 of the Exchange Act or that is required to file reports pursuant to Section 15(d) of the Exchange Act.

The State Board of Accountancy then voted to revoke Mr. Wachtel's CPA license.

VI. MANAGEMENT ACCOUNTANTS SHOULD HEED THE ABOVE WARNING

One of the most common schemes is the bill-and-hold sales transaction. While it's not necessarily a GAAP violation, it's often associated with financial frauds and calls for deeper investigation. The SEC says that all of the following conditions must be met for revenue recognition to be appropriate:

- The risks of ownership must have passed to the buyer.
- The customer must have a written commitment to purchase the goods.

- The buyer must request the bill-and-hold sales transaction and substantiate a business purpose for it.
- A fixed delivery date must exist.
- The seller must not retain any significant specific performance obligations.
- The goods must be complete and ready for shipment and not subject to being used to fill other orders.

To make matters even more difficult, the SEC points out that the following additional factors be considered:

- The extent to which the seller is modifying its normal terms for this transaction.
- The seller's history of employing bill and hold transactions.
- The extent to which the buyer will lose if the market value of the held goods subsequently declines.
- The extent to which the holding risk of the seller can be insured.
- The extent to which the seller's holding of the goods really creates a contingent sale that the buyer could reject.

VII. SARBANES-OXLEY CORPORATE RESPONSIBILITY ACT OF 2002

Title III of the Sarbanes-Oxley Act deals with making corporations more responsible for the financial statements they issue. Some of the major changes affect audit committees and are designed to make them more independent. In particular, the Act vests the audit committee of an issuer with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It also requires committee members to be a member of the board of directors of the issuer, and to be otherwise independent.

Title IX of the Sarbanes-Oxley Act amends Federal criminal law to increase criminal penalties for: 1) conspiracy to commit offense or to defraud the United States, including its agencies; and 2) mail and wire fraud.

VIII. IMA ETHICS HOTLINE NOW OPEN TO ALL FINANCIAL PROFESSIONALS

In response to the need for businesses to maintain the highest ethical standards, the Institute of Management Accountants provides financial professionals free, confidential guidance on ethical issues through the IMA Ethics Hotline.

Since Enron and other corporate accounting scandals, ethics programs and hotlines have become an unofficial requirement for businesses. Confidential hotlines, in particular, are gaining popularity to protect an employee from being labeled a "whistleblower."

Financial professionals can call the hotline toll-free at 1-800-245-1383. The IMA does not record phone numbers. Confidentiality is maintained at all times.

IX. FEDERAL SENTENCING GUIDELINES

Under the revised sentencing guidelines, there are five things you can do to change the culture of your company and reduce your firm's potential exposure.

1. Create a formal, written ethics policy.
2. Require managers to monitor ethics compliance.
3. Screen potential employees carefully before hiring.
4. Develop incentives to promote compliance.
5. Encourage employees to speak up when they encounter problems.

Companies that embrace the five items above will receive lighter sentences in the event they are convicted of wrongdoing.

X. STOCK OPTION BACKDATING

In the past, there was a flurry of controversy over stock option backdating. This controversy is the direct result of an ethical breakdown in corporate America. While it may take years to sort out the full impact of this dubious practice, here are a few of the possible impacts excerpted from articles written by the experts in employee ownership at the National Center for Employee Ownership (www.NCEO.org):

1. **Shareholder Litigation:** Backdating will be a field day for securities lawyers for a number of reasons. If a company said it was issuing options at fair market value, but really didn't, shareholders could sue because they never approved such a plan. Furthermore, IRS rules make shareholder approval a condition of tax-qualified incentive stock option plans.

2. **SEC Enforcement:** There are numerous violations that could be involved with backdating. If an executive got options timed just before the release of data that would affect the stock price, that's potentially insider trading. If the options were granted in a way not in accordance with the plan, that could mean that proper disclosures from the executive to the SEC had not been made. If the two-day rule for reporting grants was effectively violated (because the grant date was pushed back more than two days over what the company actually claimed it was), then the securities laws are violated again.

3. **Corporate Taxes:** It's not entirely clear how the new rules on the taxation of deferred compensation will apply to backdated options issued before the effective date of the new deferred compensation rules under Internal Revenue Code Section 409A, which says that certain kinds of deferred compensation will be heavily taxed unless the recipient specified well in advance when the award would be paid. Options generally do not require such an advance election (you can exercise whenever you like once they are vested until they expire; that's why they are so appealing). Option grants at fair market value are not covered by Section 409A, but discounted options are. More clear is that if the options were incentive stock options, then the backdating would disqualify the option as an incentive option, and the executive would owe big-time back taxes on the exercised award, even if the stock had not yet been sold. If the exercise date is bogus, that means the company has underwithheld taxes on the exercise, and that means it owes the government, with penalties and interest. Failure to withhold payroll taxes on non-qualified options can result in the denial of the corporate tax deduction for the compensation element of the stock option award. This alone could result in hundreds of millions of dollars in unpaid corporate income taxes.

4. **Financial Statements and Restatements:** Rules for recording the impact of options expenses have changed, but under both the old rules and the new rules, pretending the awards were granted at a price they were not requires companies to go back and restate earnings.

5. **Excess Compensation:** Companies can take tax deductions for compensation to top executives over $1 million only if it is performance-based. Backdated options are not, so there may well be tax penalties.

6. **The Alternative Minimum Tax:** Employees who have incentive stock options do not have to pay any tax when they exercise the option, only when they sell the stock (provided they hold the shares for one year after exercise and two years after grant). At sale, they only would pay capital gains taxes, but they may be subject to the alternative minimum tax (AMT) requiring them to count the spread on the option at exercise as a "preference" item. Many employees (especially executives) would have held on to the stock after exercise for at least a year and paid the AMT. But backdated options cannot be incentive options because incentive options must be issued at fair market value. So, that means they now owe regular tax on the exercise of the option from years ago.

7. **Changes to Option Programs:** This scandal could force companies to reduce or eliminate the granting of options. Why risk the hassle? Just cancel the plan.

AICPA Ethics Guidance for CPAs in Business and Industry

Use these tips from the AICPA when you are confronted with an ethical dilemma:

- Do your best to resolve the issue within your own organization, whether that is your department in a larger organization or the company as a whole. Most issues are easily resolved.
- Be cognizant of your obligations to your employer's external accountant. You must be candid and must not knowingly misrepresent facts or fail to disclose material information to them.
- One of the most common ethics violations by CPAs in business and industry relates to Subordination of Judgment. This interpretation may be especially relevant if the CPA has a disagreement or dispute with their manager on the preparation of financial statements or the recording of transactions.
- Don't overlook an ethics policy or statement in place at your company. In a smaller company, you might need to rely on outside resources as ethics policies might not be fully developed or documented.
- Maintain professional skepticism. If you get an explanation for the situation, think about whether it makes sense. Continue to observe over time to see if the situation plays out as expected.
- Maintain documentation of the issue – your thoughts and decisions all along the way, and the parties with whom you discussed these issues – to review later as may be necessary.
- Even if you are successful in a particular situation, you might find that there are other implications that make it impossible to continue working at a company. In this situation, you should seek employment elsewhere.
- Depending on the severity of the issue, you may want to consult with people that you respect from outside the company. Also, consider whether you need to consult with an attorney.

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CHAPTER 4: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1.	**The AICPA codified the Code of Professional Conduct into three functional areas, including all of the following except:** **A.** Members in Public Practice **B.** Members in Business **C.** Member in Public Practice and Business **D.** Other Members (retired, unemployed, etc.)

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CHAPTER 4: SOLUTION AND SUGGESTED RESPONSES

Below is the solution and suggested responses for the question on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. The groupings are based on the member's area of practice, including public practice. The term member relates to any CPA, whether or not he or she is a member of the AICPA. **B.** Incorrect. The groupings are based on the member's area of practice, including business. The term member relates to any CPA, whether or not he or she is a member of the AICPA. **C.** **CORRECT.** There is not a part that includes a combination of these groups. **D.** Incorrect. The groupings are based on the member's area of practice, including a grouping of other members that do not fall into the main two categories. *(See page 81 of the course material.)*

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GLOSSARY

Alternative Practice Structures (APS) - A nontraditional structure for the practice of public accounting in which a traditional CPA firm engaged in auditing and other attestation services might be closely aligned with another organization, public or private, that performs other professional services (e.g., tax and consulting).

American Institute of Certified Public Accountants (AICPA) - The national professional organization for all certified public accountants (CPAs).

Client's records - Any accounting or other records belonging to the client that were given to the member by, or on behalf of, the client.

Close relative - Close relatives are the member's nondependent children (including grandchildren and stepchildren), brothers and sisters, grandparents, parents, and parents-in-law. Spouses of any of the above are also close relatives. The SEC definition of close relatives expands the above to include a spouse's brothers and sisters and their spouses.

Code of Professional Conduct (the Code) - The Code was adopted by the membership of the AICPA to provide guidance and rules to all members on various ethics requirements. The Code consists of: 1) Principles, 2) Rules, 3) Interpretations, and 4) Ethics Rulings.

Conflict of interest - A conflict of interest may occur if a member performs a professional service for a client or employer, and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity.

Consulting services - Professional services that use the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process.

Contingent fee - A fee for performing any service in which the amount of the fee (or whether a fee will be paid) depends on the results of the service.

Direct financial interest - A direct financial interest is created when a member invests in a client entity.

Disqualifying services - Term used to refer to the following services, which when performed for a client prohibit the member from accepting a contingent fee or commission: (a) An audit or a review of a financial statement; (b) An examination of prospective financial information; (c) A compilation of a financial statement expected to be used by third parties except when the compilation report discloses a lack of independence.

Ethics Rulings - Part of the Code of Professional Conduct. Rulings summarize the application of rules and interpretations to a particular set of factual circumstances.

Firm - A form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof.

Former practitioner - A proprietor, partner, shareholder or equivalent of a firm, who leaves by resignation, termination, retirement, or sale of all or part of the practice.

Holding out as a CPA - Includes any action initiated by a member, whether or not in public practice, that informs others of his or her status as a CPA.

Independence in appearance - If there are circumstances that a reasonable person might believe are likely to impair independence, the CPA is not independent in appearance. To be recognized as independent, the auditor must be free from any obligation to or interest in the client, its management, or its owners.

Independence in fact - To be independent in fact (mental independence), the CPA must have integrity and objectivity. If there is evidence that independence is actually lacking, the auditor is not independent in fact.

Indirect financial interest - An indirect financial interest is created when a member invests in a nonclient entity that has a financial interest in a client.

Integrity - An element of character fundamental to professional recognition. It is the quality from which public trust derives and the benchmark against which a member must ultimately test all decisions.

Internal audit outsourcing - Internal audit outsourcing involves performing audit procedures that are generally of the type considered to be extensions of audit scope applied in the audit of financial statements. Examples of such procedures might include confirming receivables, analyzing fluctuations in account balances, and testing and evaluating the effectiveness of controls.

Interpretations of rules of conduct - Part of the Code of Professional Conduct. Interpretations are pronouncements issued by the AICPA's Division of Professional Ethics to provide guidelines concerning the scope and application of the rules of conduct.

Joint closely held business investment - An investment that is subject to control by the member, or the member's firm, client or its officers, directors, or principal stockholders, or any combination of the above.

Joint Ethics Enforcement Program (JEEP) - The AICPA and most state societies cooperate in the Joint Ethics Enforcement Program (JEEP) in bringing enforcement actions against their members.

Member - In its broadest sense, "member" is a term used to describe a member, associate member, or international associate of the AICPA. All members must adhere to the AICPA's Code of Professional Conduct. For the purposes of applying the independence rules, the term "member" identifies the people in a CPA firm and their spouses, dependents, and cohabitants who are subject to the independence requirements.

Multidisciplinary practices (MDP) - Arrangements in which CPAs share fees with attorneys or other professionals.

National Association of State Boards of Accountancy (NASBA) - A voluntary organization composed of the state boards of accountancy. It promotes communication, coordination, and uniformity among state boards.

Objectivity - The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Objectivity is a state of mind, a quality that lends value to a member's services.

Period of professional engagement - The period of engagement starts when the member begins the service requiring independence and ends upon termination of the relationship (by the member or the client) or, if later, when the report is issued. The period does not stop when the report is issued and restart with the beginning of the next engagement. The period of engagement typically covers many periods.

Practice of public accounting - According to the Code of Professional Conduct, the practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPAs, of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements on Standards for Tax Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements. However, a member or member's firm, while holding out as CPAs, is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph.

Principles - Positive statements of responsibility in the Code of Professional Conduct that provide the framework for the rules, which govern performance.

Professional services - Includes all services performed by a member while holding out as a CPA.

Rules - Broad but specific descriptions of conduct that would violate the responsibilities stated in the principles in the Code of Professional Conduct.

Securities and Exchange Commission (SEC) - A federal government regulatory agency with responsibility for administering the federal securities laws.

State boards of accountancy - State government regulatory organizations. Each state government issues a license to practice within the particular state under that state's accountancy statute.

State societies of CPAs - Voluntary organizations of CPAs within each individual state.

Statements on Standards for Tax Services (SSTS) - SSTS superseded and replaced the AICPA's Statements on Responsibilities in Tax Practice (SRTP). They are enforceable standards of conduct for tax practice under the Code of Professional Conduct.

Unpaid fees - Fees for: 1) audit, and 2) other professional services that relate to certain prior periods that are delinquent as of the date the current year's audit engagement begins, if the client is an SEC registrant, or the date the audit report is issued for non-SEC clients (i.e., AICPA rule).

Yellow Book - Governmental Auditing Standards issued by the Government Accountability Office.

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