

Professional Education Services, LP



Quality education offered by PES...

Ethics and Professional Conduct for Massachusetts CPAs

Course #4925D

Course Material



Professional Education Services, LP

The Professional's Choice for CPE. sm

4208 Douglas Blvd. • Suite 50 • Granite Bay, CA 95746

To Order: 1-800-998-5024 • Customer Service: 1-800-990-2731 • Fax: 916-791-4099

www.mypescpe.com • www.pescpe.com • www.pesqascpe.com • www.eacpe.com

**ETHICS AND PROFESSIONAL CONDUCT FOR MASSACHUSETTS CPAS
(COURSE #4925D)**

TABLE OF CONTENTS

	<u>Page</u>
Introduction	I-1
Chapter 1: Introduction to the Study of Ethics	1-1
Review Questions & Solutions	1-4
Chapter 2: The Value of Professional Codes of Ethics	2-1
Review Questions & Solutions	2-3
Chapter 3: The Code of Professional Conduct	3-1
Review Questions & Solutions	3-17
Chapter 4: Understanding the Code of Professional Conduct	4-1
Review Questions & Solutions	4-24
Chapter 5: Ethics and the Tax Professional	5-1
Review Questions & Solutions	5-45
Glossary	
Index	

INTRODUCTION

Almost all states require that CPAs pass an ethics course prior to obtaining their initial CPA certificate. More and more states are adopting regulations mandating ethics CPE as a condition of renewing one's right to practice. CPAs often ask, "Why an ethics course – I've been practicing for years." The answer is simple. The accounting industry is undergoing change at a rapid pace.

Massachusetts law is often different from the AICPA. Thus, while you could be acting ethically in the eyes of the AICPA, you could be in violation of Massachusetts law.

BOARD OF ACCOUNTANCY INFORMATION

The Board of Public Accountancy grants certificates and licenses to practice public accountancy to qualified individuals who comply with the requirements of the statute. The Board monitors licensees' practice of public accountancy to insure that the services provided to the public are in accordance with the ethical standards of Massachusetts General Laws and Board regulations. The Board also insures that licensees have complied with all continuing education requirements necessary to renew their licenses.

The Board of Public Accountancy licenses approximately 13,100 professionals in the Commonwealth. In a recent fiscal year, the Board received 37 new complaints and resolved 34 complaints from this and previous fiscal years. The Board held four investigative conferences, revoked one license, suspended one license, accepted the voluntary surrender of one license, and issued one censure. The Board collected a total of \$1,000 in fines.

FREQUENTLY ASKED QUESTIONS

Q. How do I renew an expired license?

A. In order to renew an expired license, a written request to the Board Office is required. Included in this written request, expired licensees must ask the Board Staff to prepare a reinstatement package. Please also include a current address and license number for verification.

Q. Can CPA firms admit non-CPA owners?

A. As of September 24, 2001, licensed CPA firms (partnerships, corporations, LLCs and LLPs) may organize or add partners, shareholders, or members up to 49 percent ownership with individuals who do not possess a CPA license.

Q. What are the Continuing Professional Education Requirements?

A. If a license is renewed on time, the required number of hours of Continuing Professional Education (CPE) to renew that license to practice is 80 hours. This requirement is due in connection with the renewal of your license.

Effective for all licenses expiring on or after June 30, 2007, four hours of acceptable continuing education shall be in the area of professional ethics, within the existing 80 hours of mandatory CPE every two years.

Q. What is the Reciprocity rule as of January 1, 2007?

A. The Board amended its reciprocity requirements for full time practicing CPAs who wish to enter Massachusetts either incidental or to open an office and practice. The change is intended to recognize the uniformity in licensing requirements of substantially equivalent state Boards and lessen the administrative burden and timing delays for practicing CPAs. These new rules are set forth in 252 CMR 2.08, and a new Short Form (SE) Reciprocal Application is now available. The Short Form is available only for CPAs in the full time practice of public accountancy for five total years out of the last ten years prior to applying for the reciprocal license in Massachusetts.

Q. How do I change my name and/or mailing address?

A. Name changes can only be done by submitting the completed Name Change Form available at the Board's website at www.mass.gov/dpl/boards/pa. Mailing address changes can be done online provided that you have in your possession your most current CPA wallet license card. If not, you must download and complete the address change form at this website and either fax it to 617-727-0139 or mail it to the address provided on the form.

CODE OF ETHICS AND RULES OF PROFESSIONAL CONDUCT

- 3.01: Independence, Integrity and Objectivity
- 3.02: Competence and Technical Standards
- 3.03: Responsibilities to Clients
- 3.04: Responsibilities to Colleagues
- 3.05: Other Responsibilities and Practices

The Code of Ethics and Rules of Professional Conduct derive their authority from M.G.L. c. 112, § 87A½ subsection (4) which provides that the Massachusetts Board of Public Accountancy may make such rules of professional conduct as may be instrumental in fixing and maintaining high standards of integrity and dignity in the profession of public accounting, and for the enforcement of such rules and other statutory requirements.

The Code of Ethics and Professional Conduct are relatively short and generally follow the AICPA Code of Professional Conduct. Accordingly, the remainder of this course focuses on the AICPA Code. You may view the Massachusetts Code on the Board's website at www.mass.gov/dpl/boards/pa/.

CHAPTER 1: INTRODUCTION TO THE STUDY OF ETHICS

Objectives: After completing this chapter, you will be able to:

- Explain the function of ethics.
- Discuss the theory of utilitarianism.
- Describe the history of ethics in Western civilization.
- Contrast the term “positive laws” with “natural laws.”
- Discuss whether the AICPA code of ethics is a positive law or natural law.
- Explain why people follow rules of laws.

Ethics has a number of functions or goals. The primary function is to develop formulas or logical constructs that can be used in choosing between various courses of action. The "moral" or "ethical" thing to do is considered the right thing to do. But it is not always easy to know what the moral course of action is. Ethical constructs and theories, such as Utilitarianism, which will be discussed later, are designed to be used as tools of thought in selecting an appropriate, ethical course of action. It does not matter if your goal is to be the best CPA or the best spouse or friend; the principles that guide one's actions will theoretically be the same.

Webster's Dictionary defines "ethics" as "the discipline dealing with what is good and bad and with moral duty and obligation" and as "a set of moral principles or values." The word "moral" is defined as "of or relating to principles of right and wrong in behavior." Ethics has also been defined as the "science of conduct." First and foremost, ethics is a philosophy. The study of ethics has a long and rich history in Western civilization, beginning with the early Greek philosophers such as Plato and Aristotle, emerging along with early Christian thought in the medieval period and continuing into modern European scholarship. Throughout the centuries, the great philosophers have attempted to develop normative constructs to use in defining behavior. Many schools of thought have developed that have been used not only to define conduct, but to establish norms. These theories have been used variously to justify different courses of conduct as ethical and to promote different modes of behavior.

OBSERVATION: *Nowhere in the dictionary will you find the definition of ethics as doing that which one is legally obligated to do. Ethical responsibilities exceed legal obligations.*

The modern professional rules of conduct that govern CPAs – like those governing attorneys and other professionals – have developed out of those schools of thought with an eye toward establishing a set of norms that benefit and promote the profession while protecting consumers. A general understanding of some of the background of this field of study is helpful to more fully understand the goal of the rules of professional conduct governing CPAs. This type of understanding is also useful in analyzing situations that may arise that do not fall squarely within the parameters of one of the specific professional rules. The ethical CPA should be able to determine the appropriate course of action regardless of the circumstances in which she finds herself. We will begin our discussion with a brief overview of a few of the major philosophical ethical constructs and then examine how those constructs can be used as models in guiding the behavior of CPAs.

Most societies attempt to compel ethical behavior by requiring adherence to a series of laws (in this way, the rules of professional conduct governing CPAs can be viewed as laws designed to ensure that CPAs act ethically). English philosopher John Austin wrote that "a law, in the most general and comprehensive acceptation in which the term, in its literal meaning, is employed, may be said to be a rule laid down for the guidance of an intelligent being by an intelligent being having power over him." This definition is taken from Austin's "The Providence of Jurisprudence Determined," first published in 1832. Austin defines several types of laws. First, according to Austin, are laws laid down by God to govern the behavior of man. These are referred to as "natural laws."

Next are laws established by men, which are termed "positive laws," or laws that exist by position. Every law, according to Austin, is a "command":

Summary: Philosopher John Austin believed there are 2 types of laws:

- 1) Natural Laws – Laws laid down by God to govern the behavior of man;
- 2) Positive Laws – Laws that are established by men.

Viewed according to this philosophical model, the AICPA's Code of Professional Conduct is most properly characterized as a set of commands. As they are commands laid down by man to govern the conduct of man, philosopher John Austin would classify the AICPA's Code of Professional Conduct as a "positive law." And as the result of a failure to follow or abide by a rule of professional conduct can lead to the imposition of a punishment or a sanction, that rule of professional conduct can again, according to Austin's philosophical model, properly be referred to as a positive law. Even though the purpose of the rule is to achieve a certain good, the rule is defined by the sanction that is threatened when there is non-compliance:

I am determined or inclined to comply with the wish of another, by the fear of disadvantage or evil. I am also determined or inclined to comply with the wish of another, by the hope of advantage or good. But it is only by the chance of incurring evil, that I am bound or obliged to compliance. It is only by conditional evil, that duties are sanctioned or enforced. It is the power and purpose of inflicting eventual evil, and not the power and purpose of imparting eventual good, which gives to the expression of a wish the name of a command.

Thus, the AICPA Code requirement that CPAs "maintain objectivity and be free of conflicts of interest in discharging professional responsibilities" (Article IV) takes the form of a "command" over CPAs through the risk that a CPA who fails to act with objectivity in discharging his or her obligations could be sanctioned by the AICPA. It is through knowledge that a sanction is possible that the CPA follows the "commands" of the rules of professional conduct.

It is through the fact that the members of the group, in this case CPAs, follow the same set of commands, that a "society" is established: "In order that a given society may form a society political, the generality or bulk of its members must habitually obey a superior determinate as well as common." Thus, accountants, while they do not form a "society" within the traditional meaning of the term, defined as a political entity, do form a society in the broader definition as a group of individuals who voluntarily submit themselves to the same set of rules under the threat that non-compliance with any particular positive law can lead to the imposition of a sanction.

CHAPTER 1 – REVIEW QUESTIONS

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

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. The study of ethics as a philosophy began:
 - a) in the 20th century
 - b) with ancient Greek philosophers
 - c) with the development of Christianity
 - d) with medieval philosophers

2. The AICPA's Code of Professional Conduct are most properly classified, according to Austin, as:
 - a) natural laws
 - b) philosophical models
 - c) positive laws
 - d) commands

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The study of ethics as a philosophy began over 2000 years ago.
- B: Correct.** The study of ethics as a philosophy began with ancient Greek philosophers such as Plato and Aristotle.
- C: Incorrect. The study of ethics began with Plato which predates Christianity.
- D: Incorrect. The study of ethics was well founded by medieval times.

(See page 1-1 of the course material.)

2. A: Incorrect. Natural laws are laid out by God. God did not create the AICPA Code of Professional Conduct.
- B: Incorrect. The AICPA Code of Professional Conduct is a set of commands, not a philosophical model.
- C: Correct.** Austin considers every set of commands as a positive law.
- D: Incorrect. Although the AICPA Code of Professional Conduct is a set of commands, under Austin's philosophical model a set of commands is a positive law. Most people studying philosophy would consider both c and d to be correct answers.

(See page 1-2 of the course material.)

CHAPTER 2: THE VALUE OF PROFESSIONAL CODES OF ETHICS

Objectives: After completing this chapter, you will be able to:

- Discuss how professional codes of ethics protect consumers and promote the CPA profession.
- Explain how being ethical will lead to greater professional success.
- Describe the difference between blindly following the ethical rules and truly applying the ethical concepts to one's thought process.

As we discussed in Chapter 1, professional ethical codes have been developed to both protect consumers and promote particular professions. While not expressly set forth in codes such as the AICPA, these practical, often very specific ethical rules are based at least in part on abstract philosophical theories like those discussed in Chapter 2.

It is easy to say that professional ethical codes have been developed to protect consumers and to promote the business whose ethics are being regulated. Stated in the abstract, however, this is of limited value. To truly understand the ethical rules governing CPAs that will be detailed in later chapters, it is important to have a better understanding of the value that the rules provide. As we discussed in Chapter 1, the field of ethics is involved in defining behavior as good or bad. People in business generally have as their primary motivation increasing profits. If we assume, contrary to some philosophical theories, that people will not behave ethically simply because it is the right thing to do, then there must be some additional incentive or motivation for people to act in an ethical manner. One obvious motivation is the fear of sanction or punishment that can come with non-compliance (Austin's theory discussed in Chapter 1). No CPA would reasonably do something that he knew could result in the loss of his license to practice because such action would threaten the person's livelihood. But there are other reasons that the CPA should be concerned about following ethical rules. First, being ethical is the right thing to do. Second, being ethical will often lead to greater professional success.

In the ideal world, ethical rules governing CPAs are available as guideposts, tools to turn to when one is faced with a predicament and is trying to determine the best, most ethical course of action. For example, if John, a CPA, has a client, Company Y, that offers John a bonus if he will agree not to report all of Company Y's income, John might be faced with a predicament. John might ask: "Who does it really hurt if we underreport our income and pay less corporate tax?" At the same time, John might need the extra money being offered by Company Y so that his son can get a potentially life-saving operation. It would certainly be tempting for anyone in John's position to take the money. In making his decision, John must carefully examine the true consequences of taking the money. There is little doubt that to accept the payment in return for signing a knowingly false return violates the professional rules of ethics (the specific rules are the subject of later chapters). But what else might motivate John to reject the payment?

If John is willing to accept payment in exchange for signing a false return, this means that there are probably other CPAs who would be willing to do the same thing. Once John does it the first time, it becomes easier for him to do it again. The more frequently CPAs are willing to sign false returns, the less value there is in having the return signed. Why? The tendency to rely on the signature as an affirmation of its truthfulness is diminished. Once enough people feel that the accuracy of a return cannot be relied on, the return will in fact have little practical value. In the absence of value, few people will be willing to pay for the preparation of the return. By a certain point in time, there will not be enough clients to keep John in business. What started out as a decision to lie on one return for an ostensibly good motive leads to the loss of his business.

Does it matter that John's decision not to sign the false return is motivated by a fear of sanction for violation of the professional rule of ethics? Certainly it is easy to say in the abstract that it would be better if John's decision not to sign the false return were motivated by his desire to do the right thing. And there will always be some people whose motivation in following the ethical rules is an altruistic desire to do the right thing rather than a fear of sanction. People who blindly adhere to the rules out of fear of sanction may indeed be ethical accountants, but on some level, there will always be those who decide to break the rules if they think they can get away with it. Therefore, in the ideal world accountants will follow ethical rules out of a desire to be an ethical accountant. And in the long run, the profession is benefited by such motivation because it will generally mean that less time is spent on policing professional conduct. In the long run, the profession also wins because the public recognizes CPAs as ethical people and is more likely to engage their services.

Ethical rules governing CPAs and other professionals therefore have a joint purpose. On the one hand, as we said earlier, the rules protect consumers. This is true regardless of what motivates the individual CPA to follow them. The rules also help to promote the profession by providing a consistency in the way that problems are approached. But since not all problems or predicaments are predictable, and therefore there is no rule to govern every potential contingency, the truly ethical accountant is one who understands the value of the rules and the basis behind them. That accountant is therefore better situated to determine the ethical course of action when faced with a difficult situation. The most important reason for CPAs to follow professional ethics is simply to behave in the most ethical manner.

CHAPTER 2 – REVIEW QUESTIONS

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

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. What is the most important reason CPAs should follow professional ethics:
 - a) to avoid monetary sanctions
 - b) to avoid losing one's license
 - c) to make the most money
 - d) to behave in the most ethical way

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The professional ethics rules do not have monetary sanctions.
B: Incorrect. The board of accountancy is the only entity with the authority to revoke one's license.
C: Incorrect. Making money is not the most important reason to act ethically.
D: Correct. Following professional ethics rules will guide the CPA to behave in the most ethical way.

(See page 2-2 of the course material.)

CHAPTER 3: THE CODE OF PROFESSIONAL CONDUCT

Objectives: After completing this chapter, you will be able to:

- List the six guiding principles in the AICPA Code of Professional Conduct.
- Explain the difference between the principles and the rules.
- Discuss how to apply the rules to specific actions common to the CPA community.

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.

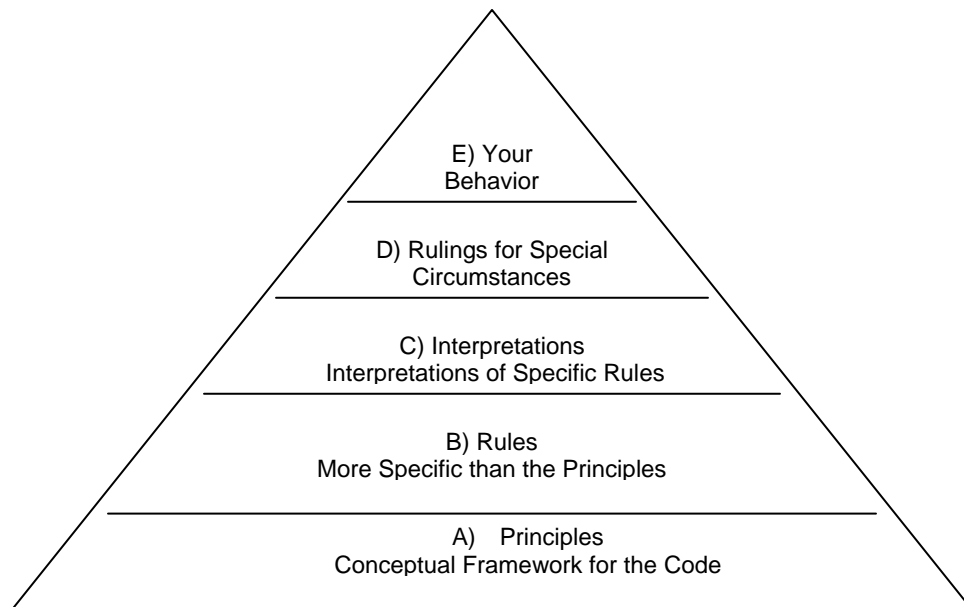
A member of the AICPA also must be aware of Interpretations of the AICPA Rules of Conduct. After public exposure, Interpretations of the AICPA Rules of Conduct are published by the Executive Committee of the Professional Ethics Division. Interpretations are not intended to limit the scope or application 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: Why do I care about the AICPA rules if I am not a member of the AICPA?

Answer: 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 AICPA SEC Practice Section (SECPS) if the member's firm is a member of the SECPS, 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.*

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.

PRINCIPLES

The Principles of the Code of Professional Conduct:

I. Responsibilities

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

II. 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.

III. Integrity

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

IV. 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.

V. 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.

VI. 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.

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 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 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 while holding out as a CPA.

Below is a listing of the applicable rules followed by a discussion of each rule:

Rule 101	Independence
Rule 102	Integrity and Objectivity
Rule 201	General Standards
Rule 202	Compliance with Standards
Rule 203	Accounting Principles
Rule 301	Confidential Client Information
Rule 302	Contingent Fees
Rule 501	Acts Discreditable
Rule 502	Advertising and Other Forms of Solicitation
Rule 503	Commissions and Referral Fees
Rule 505	Form of Organization and Name

Rule 101 - Independence

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

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.

Rule 101 is applicable to all professional services provided by a CPA that require independence.

OBSERVATION: *A CPA may conduct a compilation engagement when he or she is not independent, but the compilation report must be modified to disclose the lack of independence.*

Rule 102 - Integrity and Objectivity

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 102 is very broad on purpose. The Code of Professional Conduct could not possibly proscribe every action that is to be avoided. Thus, Rule 102 could cover a variety of misconduct.

Rule 201 - General Standards

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 (ET 201.01).

Rule 201 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.

Rule 202 - Compliance with Standards

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

Rule 202 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.*

Rule 203 - Accounting Principles

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 have 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, and FASAB as bodies to promulgate accounting principles. In addition, several AICPA committees have been designated to promulgate standards in their respective subject areas.*

Rule 203 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.

Rule 301 - Confidential Client Information

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

This rule shall not be construed (1) to relieve a member of his or her professional obligations under Rules 202 and 203, (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 the 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.

NOTE: An auditor should have access to a variety of information held by the client if the engagement is to be successful. The client will grant the auditor access to sensitive files and reports only if it can expect the auditor to hold the information in confidence. The purpose of Rule 301 is to encourage a free flow of information from the client to the CPA; however, the rule makes it clear that the principle of confidentiality is not absolute. The confidentiality concept does not allow the client to omit information that is required by generally accepted accounting principles. SAS-32 (Adequacy of Disclosure in Financial Statements) reinforces this position by stating that if a client omits information that is required by GAAP, a qualified or adverse opinion must be expressed. On the other hand, SAS-32 does note that an auditor ordinarily should not make available information that is not required to be disclosed to comply with GAAP.

Rule 301 recognizes the confidentiality of client information, but makes it clear that the information does not constitute privileged communication. In most states, and most federal courts, the CPA can be forced to testify in a case involving the client. Thus, the rule recognizes that an auditor must respond to a subpoena or summons.

In recent years, the concept of peer review has been accepted by the profession. Rule 301 allows a peer or quality review of a CPA's professional practice as part of an AICPA or state society of CPAs program.

Finally, Rule 301 states that it is not a violation of confidentiality when a member initiates a complaint with or responds to inquiries from a recognized investigative or disciplinary body such as the AICPA's Professional Ethics Division or Trial Board.

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

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 (Windows NT/2000/XP or Linux), 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.

Although Microsoft provides a form of encryption through Windows Encrypted File Service (EFS), that encryption is keyed to your user login. If the intruder is able to login as "you," he or she has access to your data even if it is encrypted with EFS.

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, zip drives, and CDs are excellent choices for backing up your files. You can even use your digital music player to back up your data; these players don't just copy music files, they can copy any data. Players are easily hooked up to a laptop through the USB port and have up to 20-gigabyte hard drives.

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 301, 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 AICPA's rules on Professional Ethics and Conduct. In 2004, the AICPA adopted revised ethics rulings to address these concerns.

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

Rule 302 - Contingent Fees

A member in public practice shall not:

1. 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:
 - 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; or
2. Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.

The prohibition in (1) above applies during the period in which the member or the 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.

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 the 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.

A member's fees may vary depending 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.

Before 1991, Rule 302 prohibited contingent fees for all professional engagements (with the exception of certain fees fixed by the judicial or quasi-judicial process). In 1985, The Federal Trade Commission (FTC) challenged the position of the profession concerning contingent fees on the basis of restraint of trade. After prolonged negotiations between the AICPA and the FTC, Rule 301 (as reproduced above) was issued to modify the prior prohibition against contingent fees.

Rule 302 prohibits contingent fees for all additional professional services when the CPA has performed an attestation engagement, which includes audits, reviews, and examinations of prospective financial information. Also, the CPA may not perform any services for a client on a contingent fee basis when the CPA has performed a compilation engagement if the compilation report is expected to be used by a third party and does not disclose that the CPA is not independent with respect to the client.

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, 2001, and the date of the auditor's report is March 12, 2002, no services could be performed on a contingent fee basis by the auditor for the period from January 1, 2001, through March 12, 2002.

Rule 302 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.

Rule 501 - Acts Discreditable

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

NOTE: Rule 501 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.

Rule 502 - Advertising and Other Forms of Solicitation

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, overreaching, or harassing conduct is prohibited.

OBSERVATION: *Members who are not in public practice are exempt from much of Rule 502.*

Rule 503 - Commissions and Referral Fees

A. 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 the 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.

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.

B. 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.

C. 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.

OBSERVATION: *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 violate Rule 101 (Independence).*

OBSERVATION: *As with contingent fees, the most important point for CPAs in public practice to remember is that the Boards of Accountancy may continue to prohibit commissions. Change is coming. However, the practitioner should not violate the law in anticipation of change.*

OBSERVATION: *The 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 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.*

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.

Rule 504 - Incompatible Occupations (Withdrawn)

The concept of incompatible occupations now is covered by Rule 101 (Independence).

Rule 505 - Form of Organization and Name

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

A member shall not practice public accounting under a firm name that is misleading. Names of one or more past owners may be included in the firm name of a successor organization.

NOTE: Also, an owner surviving the death or withdrawal of all other owners may continue to practice under a name which includes the name of past owners for up to two years after becoming a sole practitioner.

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

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. However, because of the rules adopted by the AICPA, a nontraditional professional, no matter how competent or important to the firm, could not be an owner of the firm. These rules changed about ten years ago, and the updated rules follow.

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.

CHAPTER 3 – REVIEW QUESTIONS

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

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. Why does this ethics course examine the AICPA Code of Professional Conduct when membership in the AICPA is voluntary:
 - a) although membership in the AICPA is voluntary, federal law requires that all CPAs adhere to the AICPA Code of Professional Conduct
 - b) most state boards of accountancy pattern their laws and regulations after the AICPA Code or refer to it
 - c) membership in the AICPA is not voluntary; membership is required for all CPAs and firms doing attest work
 - d) most state CPA societies pattern their code of conduct after the AICPA Code, and most states require their licensees belong to their state CPA Society

2. The fundamental theme of the six principles of the Code of Professional Conduct is:
 - a) to be committed to honorable behavior
 - b) to sacrifice personal advantage
 - c) to be committed to honorable behavior, even at the sacrifice of personal advantage
 - d) to make the most money possible in the shortest possible time without violating any laws or standards of decency

3. Which of the following is true regarding Rule 102 – Integrity and Objectivity:
 - a) Rule 102 is very broad on purpose
 - b) Rule 102 provides a “safe harbor” against allegations of possible violations provided a CPA is following the orders of one’s boss or another superior
 - c) Rule 102 provides a very long list of prohibited actions, but the list does not include every possible instance of possible violations
 - d) Rule 102 only applies to CPAs doing attest engagements

4. AICPA Rule 201 requires that a CPA be competent. Nash, CPA seeks to provide services to a new client in an industry that he has not previously served. Which of the following is true regarding Nash, CPA providing services to this client:
- a) Rule 201 requires that Nash, CPA have sufficient professional competence prior to accepting any engagement
 - b) Rule 201 would not apply in this case since Nash is a CPA. Rule 201 only applies to non-CPA subordinates
 - c) Rule 201 allows Nash, CPA to accept the engagement as long as it can be completed competently
 - d) Rule 201 would require Nash, CPA to engage the services of an expert in that industry prior to accepting the engagement but would not require that Nash, CPA be competent in that area

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Membership in the AICPA is voluntary. Federal law does not explicitly state that CPAs must follow the AICPA Code of Professional Conduct.

B: Correct. Most state boards of accountancy pattern their regulations on the AICPA Code of Professional Conduct and then address specific instances where their regulations differ.

C: Incorrect. Membership in the AICPA and state CPA societies is voluntary.

D: Incorrect. Most state CPA societies pattern their code of conduct after the AICPA Code, but state CPA society membership is voluntary.

(See page 3-1 in the course material.)

2. A: Incorrect. Being committed to honorable behavior is only a part of the fundamental theme.

B: Incorrect. Personal sacrifice is only a part of the fundamental theme.

C: Correct. Both honorable behavior and personal sacrifice together comprise the fundamental theme.

D: Incorrect. Making money is not part of the fundamental theme.

(See the discussion of the Six Principles in the course material.)

3. **A: Correct.** The AICPA Code of Professional Conduct could not possibly list every possible violation.

B: Incorrect. Rule 102 specifies that a CPA must not subordinate his or her judgment to others. There is no “safe harbor.”

C: Incorrect. The AICPA Code of Professional Conduct could not possibly list every possible violation and therefore does not even begin to list possible violations.

D: Incorrect. Rule 102 applies to all CPAs. CPAs in industry must not subordinate their judgment to others.

(See Rule 102 in the course material.)

4. A: Incorrect. A CPA should undertake only those engagements that the firm reasonably expects can be completed competently. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate.

B: Incorrect. Rule 201 clearly applies to all CPAs.

C: Correct. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate.

D: Incorrect. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate. Nash, CPA is ultimately responsible to ensure that competence is attained.

(See Rule 201 in the course material.)

CHAPTER 4: UNDERSTANDING THE CODE OF PROFESSIONAL CONDUCT

Objectives: After completing this chapter, you will be able to:

- Discuss how rule interpretations apply to the rules themselves.
- Discuss the interpretations as they apply to your practice as a CPA.
- Discuss how you would apply the interpretations in a variety of specific circumstances.
- Describe the difference between principles, rules, and interpretations.

Introduction

The previous chapter outlined the Code of Professional Conduct as set forth by the AICPA. This chapter will assist in applying these Codes to the accounting profession. The Interpretations detailed in this chapter are issued by the AICPA to better explain the Code of Professional Conduct. This material should help illustrate how the codes relate to professional responsibility. The term “covered member” is used throughout the Interpretations. Since all states require a CPA to follow AICPA regulations (or state regulations that are similar), covered member in essence refers to all CPAs, as well as non-CPA owners of CPA firms.

Independence, Integrity, Objectivity

- Independence encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the CPA's report. The CPA must be free from any obligation to or interest in the client, its management, or its owners.
- Integrity requires the CPA to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. A CPA has a dual responsibility – to the public and to the client.
- Objectivity is a state of mind and a quality that lends value to a CPA's services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

AICPA Interpretations of Rules 101 and 102

RULE 101 - INDEPENDENCE

Interpretation 101-1 (Interpretation of Rule 101) Whereas Rule 101 establishes the broad principle that a CPA must be independent (independence in fact), this Interpretation provides more specific guidelines concerning the types of relationships that a CPA should avoid. Independence is considered to be impaired if:

A. During the period of a professional engagement a covered member:

1. Had or was committed to acquire any direct or material indirect financial interest in the client.
 2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client, and
 - i) The covered member (individually or with others) had the authority to make investment decisions for the trust or estate; or
 - ii) The trust or estate owned or was committed to acquire more than 10 percent of the client's outstanding equity securities or other ownership interests; or
 - iii) The value of the trust's or estate's holdings in the client exceeded 10 percent of the total assets of the trust or estate.
 3. Had a joint closely held investment that was material to the covered member.
 4. Except as specifically permitted in Interpretation 101-5, had any loan to or from the client, or any officer or director of the client, or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests.
- B. During the period of the professional engagement, a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than five percent of a client's outstanding equity securities or other ownership interests.
- C. During the period covered by the financial statements or during the period of the professional engagement, a partner or professional employee of the firm was simultaneously associated with the client as a(n):
1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;
 2. Promoter, underwriter, or voting trustee; or
 3. Trustee for any pension or profit-sharing trust of the client.

Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client

An individual who was formerly (i) employed by a client or (ii) associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm's independence if the individual:

1. Participated on the attest engagement team or was an individual in a position to influence the attest engagement for the client when the attest engagement covers any period that includes his or her former employment or association with that client; or

2. Was otherwise a covered member with respect to the client unless the individual first dissociates from the client by:
 - a. Terminating any relationships with the client described in Interpretation 101-1C;
 - b. Disposing of any direct or material indirect financial interest in the client;
 - c. Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation 101-5;
 - d. Ceasing to participate¹ in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis; and
 - e. Liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty² significant to the benefits is imposed upon liquidation or transfer.

Application of the Independence Rules to a Covered Member's Immediate Family

Except as stated in the following paragraph, a covered member's immediate family is subject to Rule 101 and its interpretations and rulings.

The exceptions are that independence would not be considered to be impaired solely as a result of the following:

1. An individual in a covered member's immediate family was employed by the client in a position other than a key position;
2. In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is a client, is sponsored by a client, or that invests in a client (provided such plan is normally offered to all employees in similar positions):
 - a. A partner or manager who provides ten or more hours of non-attest services to the client; or
 - b. Any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement.

For purposes of determining materiality under Rule 101, the financial interests of the covered member and his or her immediate family should be aggregated.

OBSERVATION: *At this point, you may believe the independence rules are very complex. You may wish to skim the independence rules, paying particular attention to the observations presented throughout the chapter.*

¹ See Ethics Ruling No. 107, "Participation in Health and Welfare Plan of Client," for instances in which participation was the result of permitted employment of the individual's spouse or spousal equivalent.

² A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed or market losses that may be incurred as a result of the liquidation or transfer.

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

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.

Grandfathered Employment Relationships

Employment relationships of a covered member's immediate family and close relatives with an existing attest client that impair independence under the interpretation and that existed as of November 2001, will not be deemed to impair independence provided such relationships were permitted under preexisting requirements of Rule 101 and its interpretations and rulings.

Other Considerations

It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. In the absence of an independence interpretation or ruling under Rule 101 that addresses a particular circumstance, a member should evaluate whether that circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence. When making that evaluation, members should refer to the risk-

based approach described in the Conceptual Framework for AICPA Independence Standards. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented.³

Interpretation 101-6 (The Effect of Actual or Threatened Litigation on Independence) In some circumstances, independence may be considered to be impaired as a result of litigation or the expressed intention to commence litigation as discussed below.

Litigation Between Client and Member

The relationship between the management of the client and a covered member must be characterized by complete candor and full disclosure regarding all aspects of the client's business operations. In addition, there must be an absence of bias on the part of the covered member so that he or she can exercise professional judgment on the financial reporting decisions made by the management. When the present management of a client company commences, or expresses an intention to commence, legal action against a covered member, the covered member and the client's management may be placed in adversarial positions in which the management's willingness to make complete disclosures and the covered member's objectivity may be affected by self-interest.

For the reasons outlined above, independence may be impaired whenever the covered member and the covered member's client or its management are in threatened or actual positions of material adverse interests by reason of threatened or actual litigation. Because of the complexity and diversity of the situations of adverse interests which may arise, however, it is difficult to prescribe precise points at which independence may be impaired. The following criteria are offered as guidelines:

1. The commencement of litigation by the present management alleging deficiencies in audit work for the client would be considered to impair independence.
2. The commencement of litigation by the covered member against the present management alleging management fraud or deceit would be considered to impair independence.
3. An expressed intention by the present management to commence litigation against the covered member alleging deficiencies in audit work for the client would be considered to impair independence if the auditor concludes that it is probable that such a claim will be filed.

³ A failure to prepare the required documentation would be considered a violation of Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct. Independence would not be considered to be impaired provided the member can demonstrate that he or she did apply safeguards to eliminate unacceptable threats or reduce them to an acceptable level. [Footnote added, effective April 30, 2006, by the Professional Ethics Executive Committee.]

4. Litigation not related to performance of an attest engagement for the client (whether threatened or actual) for an amount not material to the covered member's firm⁴ or to the client company⁵ would not generally be considered to affect the relationship in such a way as to impair independence. Such claims may arise, for example, out of disputes as to billings for services, results of tax or management services advice or similar matters.

Litigation by Security Holders

A covered member may also become involved in litigation ("primary litigation") in which the covered member and the client or its management are defendants. Such litigation may arise, for example, when one or more stockholders bring a stockholders' derivative action or a so-called "class action" against the client or its management, its officers, directors, underwriters and covered members under the securities laws. Such primary litigation in itself would not alter fundamental relationships between the client or its management and the covered member and therefore would not be deemed to have an adverse impact on independence. These situations should be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies or if the covered member alleges fraud or deceit by the present management as a defense. In assessing the extent to which independence may be impaired under these conditions, the covered member should consider the following additional guidelines:

1. The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the covered member's firm⁶ or to the client.
2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.
3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

⁴ Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

⁵ Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

⁶ Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

Other Third-Party Litigation

Another type of third-party litigation against the covered member may be commenced by a lending institution, other creditor, security holder, or insurance company who alleges reliance on financial statements of the client with which the covered member is associated as a basis for extending credit or insurance coverage to the client. In some instances, an insurance company may commence litigation (under subrogation rights) against the covered member in the name of the client to recover losses reimbursed to the client. These types of litigation would not normally affect independence with respect to a client who is either not the plaintiff or is only the nominal plaintiff, since the relationship between the covered member and client management would not be affected. They should be examined carefully, however, since the potential for adverse interests may exist if the covered member alleges, in his defense, fraud, or deceit by the present management.

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member (“the plaintiff client”), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member’s firm⁷ or to the plaintiff client.

Effects of Impairment of Independence

If the covered member believes that the circumstances would lead a reasonable person having knowledge of the facts to conclude that the actual or intended litigation poses an unacceptable threat to independence, the covered member should either: a) disengage himself or herself; or b) disclaim an opinion because of lack of independence. Such disengagement may take the form of resignation or cessation of any attest engagement then in progress pending resolution of the issue between the parties.

Termination of Impairment

The conditions giving rise to a lack of independence are generally eliminated when a final resolution is reached and the matters at issue no longer affect the relationship between the covered member and client. The covered member should carefully review the conditions of such resolution to determine that all impairments to the covered member’s objectivity have been removed.

⁷ Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

RULE 102 – INTEGRITY AND OBJECTIVITY

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.*

Interpretation 102-1 (Knowing Misrepresentations in the Preparation of Financial Statements or Records) A member shall be considered to have knowingly misrepresented facts in violation of Rule 102 when he or she knowingly:

- a. Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records; or
- b. Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry; or
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Interpretation 102-2 (Conflicts 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. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, *Confidential Client Information*.

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under Rule 101, 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.

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 Rule 301: Confidential Client Information.

Interpretation 102-3 (Obligations of a Member to His or Her Employer's External Accountant) Under Rule 102, a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her 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 his or her employer's external accountant requests written representation.

Interpretation 102-4 (Subordination of Judgment by a Member) Rule 102 prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment:

1. The member should consider whether (a) the entry or the failure to record a transaction in the records, or (b) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.

2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.
3. If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.
4. The member should at all times be cognizant of his or her obligations under Interpretation 102-3.

OBSERVATION: *In an audit engagement, guidance established by SAS No. 108 (Planning and Supervision) with respect to the subordination of judgment should be observed.*

Q: Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended March 31, 2005, 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.

Interpretation 102-5 (Applicability of Rule 102 to Members Performing Educational Services) Educational services (for example, teaching full- or part-time at a university, teaching a continuing professional education course, or engaging in research and scholarship) are professional services as defined in ET section 92.11 and are therefore subject to Rule 102. Rule 102 provides that the 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.

Interpretation 102-6 (Professional Services Involving Client Advocacy) A member or a member's firm may be requested by a client—

1. To perform tax or consulting services engagements that involve acting as an advocate for the client.
2. To act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

Services provided or actions taken pursuant to such types of client requests are professional services governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, General Standards, Rule 202, Compliance With Standards, and Rule 203, Accounting Principles, and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with Rule 102, which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with Rule 101 of the Code of Professional Conduct.

Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.

AICPA Interpretations of Rules 201 and 203

RULE 201 – GENERAL STANDARDS

Interpretation 201-1 (Competence) A member's agreement to perform professional services implies that the member has the necessary competence to complete those professional services according to professional standards, applying his or her knowledge and skill with reasonable care and diligence, but the member does not assume a responsibility for infallibility of knowledge or judgment.

Competence to perform professional services involves both the technical qualifications of the member and the member's staff and the ability to supervise and evaluate the quality of the work performed. Competence relates both to knowledge of the profession's standards, techniques and the technical subject matter involved, and to the capability to exercise sound judgment in applying such knowledge in the performance of professional services.

The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. In some cases, however, additional research or consultation with others may be necessary during the performance of the professional services. This does not ordinarily represent a lack of competence, but rather is a normal part of the performance of professional services.

However, if a member is unable to gain sufficient competence through these means, the member should suggest, in fairness to the client and the public, the engagement of someone competent to perform the needed professional service, either independently or as an associate.

OBSERVATION: *If a CPA is unable to obtain sufficient technical knowledge, he should refer the engagement to someone competent to perform the needed services.*

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 Rule 201 – General Standards.

RULE 203 – ACCOUNTING PRINCIPLES

Interpretation 203-1 (Departures from Established Accounting Principles) Rule 203 was adopted to require compliance with accounting principles promulgated by the body designated by Council to establish such principles. There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.

However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.

The question of what constitutes unusual circumstances as referred to in Rule 203 is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle would be regarded generally by reasonable men as producing a misleading result.

Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances which would not ordinarily be regarded as unusual in the context of Rule 203.

Interpretation 203-2 (Status of FASB, GASB and FASAB Interpretations) Council is authorized under Rule 203 to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Statements of Financial Accounting Standards, together with those Accounting Research Bulletins and APB Opinions which are not superseded by action of the FASB, constitute accounting principles as contemplated in Rule 203. Council has also designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203. Council has also designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities to Rule 203.

In determining the existence of a departure from an accounting principle established by a Statement of Financial Accounting Standards, Accounting Research Bulletin or APB Opinion encompassed by Rule 203, or the existence of a departure from an accounting principle established by a Statement of Governmental Accounting Standards or a Statement of Federal Accounting Standards encompassed by Rule 203, the division of professional ethics will construe such Statements, Bulletin or Opinion in the light of any interpretations thereof issued by the FASB or the GASB.

Interpretation 203-4 (Responsibility of Employees for Preparation of Financial Statements in Conformity with GAAP) Rule 203 provides, in part, that a member shall not state affirmatively that financial statements or other financial data of an entity are presented in conformity with generally accepted accounting principles (GAAP) if such statements or data contain any departure from an accounting principle promulgated by a body designated by Council to establish such principles that has a material effect on the statements or data taken as a whole.

Rule 203 applies to all members with respect to any affirmation that financial statements or other financial data are presented in conformity with GAAP. Representation regarding GAAP conformity included in a letter or other communication from a client entity to its auditor or others related to that entity's financial statements is subject to Rule 203 and may be considered an affirmative statement within the meaning of the rule with respect to members who signed the letter or other communication; for example, signing reports to regulatory authorities, creditors and auditors.

AICPA Interpretations of Rules 301 and 302

RULE 301 – CONFIDENTIAL CLIENT INFORMATION

Interpretation 301-3 (Confidential Information and the Purchase, Sale, or Merger of a Practice) Rule 301 prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client. The rule provides that it shall not be construed to prohibit the review of a member's professional practice under AICPA or state CPA society authorization.

For purposes of Rule 301, a review of a member's professional practice is hereby authorized to include a review in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice. The member must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information.

Members reviewing a practice in connection with a prospective purchase or merger shall not use to their advantage nor disclose any member's confidential client information that comes to their attention.

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.

RULE 302 – CONTINGENT FEES

Interpretation 302-1 (Contingent Fees in Tax Matters) This interpretation defines certain terms in Rule 302 and provides examples of the application of the rule.

Definition of Terms

(a) Preparation of an original or amended tax return or claim for tax refund includes giving advice on events which have occurred at the time the advice is given if such advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a return or claim for refund.

(b) A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member's client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns.

Examples

The following are examples, not all-inclusive, of circumstances where a contingent fee would be permitted:

1. Representing a client in an examination by a revenue agent of the client's federal or state income tax return.

2. Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.
3. Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation (\$1 million at March 1991) or state taxing authority.
4. Requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests.
5. Requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority review process for hearing all taxpayer arguments relating to assessed value.
6. Representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

The following is an example of a circumstance where a contingent fee would not be permitted:

- Preparing an amended federal or state income tax return for a client claiming a refund of taxes because a deduction was inadvertently omitted from the return originally filed. There is no question as to the propriety of the deduction; rather the claim is filed to correct an omission.

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.

OBSERVATION: *There are currently no rules in the 400 series.*

AICPA Interpretations of Rules 501, 502 and 505

RULE 501 – ACTS DISCREDITABLE

Interpretation 501-1 (Response to Requests by Clients and Former Clients for Records)

Terminology

The following terms are defined below solely for use with this Interpretation:

- *Client provided records* are accounting or other records belonging to the client that were provided to the member by or on behalf of the client.
- *Client records prepared by the member* are accounting or other records (for example, tax returns, general ledgers, subsidiary journals, and supporting schedules such as detailed employee payroll records and depreciation schedules) that the member was engaged to prepare for the client.
- *Supporting records* are information not reflected in the client's books and records that are otherwise not available to the client with the result that the client's financial information is incomplete. For example, supporting records include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) that are produced by the member during an engagement (for example, an audit).
- *Member's working papers* include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member.

Interpretation

When a client or former client (client) makes a request for client-provided records, client records prepared by the member, or supporting records that are in the custody or control of the member or the member's firm (member) that have not previously been provided to the client, the member should respond to the client's request as follows:⁸

- *Client provided records* in the member's custody or control should be returned to the client.
- *Client records prepared by the member* should be provided to the client, except that client records prepared by the member may be withheld if the preparation of such records is not complete or there are fees due the member for the engagement to prepare those records.
- *Supporting records* relating to a completed and issued work product should be provided to the client, except that such supporting records may be withheld if there are fees due to the member for the specific work product.

Once the member has complied with these requirements, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such records.

⁸ The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.

Member's working papers are the member's property and need not be provided to the client under provisions of this interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

In connection with any request for client-provided records, client records prepared by the member, or supporting records, the member may:

- Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client;
- Provide the requested records in any format usable by the client;⁹ and
- Make and retain copies of any records returned or provided to the client.

Where a member is required to return or provide records to the client, the member should comply with the client's request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that the statutes of the state in which the member practices grants the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation. In addition, certain states have laws and regulations that impose obligations on the member greater than the provisions of this interpretation and should be complied with.

Interpretation 501-2 (Discrimination in Employment Practices) Whenever a member is finally determined by a court of competent jurisdiction to have violated any of the antidiscrimination laws of the United States or any state or municipality thereof, including those related to sexual and other forms of harassment, or has waived or lost his/her right of appeal after a hearing by an administrative agency, the member will be presumed to have committed an act discreditable to the profession in violation of Rule 501.

OBSERVATION: *These acts are also a violation of federal and state law.*

Interpretation 501-3 (Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits) Engagements for audits of government grants, government units or other recipients of government monies typically require that such audits be in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards. If a member has accepted such an engagement and undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules and regulations, in addition to generally accepted auditing standards, he is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of Rule 501, unless the member discloses in his report the fact that such requirements were not followed and the reasons therefore.

⁹ The member is not required to convert records that are not in electronic format. However, if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client's request should be honored.

Interpretation 501-4 (Negligence in the Preparation of Financial Statements or Records) A member shall be considered to have committed an act discreditable to the profession in violation of Rule 501 when, by virtue of his or her negligence, such member –

- a. Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity; or
- b. Fails to correct an entity's financial statements that are materially false and misleading when the member has the authority to record an entry; or
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Interpretation 501-5 (Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies) Many governmental bodies, commissions or other regulatory agencies have established requirements such as audit standards, guides, rules, and regulations that members are required to follow in the preparation of financial statements or related information, or in performing attest or similar services for entities subject to their jurisdiction. For example, the Securities and Exchange Commission, Federal Communications Commission, state insurance commissions, and other regulatory agencies, such as the Public Company Accounting Oversight Board, have established such requirements.

If a member prepares financial statements or related information (for example, management's discussion and analysis) for purposes of reporting to such bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to generally accepted accounting principles. If a member agrees to perform an attest or similar service for the purpose of reporting to such bodies, commissions, or regulatory agencies, the member should follow such requirements, in addition to generally accepted auditing standards (where applicable). A material departure from such requirements is an act discreditable to the profession, unless the member discloses in the financial statements or his or her report, as applicable, that such requirements were not followed and the reasons therefore.

Case Study
Acts Discreditable

According to the Department of Labor, most SIMPLE IRA plans are also subject to Title I of ERISA. Under the Department of Labor regulations at 29 CFR 2510.3-102, salary reduction contributions to these plans must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described above.

A CPA firm was required to make contributions to the financial institution that managed the CPA firm's employee SIMPLE IRA plan no later than the close of the 30 day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The CPA firm informed employees that SIMPLE IRA funds would not be deposited by the date required. For a period of two years, the CPA firm did not make timely contributions to the financial institution managing the SIMPLE IRA plan. When the CPA firm deposited the funds, the CPA firm also deposited interest into each employee's SIMPLE IRA plan.

Interpretation 501-6 (Solicitation or Disclosure of CPA Examination Questions and Answers) A member who solicits or knowingly discloses the May 1996 or later Uniform CPA Examination question(s) and/or answer(s) without the written authorization of the AICPA shall be considered to have committed an act discreditable to the profession in violation of Rule 501.

OBSERVATION: *Prior to May 1996, exam questions were released after each exam. Accordingly, the prohibition does not apply to exam review courses utilizing pre-1996 exam questions.*

Interpretation 501-7 (Failure to File Tax Return or Pay Tax Liability) A member who fails to comply with applicable federal, state, or local laws or regulations regarding the timely filing of his or her personal tax returns or tax returns of the member's firm, or the timely remittance of all payroll and other taxes collected on behalf of others, may be considered to have committed an act discreditable to the profession in violation of Rule 501.

Interpretation 501-8 (Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services) Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or that provide that the existence of such provisions causes a member to be disqualified from providing such services to these entities. For example, federal banking regulators, state insurance commissions, and the Securities and Exchange Commission have established such requirements.

If a member enters into, or directs or knowingly permits another individual to enter into, a contract for the performance of audit or other attest services that are subject to the requirements of these regulators, the member should not include, or knowingly permit or direct another individual to include, an indemnification or limitation of liability provision that would cause the regulated entity or a member to be in violation of such requirements or that would cause a member to be disqualified from providing such services to the regulated entity. A member who enters into, or directs or knowingly permits another individual to enter into, such an agreement for the performance of audit or other attest services that would cause the regulated entity or a member to be in violation of such requirements, or that would cause a member to be disqualified from providing such services to the regulated entity, would be considered to have committed an act discreditable to the profession.

Members should also consult Ethics Ruling No. 94, "Indemnification Clause in Engagement Letters," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* under Rule 101, *Independence* and Ethics Ruling No. 102, "Indemnification of a Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* under Rule 101, *Independence*, for guidance related to use of indemnification clauses in engagement letters and the impact on a member's independence.

RULE 502 – ADVERTISING AND OTHER FORMS OF SOLICITATION

Interpretation 502-2 (False, Misleading or Deceptive Acts in Advertising or Solicitation) 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.

Interpretation 502-5 (Engagements Obtained Through Efforts of Third Parties)

Members are often asked to render professional services to clients or customers of third parties. Such third parties may have obtained such clients or customers as the result of their advertising and solicitation efforts.

Members are permitted to enter into such engagements. The member has the responsibility to ascertain that all promotional efforts are within the bounds of the Rules of Conduct. Such action is required because the members will receive the benefits of such efforts by third parties, and members must not do through others what they are prohibited from doing themselves by the Rules of Conduct.

RULE 505 – FORM OF ORGANIZATION AND NAME

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

A member shall not practice public accounting under a firm name that is misleading. Names of one or more past owners may be included in the firm name of a successor organization.

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

Firm Names

No firm title need name every owner. Such a requirement could become unworkable. The firm may use the names of all or some of the owners. Or the firm may follow the name of one or more owners with designations “Company”, “and Company”, or “associates.” Thus, the firm “Howard, Fine and Howard” could choose instead to describe itself (among other possibilities) as “The Mo Howard Company,” “Mo Howard and Company,” “Howard, Fine and Associates,” or “Fine, Howard and Company.”

The firm name is a valuable asset, protected by law; it represents the professional competence and reliability of each member of the firm, whether the member’s own name is included in the title or not. No wonder the firm is slow to change it – even when individual owners die, retire or strike out on their own.

Rule 505 acknowledges this concern for continuity:

Names of one or more past owners may be included in the firm name of a successor organization. Also, an owner surviving the death or withdrawal of all other owners may continue to practice under a name which includes the name of past owners for up to two years after becoming a sole proprietor.

Fictitious Names

The rules over the years have historically prohibited the use of fictitious names or names that indicated a specialty.

It was felt that the rule regarding firm name should be consistent with the rule on advertising. The only restriction now left on advertising is that it not be false, misleading or deceptive. Since a member may now advertise a specialty, there is no reason a firm name should not be allowed to do so if the false, misleading, or deceptive test is met.

Q: Three CPA firms wish to form an association – not a partnership – to be known as “Smith, Jones 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.

Interpretation 505-1 Deleted.

Interpretation 505-2 (Application of Rules of Conduct to Members Who Own a Separate Business)

A member in the practice of public accounting may own an interest in a separate business that performs for clients any of the professional services of accounting, tax, personal financial planning, litigation support services, and those services for which standards are promulgated by bodies designated by Council. If the member, individually or collectively with his or her firm or with members of his or her firm controls the separate business (as defined by generally accepted accounting principles [GAAP] in the United States of America), the entity and all its owners (including the member) and employees must comply with all of the provisions of the Code of Professional Conduct. For example, in applying Rule 503, Commissions and Referral Fees, if one or more members individually or collectively can control the separate business, such business would be subject to Rule 503, its interpretations and rulings. With respect to an attest client, Rule 101 and all its interpretations and rulings would apply to the separate business, its owners and employees.

If the member, individually or collectively with his or her firm or with members of his or her firm, does not control the separate business, the provisions of the Code would apply to the member for his or her actions but not apply to the entity, its other owners and employees. For example, the entity could enter into a contingent fee arrangement with an attest client of the member or accept commissions for the referral of products or services to such attest client.

Interpretation 505-3 (Application of Rule 505 to Alternative Practice Structures)

Rule 505, Form of Organization and Name, states, "A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council." The Council Resolution requires, among other things, that a majority of the financial interests in a firm engaged in attest services (as defined therein) be owned by CPAs. In the context of alternative practice structures (APS) in which: 1) the majority of the financial interests in the attest firm is owned by CPAs; and 2) all or substantially all of the revenues are paid to another entity in return for services and the lease of employees, equipment, and office space, questions have arisen as to the applicability of Rule 505.

The overriding focus of the Resolution is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. The Resolution contains many requirements that were developed to ensure that responsibility. In addition to the provisions of the Resolution, other requirements of the Code of Professional Conduct and bylaws ensure that responsibility:

- a. Compliance with all aspects of applicable state law or regulation.
- b. Enrollment in an AICPA-approved practice monitoring program.
- c. Membership in the SEC practice section if the attest work is for SEC clients (as defined by Council).
- d. Compliance with the independence rules prescribed by Rule 101, Independence.
- e. Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, Compliance With Standards) and all other provisions of the Code, including, Applicability.

Taken in the context of all the above-mentioned safeguards of the public interest, if the CPAs who own the attest firm remain financially responsible, under applicable law or regulation, the member is considered to be in compliance with the financial interests provision of the Resolution.

CHAPTER 4 – REVIEW QUESTIONS

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

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. A potential audit client is owned by the CPA's stepsister. Which of the following is true regarding Rule 101 (independence):
 - a) a stepsister is considered a close relative and would impair independence
 - b) a stepsister is not considered a relative and would never impair independence
 - c) if the CPA's relationship to the stepsister is very close, independence may be impaired
 - d) none of the above

2. A CPA represents two clients. The clients have adverse interest involving a limited partnership of which both clients own a percentage. Which of the following is true regarding Rule 102:
 - a) the CPA lacks independence and may not do any work for either of the clients
 - b) the CPA lacks independence and must cease working for one of the clients
 - c) although the CPA has a conflict of interest, he may continue working for both clients provided: 1) the work performed does not require independence, and 2) the relationships are disclosed to and consent is obtained from all appropriate parties
 - d) none of the above

Use the following fact pattern for the next 4 questions

Jim Smith, CPA (Smith) prepares tax returns for a large number of clients. Smith has prepared the Form 1040 and Schedule C for Joe Jones for the last ten years. Joe Jones (Jones) keeps no business records except for a profit/loss summary that Jones's wife prepares using Quicken. Smith has always calculated depreciation and made all other tax related adjustments to Jones's Quicken report to prepare Jones's Form 1040. Jones provides all the necessary documents to Smith and asks Smith to prepare Jones's current year tax return. Smith prepares Jones's current year tax return even though Jones still owes Smith fees for preparing last year's tax return as well as year-end tax planning. Smith does not use any type of client engagement letter since he only prepares tax returns.

3. Assume that Smith demands payment of all past due fees as well as payment for the current year tax return preparation prior to releasing the tax return to Jones. Which of the following is true regarding releasing the current year tax return to Jones under AICPA rules:
 - a) the AICPA does not have any rules relating to releasing client records
 - b) Smith must release the current year tax return regardless of the status of unpaid fees
 - c) Smith may withhold releasing the current year tax return pending the payment of past due fees but may not demand payment of current year fees prior to issuing the tax return
 - d) Smith may withhold releasing the current year tax return until all current and past due fees are paid

4. Jones refuses to pay any of the current or past due fees and demands a copy of all of Smith's workpapers as well as the return of all documents provided to Smith. Which of the following is true under AICPA rules:
 - a) Smith need not return any client records nor supply copies of any workpapers
 - b) Smith must return any client supplied records but need not provide copies of any workpapers
 - c) Smith must return any client supplied records and prior year depreciation records that are in Smith's prior year workpapers but not contained in the prior year tax return
 - d) Smith must return any client supplied records and copies of all workpapers

5. Jones decides to prepare his current year tax return himself. Jones does not have a copy of his prior year tax return, and a copy is not available from the IRS. Jones was due a small refund and never filed his prior year tax return and subsequently lost his copy. Jones demands that Smith provide a copy of Jones's prior year tax return and the depreciation workpapers for the current year that Smith prepared for Jones's current year tax return. Which of the following is true:
 - a) Smith is not required to provide Jones a copy of the prior year tax return or the current year depreciation workpapers
 - b) Smith must provide Jones a copy of the current year depreciation workpapers but not a copy of the prior year tax return
 - c) Smith must provide Jones a copy of the prior year tax return but not the current year depreciation work papers
 - d) Smith must provide Jones a copy of the prior year tax return and the current year depreciation workpapers

6. At this point, both Smith and Jones have spent numerous unproductive hours arguing over client records, releasing tax returns, and collecting payment. Jones has threatened to file a complaint against Smith with the AICPA. Smith has looked into filing a lawsuit in Small Claims Court against Jones. What could Smith and Jones have done to avoid this mess:
 - a) probably nothing; problems like this occur in business and are simply a fact of life
 - b) use an engagement letter to outline the obligations and expectations of both client and CPA
 - c) communicated with each other before the problem arose
 - d) both b and c would have helped

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A stepsister is not automatically considered a close relative.
B: Incorrect. A stepsister could be a close relative.
C: Correct. Independence is impaired only if the relationship is close.
D: Incorrect. Independence may be impaired.
(See Interpretation 101-1 in the course material.)

2. A: Incorrect. The clients have the adverse interest, not the CPA.
B: Incorrect. A CPA may do work for two clients with adverse interests.
C: Correct. The clients are better served by allowing the CPA to continue serving them both.
D: Incorrect. The CPA has a conflict but may continue working for both clients.
(See Interpretation 102-2 in the course material.)

3. A: Incorrect. The AICPA has extensive rules relating to CPA workpapers and the return of client records. In fact, failure to return client records is one of the most common complaints received by the AICPA ethics committee.
B: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to demand the release of the return prior to paying fees as required by the CPA.
C: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to pay only a portion of the fees and demand release of the tax return.
D: Correct. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. A completed tax return is not considered to be client records until released to the client.
(See Rule 501 and Interpretation 501-1 in the course material.)

4. A: Incorrect. Rule 501 requires the return of all client provided records upon request. Client provided records may not be withheld pending payment of current or prior engagement fees.

B: Correct. Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Note that some state laws require CPA prepared client records like depreciation records be released to the client regardless of the payment status

C: Incorrect. Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Note that some state laws require CPA prepared client records like depreciation records be released to the client regardless of the payment status. Under AICPA rules, the CPA may withhold the depreciation schedules pending payment of the fees from the engagement to prepare those records, but may not withhold the depreciation records pending payment of fees from another engagement.

D: Incorrect. Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Under AICPA rules, the CPA may withhold the depreciation schedules pending payment of the fees from the engagement to prepare those records, but may not withhold the depreciation records pending payment of fees from another engagement. Likewise, other supporting documents may be withheld pending payment of the fees related to the engagement that created the supporting documents. Under no circumstances, per AICPA Rule 501, is the CPA required to release the remainder of the CPA's workpapers. Note that some state laws require that CPA prepared client records like depreciation records and other supporting records must be released to the client regardless of the payment status of current or past due fees.

(See Interpretation 501-1 in the course material.)

5. A: Incorrect. The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return, but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation schedule is considered to be part of Smith's work product, and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

B: Incorrect. The current year depreciation is considered to be part of Smith's work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them. The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees.

C: Correct. The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation schedule is considered to be part of Smith's work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

D: Incorrect. The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation is considered to be part of Smith's work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

(See Interpretation 501-1 in the course material.)

6. A: Incorrect. Problems like this do occur, but they are not unavoidable. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both CPA and client. Also, good communication goes a long way in avoiding problems.

B: Incorrect. Although this is true, it is not the best answer. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both the CPA and client. The fact that Smith's practice is limited to preparing tax returns is not an excuse for not using an engagement letter. Although sending out a separate engagement letter might seem awkward, Smith could incorporate it into the annual client organizer that Smith sends out to clients.

C: Incorrect. Although this is true, it is not the best answer. Good communication goes a long way in avoiding problems. Jones could have disclosed the fact that his gambling problem has left him broke but that he no longer gambles and hopes to begin making payments to Smith and the many others that Jones owes debts to.

D: Correct. Using an engagement letter along with effective communication could have avoided this problem. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both CPA and client. By communicating that a gambling problem had left him broke but that he no longer gambles and hopes to begin making payments to Smith, Jones could have avoided this mess. Likewise, if Smith had communicated his displeasure in not receiving payment from Jones instead of holding the tax return hostage, Smith might have avoided this mess, helped a client, collected some of the past due debt, and saved valuable billable hours.

In addition, the CPA should consult his state board of accountancy rules regarding client records. Most states have more stringent rules requiring the unconditional release of client records prepared by the CPA and supporting records found in CPA workpapers.

(See Rule 501 in the course material.)

CHAPTER 5: ETHICS AND THE TAX PROFESSIONAL

Objectives: After completing this chapter, you will be able to:

- Discuss the Internal Revenue Service Requirements as outlined in Circular 230.
- Describe the applicable AICPA guidance on tax practice.
- Apply the AICPA standards and the IRS rules to common ethical dilemmas faced by CPAs in tax practice.

Introduction

The tax preparation and tax consulting industry has historically enjoyed less government regulation than the practice of accountancy. In most states (California being a notable exception), no professional license is required to prepare income taxes. One simply hangs out a shingle and begins business. There are currently no federal registration requirements for tax preparers. 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 proposed regulations requiring the registration of tax preparers.

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.

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. This course reprints and discusses most, but not all, of Circular 230.

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.

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 always appear on their own behalf before the IRS.
- B. Participating in rulemaking – individuals may participate in rule making.
- C. Limited practice – in a number of circumstances an individual who is not a practitioner can represent a taxpayer on a limited basis:
 - 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 may represent the corporation
 - v. A trustee, receiver, guardian, personal representative, administrator, executor, or regular full-time employee of a trust, receivership, guardianship, or estate may represent the trust, receivership, guardianship, or estate
 - vi. An individual may represent any individual or entity before personnel of the Internal Revenue Service who are outside of the United States
 - vii. An individual who prepares and signs a taxpayer’s return as the preparer, or who prepares a return but is not required (by the instructions to the return or regulations) to sign the return, may represent the taxpayer before officers and employees of the Examination Division of the Internal Revenue Service with respect to the tax liability of the taxpayer for the taxable year or period covered by that return.
- D. Preparing tax returns and furnishing information. Perhaps the most important exception applies to preparing tax returns. Any individual may prepare a tax return, appear as a witness for the taxpayer before the Internal Revenue Service, or furnish information at the request of the Service or any of its officers or employees. This is not considered practicing before the IRS.

It should be noted that signing a tax return does entail certain responsibilities as discussed later. However, preparing a tax return does not rise to the level of practicing before the IRS.

<p><i>OBSERVATION:</i> <i>None of the items above in A-D are considered to be practicing before the IRS.</i></p>

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.

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

Table of Contents (this subpart)

Section

- 10.20 Information to be furnished
- 10.21 Knowledge of client's omission
- 10.22 Diligence as to accuracy
- 10.23 Prompt disposition of pending matters
- 10.24 Assistance from disbarred or suspended persons and former Internal Revenue Service employees
- 10.25 Practice by former Government employees, their partners and their associates
- 10.26 Notaries
- 10.27 Fees
- 10.28 Return of client's records
- 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 for advising with respect to tax return positions and for preparing or signing returns
- 10.35 Requirements for covered opinions
- 10.36 Procedures to ensure compliance
- 10.37 Requirements for other written advice
- 10.38 Establishment of advisory committees

SUBPART C -- SANCTIONS FOR VIOLATION OF THE REGULATIONS

- 10.50 Sanctions
- 10.51 Incompetence and disreputable conduct
- 10.52 Violation of regulations
- 10.53 Receipt of information concerning practitioner

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 recently 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.*

(b) To the Director of the Office of Professional Responsibility.

When a proper and lawful request is made by the Director of the Office of Professional Responsibility, a practitioner must provide the Director of the Office of Professional Responsibility with any information the practitioner has concerning an inquiry by the Director of the Office of Professional Responsibility into an alleged violation of the regulations in this part by any person, and to 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.*

(c) 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, or the Director of the Office of Professional Responsibility, or his or her 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 provided in §§10.34, 10.35, 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.

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

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 Director of the Office of Professional Responsibility.

(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 on September 26, 2007.

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."

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 on September 26, 2007.

SECTION 10.31 Negotiation of taxpayer checks.

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a federal tax liability.

Practice Pointer: By completing Form 2848 "Power of Attorney and Declaration of Representative," a taxpayer may authorize their CPA to receive refund checks. However, even the power of attorney specifically forbids the CPA 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) [Reserved].

(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) [Reserved].

(f) Effective/applicability date. Section 10.34 is applicable to tax returns, documents, affidavits and other papers filed on or after September 26, 2007.

Tax Return Standards

As you can see from the sections above titled “reserved,” the IRS intends to update this section to implement the tax return preparer penalty provisions of the Small Business and Work Opportunity Tax Act of 2007 “The Act.” IRS Notice 2008-13 provides some guidance as follows:

The Act amended several provisions of the Code to extend the application of the income tax return preparer penalties to all tax return preparers, alter the standards of conduct that must be met to avoid imposition of the section 6694(a) penalty for preparing a return which reflects an understatement of liability, and increase applicable penalties under section 6694(a) and (b). The amendments made by the Act to section 6694 were effective for tax returns and claims for refund prepared after May 25, 2007 but were subsequently retroactively repealed by The Emergency Economic Stabilization Act of 2008.

As amended by the Act, section 7701(a)(36) now defines *tax return preparer* as any person that prepares for compensation a tax return or claim for refund, or a substantial portion of a tax return or claim for refund, and is no longer limited to persons who prepare income tax returns.

Section 301.7701-15 of the current Procedure and Administration Regulations defines the term *income tax preparer* to include any person who prepares for compensation all or a substantial portion of a tax return or claim for refund under Subtitle A of the Code. Operation of the current regulations brings into the preparer penalty regime a wide range of activities performed by persons who do not sign the tax return or claim for refund, who may have no knowledge of how their work is ultimately reported on the tax return or claim for refund, or who may have no knowledge of the size or complexity of the schedule, entry, or other portion of a tax return or claim for refund relative to the entire tax return.

The Act also amended section 6694(a) by raising the standards of conduct for tax return preparers. For *undisclosed positions*, the Act replaced the realistic possibility standard with a requirement that there be a reasonable belief that the tax treatment of the position would more likely than not be sustained on its merits. For *disclosed positions*, the Act replaced the nonfrivolous standard with the requirement that there be a reasonable basis for the tax treatment of the position.

SECTION 10.35 Requirements for covered opinions.

(a) A practitioner who provides a covered opinion shall comply with the standards of practice in this section.

(b) Definitions.

For purposes of this subpart –

(1) A practitioner includes any individual described in Sec. 10.2(a)(5).

(2) Covered opinion –

(i) In general

A covered opinion is written advice (including electronic communications) by a practitioner concerning one or more federal tax issues arising from:

(A) A transaction that is the same as or substantially similar to a transaction that, at the time the advice is rendered, the Internal Revenue Service has determined to be a tax avoidance transaction and identified by published guidance as a listed transaction under 26 CFR 1.6011-4(b)(2);

(B) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, the principal purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code; or

(C) Any partnership or other entity, any investment plan or arrangement, or any other plan or arrangement, a significant purpose of which is the avoidance or evasion of any tax imposed by the Internal Revenue Code if the written advice –

- (1) Is a reliance opinion;
- (2) Is a marketed opinion;
- (3) Is subject to conditions of confidentiality; or
- (4) Is subject to contractual protection.

(ii) Excluded advice

A covered opinion does not include –

(A) Written advice provided to a client during the course of an engagement if a practitioner is reasonably expected to provide subsequent written advice to the client that satisfies the requirements of this section;

(B) Written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(ii)(B) of this section (concerning the principal purpose of avoidance or evasion) that –

- (1) Concerns the qualification of a qualified plan;
- (2) Is a state or local bond opinion; or
- (3) Is included in documents required to be filed with the Securities and Exchange Commission;

(C) Written advice prepared for and provided to a taxpayer, solely for use by that taxpayer, after the taxpayer has filed a tax return with the Internal Revenue Service reflecting the tax benefits of the transaction. The preceding sentence does not apply if the practitioner knows or has reason to know that the written advice will be relied upon by the taxpayer to take a position on a tax return (including for these purposes an amended return that claims tax benefits not reported on previously filed return) filed after the date on which the advice is provided to the taxpayer;

(D) Written advice provided to an employer by a practitioner in that practitioner's capacity as an employee of that employer solely for purposes of determining the tax liability of the employer; or

(E) Written advice that does not resolve a federal tax issue in the taxpayer's favor, unless the advice reaches a conclusion favorable to the taxpayer at any confidence level (e.g., not frivolous, realistic possibility of success, reasonable basis or substantial authority) with respect to that issue. If written advice concerns more than one federal tax issue, the advice must comply with the requirements of paragraph (c) of this section with respect to any federal tax issue not described in the preceding sentence.

(3) A federal tax issue is a question concerning the federal tax treatment of an item of income, gain, loss, deduction, or credit, the existence or absence of a taxable transfer of property, or the value of property for federal tax purposes. For purposes of this subpart, a federal tax issue is significant if the Internal Revenue Service has a reasonable basis for a successful challenge and its resolution could have a significant impact, whether beneficial or adverse and under any reasonably foreseeable circumstances, on the overall federal tax treatment of the transaction(s) or matter(s) addressed in the opinion.

(4) Reliance opinion

Written advice is a reliance opinion if the advice concludes at a confidence level of at least more likely than not (a greater than 50 percent likelihood) that one or more significant federal tax issues would be resolved in the taxpayer's favor.

For purposes of this section, written advice, other than advice described in paragraph (b)(2)(1)(A) of this section (concerning listed transactions) or paragraph (b)(2)(1)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a reliance opinion if the practitioner prominently discloses in the written advice that it was not intended or written by the practitioner to be used, and that it cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Marketed opinion

(i) Written advice is a marketed opinion if the practitioner knows or has reason to know that the written advice 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 a partnership or other entity, investment plan or arrangement to one or more taxpayer(s).

(ii) For purposes of this section, written advice, other than advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions) or paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion), is not treated as a marketed opinion if the practitioner prominently discloses in the written advice that –

(A) The advice was not intended or written by the practitioner to be used, and that it cannot be used by any taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer;

(B) The advice was written to support the promotion or marketing of the transaction(s) or matter(s) addressed by the written advice; and

(C) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(6) Conditions of confidentiality

Written advice is subject to conditions of confidentiality if the practitioner imposes on one or more recipients of the written advice a limitation on disclosure of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that practitioner's tax strategies, regardless of whether the limitation on disclosure is legally binding. A claim that a transaction is proprietary or exclusive is not a limitation on disclosure if the practitioner confirms to all recipients of the written advice that there is no limitation on disclosure of the tax treatment or tax structure of the transaction that is the subject of the written advice.

(7) Contractual protection

Written advice is subject to contractual protection if the taxpayer has the right to a full or partial refund of fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) if all or a part of the intended tax consequences from the matters addressed in the written advice are not sustained, or if the fees paid to the practitioner (or a person who is a member of, associated with, or employed by the practitioner's firm) are contingent on the taxpayer's realization of tax benefits from the transaction. All the facts and circumstances relating to the matters addressed in the written advice will be considered when determining whether a fee is refundable or contingent, including the right to reimbursements of amounts that the parties to a transaction have not designated as fees or any agreement to provide services without reasonable compensation.

(8) Prominently disclosed

An item is prominently disclosed if it is readily apparent to a reader of the written advice. Whether an item is readily apparent will depend on the facts and circumstances surrounding the written advice including, but not limited to, the sophistication of the taxpayer and the length of the written advice. At a minimum, to be prominently disclosed, an item must be set forth in a separate section (and not in a footnote) in a typeface that is the same size or larger than the typeface of any discussion of the facts or law in the written advice.

(9) State or local bond opinion

A state or local bond opinion is written advice with respect to a federal tax issue included in any materials delivered to a purchaser of a state or local bond in connection with the issuance of the bond in a public or private offering, including an official statement (if one is prepared), that concerns only the excludability of interest on a state or local bond from gross income under section 103 of the Internal Revenue Code, the application of section 55 of the Internal Revenue Code to a state or local bond, the status of a state or local bond as a qualified tax-exempt obligation under section 265(b)(3) of the Internal

Revenue Code, the status of a state or local bond as a qualified zone academy bond under section 1397E of the Internal Revenue Code, or any combination of the above.

(10) The principal purpose

For purposes of this section, the principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is the avoidance or evasion of any tax imposed by the Internal Revenue Code if that purpose exceeds any other purpose. The principal purpose of a partnership or other entity, investment plan or arrangement, or other plan or arrangement is not to avoid or evade federal tax if that partnership, entity, plan or arrangement has as its purpose the claiming of tax benefits in a manner consistent with the statute and Congressional purpose. A partnership, entity, plan or arrangement may have a significant purpose of avoidance or evasion even though it does not have the principal purpose of avoidance or evasion under this paragraph (b)(10).

(c) Requirements for covered opinions.

A practitioner providing a covered opinion must comply with each of the following requirements.

(1) Factual matters

(i) The practitioner must use reasonable efforts to identify and ascertain the facts, which may relate to future events if a transaction is prospective or proposed, and determine which facts are relevant. The opinion must identify and consider all facts that the practitioner determines to be relevant.

(ii) The practitioner must not base the opinion on any unreasonable factual assumptions (including assumptions as to future events). An unreasonable factual assumption includes a factual assumption that the practitioner knows or should know is incorrect or incomplete. For example, it is unreasonable to assume that a transaction has a business purpose or that a transaction is potentially profitable apart from tax benefits. A factual assumption includes reliance on a projection, financial forecast or appraisal. It is unreasonable for a practitioner to rely on a projection, financial forecast or appraisal if the practitioner knows or should know that the projection, financial forecast or appraisal is incorrect or incomplete or was prepared by a person lacking the skills or qualifications necessary to prepare such projection, financial forecast or appraisal. The opinion must identify in a separate section all factual assumptions relied upon by the practitioner.

(iii) The practitioner must not base the opinion on any unreasonable factual representations, statements or findings of the taxpayer or any other person. An unreasonable factual representation includes a factual representation that the practitioner knows or should know is incorrect or incomplete. For example, a practitioner may not rely on a taxpayer's factual representation that a transaction has a business purpose if the representation fails to include a specific description of the business purpose or the practitioner knows or should know that the representation is incorrect or incomplete. The opinion must identify in a separate section all factual representations, statements or findings of the taxpayer relied upon by the practitioner.

(2) Relate law to facts

(i) The opinion must relate the applicable law (including potentially applicable judicial doctrines) to the relevant facts.

(ii) The practitioner must not assume the favorable resolution of any significant federal tax issue except as provided in paragraphs (c)(3)(v) and (d) of this section, or otherwise base an opinion on any unreasonable legal assumptions, representations, or conclusions.

(iii) The opinion must not contain internally inconsistent legal analyses or conclusions.

(3) Evaluation of significant federal tax issues

(i) In general

The opinion must consider all significant federal tax issues except as provided in paragraphs (c)(3)(v) and (d) of this section.

(ii) Conclusion as to each significant federal tax issue

The opinion must provide the practitioner's conclusion as to the likelihood that the taxpayer will prevail on the merits with respect to each significant federal tax issue considered in the opinion. If the practitioner is unable to reach a conclusion with respect to one or more of those issues, the opinion must state that the practitioner is unable to reach a conclusion with respect to those issues. The opinion must describe the reasons for the conclusions, including the facts and analysis supporting the conclusions, or describe the reasons that the practitioner is unable to reach a conclusion as to one or more issues. If the practitioner fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more significant federal tax issues considered, the opinion must include the appropriate disclosure(s) required under paragraph (e) of this section.

(iii) Evaluation based on chances of success on the merits

In evaluating the significant federal tax issues addressed in the opinion, the practitioner must not take into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised.

(iv) Marketed opinions

In the case of a marketed opinion, the opinion must provide the practitioner's conclusion that the taxpayer will prevail on the merits at a confidence level of at least more likely than not with respect to each significant federal tax issue. If the practitioner is unable to reach a more likely than not conclusion with respect to each significant federal tax issue, the practitioner must not provide the marketed opinion, but may provide written advice that satisfies the requirements in paragraph (b)(5)(ii) of this section.

(v) Limited scope opinions

(A) The practitioner may provide an opinion that considers less than all of the significant federal tax issues if –

(1) The practitioner and the taxpayer agree that the scope of the opinion and the taxpayer's potential reliance on the opinion for purposes of avoiding penalties that may be imposed on the taxpayer are limited to the federal tax issue(s) addressed in the opinion;

(2) The opinion is not advice described in paragraph (b)(2)(i)(A) of this section (concerning listed transactions), paragraph (b)(2)(i)(B) of this section (concerning the principal purpose of avoidance or evasion) or paragraph (b)(5) of this section (a marketed opinion); and

(3) The opinion includes the appropriate disclosure(s) required under paragraph (e) of this section.

(B) A practitioner may make reasonable assumptions regarding the favorable resolution of a federal tax issue (an assumed issue) for purposes of providing an opinion on less than all of the significant federal tax issues as provided in this paragraph (c)(3)(v). The opinion must identify in a separate section all issues for which the practitioner assumed a favorable resolution.

(4) Overall conclusion

(i) The opinion must provide the practitioner's overall conclusion as to the likelihood that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment and the reasons for that conclusion. If the practitioner is unable to reach an overall conclusion, the opinion must state that the practitioner is unable to reach an overall conclusion and describe the reasons for the practitioner's inability to reach a conclusion.

(ii) In the case of a marketed opinion, the opinion must provide the practitioner's overall conclusion that the federal tax treatment of the transaction or matter that is the subject of the opinion is the proper treatment at a confidence level of at least more likely than not.

(d) Competence to provide opinion; reliance on opinions of others.

(1) The practitioner must be knowledgeable in all of the aspects of federal tax law relevant to the opinion being rendered, except that the practitioner may rely on the opinion of another practitioner with respect to one or more significant federal tax issues, unless the practitioner knows or should know that such opinion of the other practitioner should not be relied on. If a practitioner relies on the opinion of another practitioner, the relying practitioner must identify the other opinion and set forth the conclusions reached in the other opinion.

(2) The practitioner must be satisfied that the combined analysis of the opinions, taken as a whole, and the overall conclusion, if any, satisfy the requirements of this section.

(e) Required disclosures.

A covered opinion must contain all of the following disclosures that apply -

(1) Relationship between promoter and practitioner. An opinion must prominently disclose the existence of -

(i) Any compensation arrangement, such as a referral fee or a fee-sharing arrangement, between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and any person (other than the client for whom the opinion is prepared) with respect to promoting, marketing or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion; or

(ii) Any referral agreement between the practitioner (or the practitioner's firm or any person who is a member of, associated with, or employed by the practitioner's firm) and a person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing, or recommending the entity, plan, or arrangement (or a substantially similar arrangement) that is the subject of the opinion.

(2) Marketed opinions

A marketed opinion must prominently disclose that -

(i) The opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion; and

(ii) The taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

(3) Limited scope opinions

A limited scope opinion must prominently disclose that -

(i) The opinion is limited to the one or more federal tax issues addressed in the opinion;

(ii) Additional issues may exist that could affect the federal tax treatment of the transaction or matter that is the subject of the opinion and the opinion does not consider or provide a conclusion with respect to any additional issues; and

(iii) With respect to any significant federal tax issues outside the limited scope of the opinion, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(4) Opinions that fail to reach a more likely than not conclusion

An opinion that does not reach a conclusion at a confidence level of at least more likely than not with respect to a significant federal tax issue must prominently disclose that -

(i) The opinion does not reach a conclusion at a confidence level of at least more likely than not that with respect to one or more material federal tax issues addressed by the opinion; and

(ii) With respect to those significant federal tax issues, the opinion was not written, and cannot be used by the taxpayer, for the purpose of avoiding penalties that may be imposed on the taxpayer.

(5) Advice regarding required disclosures

In the case of any disclosure required under this section, the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

(f) Effect of opinion that meets these standards

(1) In general

An opinion that meets the requirements of this section satisfies the practitioner's responsibilities under this section, but the persuasiveness of the opinion with regard to the tax issues in question and the taxpayer's good faith reliance on the opinion will be separately determined under applicable provisions of the law and regulations.

(2) Standards for other written advice

A practitioner who provides written advice that is not a covered opinion for purposes of this section is subject to the requirements of Sec. 10.37.

(g) Effective date.

This section applies to written advice that is rendered after June 20, 2005.

SECTION 10.36 Procedures to ensure compliance.

(a) Requirements for covered opinions.

Any practitioner who has (or practitioners who have or share) principal authority and responsibility for overseeing a firm's practice of providing advice concerning federal tax issues 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 Sec. 10.35. Any such practitioner will be subject to discipline for failing to comply with the requirements of this paragraph if –

(1) The practitioner through willfulness, recklessness, or gross incompetence does not take reasonable steps to ensure that the firm has adequate procedures to comply with Sec. 10.35, 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 Sec. 10.35; or

(2) The practitioner 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 the firm, that does not comply with Sec. 10.35 and

the practitioner, through willfulness, recklessness, or gross incompetence, fails to take prompt action to correct the noncompliance.

(b) Effective date.

This section is applicable after June 20, 2005.

SECTION 10.37 Requirements for other written advice.

(a) Requirements.

A practitioner must not give written advice (including electronic communications) concerning one or more federal tax issues if the practitioner bases the written advice on unreasonable factual or legal assumptions (including assumptions as to future events), unreasonably relies upon representations, statements, findings or agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a federal tax issue, takes into account the possibility that a tax return will not be audited, that an issue will not be raised on audit, or that an issue will be resolved through settlement if raised. All facts and circumstances, including the scope of the engagement and the type and specificity of the advice sought by the client will be considered in determining whether a practitioner has failed to comply with this section. 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 determination of whether a practitioner has failed to comply with this section will be made on the basis of a heightened standard of care because of the greater risk caused by the practitioner's lack of knowledge of the taxpayer's particular circumstances.

(b) Effective date.

This section applies to written advice that is rendered after June 20, 2005.

SECTION 10.38 Establishment of Advisory Committees.

(a) Advisory committees.

To promote and maintain the public's confidence in tax advisors, the Director of the Office of Professional Responsibility is authorized to establish one or more advisory committees composed of at least five individuals authorized to practice before the Internal Revenue Service. Under procedures prescribed by the Director, an advisory committee may review and make recommendations regarding professional standards or best practices for tax advisors, or more particularly, whether a practitioner may have violated Sec. 10.35 or 10.36.

(b) Effective date.

This section applies after December 20, 2004.

SUBPART C -- SANCTIONS FOR VIOLATION OF THE REGULATIONS

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 Director of the Office of Professional Responsibility 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) Sanctions to be imposed. The sanctions imposed by this section shall take into account all relevant facts and circumstances.

(e) Effective/applicability date. This section is applicable to conduct occurring on or after September 26, 2007, except paragraph (c) which 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.

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

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.

Revised Regulations on Releasing Taxpayer Information

In early 2008, the IRS released revised regulations concerning taxpayer privacy and the release of taxpayer information with an effective date of January 1, 2009. Among the new rules:

- Generally, preparers must obtain taxpayer consent, either by paper or electronically depending on how the return is being filed, before tax return information can be disclosed to any third party or used for any purpose other than filing the return.
- If the taxpayer consents to the disclosure and use of his information, the consent must identify the intended purpose of the disclosure, identify the recipients, and describe the particular authorized disclosure or use of the information.
- Mandatory language informs individual taxpayers that they are not required to sign the consent. If they sign the consent, they can set a time period for the duration of that consent. If taxpayers fail to set a time period, the consent is valid for a maximum of one year.
- To prevent consent requests from individual taxpayers from being buried in fine print, the rules require the paper consent documents to be in 12-point type on 8½ by 11 inch paper and require electronic consent requests to be in the same type as the Web site's standard text.
- Mandatory consent from taxpayers also is required if the tax information is going to be disclosed to a tax preparer located outside the United States. This provision is intended to ensure taxpayers are informed if their tax information is being sent off-shore for return preparation. The individual taxpayer's Social Security Number also must be redacted.

Many of these provisions are similar to recently enacted state laws.

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 to the Director of the Office of Professional Responsibility of the suspected violation. The report will explain the facts and reasons upon which the officer's or employee's belief rests.

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 Director of the Office of Professional Responsibility 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 to the Director of the Office of Professional Responsibility.

(c) Destruction of report.

No report made under paragraph (a) or (b) of this section shall be maintained by the Director of the Office of Professional Responsibility 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. The Director of the Office of Professional Responsibility must destroy such reports 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 on September 26, 2007.

SUMMARY OF 2005-2009 CIRCULAR 230 CHANGES

Best Practices

To ensure the integrity of the tax system, tax professionals should adhere to best practices when providing advice or assisting their clients in the preparation of a submission to the IRS. Section 10.33 describes the best practices to be observed by all tax advisors in providing clients with the highest quality representation. These best practices include: (1) communicating clearly with the client regarding the terms of the engagement and the form and scope of the advice or assistance to be rendered; (2) establishing the relevant facts, including evaluating the reasonableness of any assumptions or representations; (3) advising the client regarding the import of the conclusions reached; and (4) acting fairly and with integrity in practice before the IRS.

Standards for Covered Opinions

Section 10.35 prescribes requirements for practitioners who provide covered opinions. Covered opinions include written advice that concerns one or more federal tax issues arising from a listed transaction, any plan or arrangement which the principal purpose is the avoidance or evasion of any tax, or any plan or arrangement with the significant purpose of avoidance or evasion of tax if the written advice is a reliance opinion, a marketed opinion, subject to conditions of confidentiality, or subject to contractual protection.

Requirements for Covered Opinions

A practitioner providing a covered opinion, including a marketed opinion, must not assume that a transaction has a business purpose or is potentially profitable apart from tax benefits, or make an assumption with respect to a material valuation issue.

Required Disclosures

Section 10.35(e) provides disclosures that are required to be made in the beginning of marketed opinions, limited scope opinions, and opinions that fail to reach a conclusion at a confidence level of at least more likely than not. In addition, certain relationships between the practitioner and a person promoting or marketing an opinion must be disclosed. A practitioner may be required to make more than one of the disclosures described below.

1. Relationship Between Practitioner and Promoter

Under §10.35(e)(1), a practitioner must disclose if the practitioner has a compensation arrangement with any person (other than the client for whom the opinion is prepared) with respect to the promoting, marketing or recommending of the entity, plan, or arrangement that is the subject of the opinion. A practitioner also must disclose if there is any referral agreement between the practitioner and any person (other than the client for whom the opinion is prepared) engaged in the promoting, marketing, or recommending of the entity, plan, or arrangement that is the subject of the opinion.

2. Marketed Opinions

Under §10.35(e)(2), a practitioner must disclose that the opinion was written to support the promotion or marketing of the transaction(s) or matter(s) addressed in the opinion. The practitioner also must state that taxpayers should seek advice from their own tax advisors.

3. Limited Scope Opinion

Under §10.35(e)(3), a practitioner must disclose in a limited scope opinion that additional issue(s) may exist that could affect the federal tax treatment of the tax issues addressed in the opinion, that the opinion does not consider or reach a conclusion with respect to those additional issues and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the taxpayer.

4. Opinions That Fail to Reach a Conclusion at a Confidence Level of at Least More Likely Than Not

Under §10.35(e)(4), a practitioner must disclose that the opinion fails to reach a conclusion at a confidence level of at least more likely than not with respect to one or more material federal tax issue(s) addressed by the opinion and that the opinion was not written, and cannot be used by the recipient, for the purpose of avoiding penalties that may be imposed on the taxpayer.

5. Advice Regarding Required Disclosures

Under §10.35(e)(5), the practitioner may not provide advice to any person that is contrary to or inconsistent with the required disclosure.

Procedures to Ensure Compliance

Section 10.36 provides that tax advisors with responsibility for overseeing a firm's practice before the IRS should take reasonable steps to ensure that the firm's procedures for all members, associates, and employees are consistent with the best practices described in §10.35.

Requirement for Other Written Advice

Under Section 10.37, a practitioner must not give written advice concerning one or more federal tax issues if the practitioner bases the advice on unreasonable factual or legal assumptions, unreasonably relies upon representations, statements, findings or

agreements of the taxpayer or any other person, does not consider all relevant facts that the practitioner knows or should know, or, in evaluating a federal tax issue, takes into account the possibility that a tax return will not be audited.

Disclaimers

The new regulations virtually require tax practitioners to include a disclaimer in most written communications to clients to the effect that any tax advice provided in such communication may not be relied upon by the taxpayer to avoid tax penalties. An example of a typical disclaimer follows:

IRS Circular 230 Disclaimer: To ensure compliance with IRS Circular 230, any U.S. federal tax advice provided in this communication is not intended or written to be used, and it cannot be used by the recipient or any other taxpayer (i) for the purpose of avoiding tax penalties that may be imposed on the recipient or any other taxpayer, or (ii) in promoting, marketing, or recommending to another party a partnership or other entity, investment plan, arrangement or other transaction addressed herein.

The new regulations pose greater potential malpractice liability for any Circular 230 non-compliance.

Who May Practice

A new designation was created. The “enrolled retirement plan agent” is limited to representing taxpayers with regard to retirement plans.

Contingent Fees

Allows a contingent fee for representing a taxpayer with an IRS examination. Contingent fees will also be allowed for interest and penalty reviews because there is no exploitation of the audit lottery in these situations as they are generally completed on a post-examination basis. Practitioners may also charge a contingent fee in connection with any judicial proceeding arising under the Internal Revenue Code.

Conflicts

A practitioner is required to obtain written consent from each client in order to represent clients with conflicting interests.

Future Revisions to Circular 230

The IRS will likely continue to revise Circular 230 in order to better enforce the Internal Revenue Code.

STATEMENTS ON STANDARDS FOR TAX SERVICES

In all tax return engagements, and especially those gray areas which challenge the CPA's judgment and integrity, the CPA has an ethical obligation to look at the AICPA's Statements on Standards for Tax Services (SSTSs). The SSTSs are intended to establish standards for tax practice and to define the CPA's responsibility to the client, the public, the Government and the accounting profession. The SSTSs are informative in nature. Prior to October 31, 2000 tax guidance was limited to the AICPA's Statements on Responsibilities in Tax Practice (SRTPs). The SRTPs and the new SSTSs are generally the same except the previously voluntary standards are now enforceable. In the past, many CPAs have stated that since they are not members of the AICPA, the SSTSs have no meaning to them. This is simply not true! The SSTSs increase the value of the CPA designation by setting CPAs apart from unscrupulous individuals who abuse the tax system. One good example is the recent IRS crackdown on fraud in the electronic filing of tax returns. The IRS now requires participants to submit a full set of fingerprints and consent to a background search. CPAs, because of their integrity and high ethical standards, are exempt from this burden. Practice standards are the hallmark of calling one's self a professional.

Another reason for understanding and adhering to the SSTSs is that the public demands it. The SSTSs are often referred to by plaintiffs' attorneys in prosecuting a tax malpractice case. Accordingly, adhering to these standards can help you avoid the courtroom and could result in discounts on your malpractice insurance premiums. The SSTSs are reproduced here for your education and convenience.

SSTS-1 Tax Return Positions

SSTS-1 describes the overall standard that a CPA should use when doing tax planning and when preparing tax returns. SSTS-1 is very similar to the crux of Circular 230. It is referred to as the "Realistic Possibility Standard".

SSTS-1

- I. With respect to the tax return positions, a CPA should comply with the following standards:
 - a. A CPA should not recommend a tax return position or prepare or sign a tax return taking a position unless the CPA has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged.
 - b. Notwithstanding paragraph a, a CPA may recommend a tax return position if the CPA: 1) concludes that there is a reasonable basis for the position, and 2) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph a, a member may prepare or sign a tax return that reflects a position if: 1) the member concludes there is a reasonable basis for the position, and 2) the position is appropriately disclosed.

- II. The CPA should not recommend a tax return position that:
 - a. Exploits the audit selection process; or
 - b. Serves as a mere “arguing” position advanced solely to obtain leverage in negotiation with a taxing authority.
- III. A CPA has both the right and responsibility to be an advocate for the client with respect to any positions satisfying the aforementioned standards.

How to Apply SSTS-1 to Your Tax Practice

- I. Our self-assessment tax system will function only if taxpayers file returns that are true, correct and complete. A tax return is primarily a taxpayer’s statement of facts. Accordingly, the taxpayer has the final responsibility for all omissions and misstatements.
- II. CPAs in tax practice have a duty to the tax system as well as to their clients. However, taxpayers have no obligation to pay more taxes than their lowest legal tax. The CPA’s highest duty is to the client in assisting the client achieve the lowest legal tax.
- III. The standards require that a CPA in good faith believe that either:
 - a. The position is warranted in existing law, or;
 - b. Can be supported by a good faith argument for an extension, modification or reversal of existing law.

The CPA may reasonably reach the conclusion that a position is warranted based on:

- a. IRS general counsel memoranda
- b. Private letter rulings
- c. Treaties
- d. A general explanation of a tax act prepared by the joint committee on taxation.

The above sources meet this standard even if they do not meet the Section 6661 test of “authority.” All that is required to meet this standard is a good faith belief that the standard is met when the return is filed.

- IV. When a CPA believes that two or more positions meet the standards above, the CPA may discuss with the client:
 - a. A relative likelihood that the different positions could cause the client’s tax return to be examined;
 - b. The relative likelihood that any position would be challenged in an audit.

NOTE: The IRS issues a revenue procedure annually which details what constitutes “adequate disclosure.” Although the IRS determination of adequate disclosure is not controlling for purposes of SSTs, it is nevertheless a good “safety net” that can be relied upon. See, for example, Rev. Proc. 2003-77.

V. What if the position the client wants to use could result in a taxpayer penalty?

The CPA should do the following:

- a. Discuss with the client the possibility that a penalty could be assessed.
- b. Advise the client that penalties are cumulative and are in addition to interest.
- c. Discuss the benefits of voluntary disclosure of the position on the tax return. Inform the client that voluntary disclosure could mitigate the likelihood of penalties being imposed. The client should also be advised that disclosure would reduce the chances of the statute of limitations being extended from three years to six years.

Examples Under SSTs-1 Interpretation A-2

The following examples deal with general fact patterns. Accordingly, the application of the guidance discussed in the General Interpretation section to variations in such general facts or to particular facts or circumstances may lead to different conclusions. In each illustration there is no authority other than that indicated.

Example 1. A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supports a position favorable to the taxpayer. The taxpayer believes, and the member concurs, that the new statute is inequitable as applied to the taxpayer’s situation. The statute is constitutional, clearly drafted, and unambiguous. The legislative history discussing the new statute contains general comments that do not specifically address the taxpayer’s situation.

Conclusion. The member should recommend the return position supported by the new statute. A position contrary to a constitutional, clear, and unambiguous statute would ordinarily be considered a frivolous position.

Example 2. The facts are the same as in Example 1 except that the legislative history discussing the new statute specifically addresses the taxpayer’s situation and supports a position favorable to the taxpayer.

Conclusion. In a case where the statute is clearly and unambiguously against the taxpayer’s position but a contrary position exists based on legislative history specifically addressing the taxpayer’s situation, a return position based either on the statutory language or on the legislative history satisfies the realistic possibility standard.

Example 3. The facts are the same as in Example 1 except that the legislative history can be interpreted to provide some evidence or authority in support of the taxpayer's position; however, the legislative history does not specifically address the situation.

Conclusion. In a case where the statute is clear and unambiguous, a contrary position based on an interpretation of the legislative history that does not explicitly address the taxpayer's situation does not meet the realistic possibility standard. However, because the legislative history provides some support or evidence for the taxpayer's position, such a return position is not frivolous. A member may recommend the position to the taxpayer if the member also recommends appropriate disclosure.

Example 4. A taxpayer is faced with an issue involving the interpretation of a new statute. Following its passage, the statute was widely recognized to contain a drafting error, and a technical correction proposal has been introduced. The taxing authority issues a pronouncement indicating how it will administer the provision. The pronouncement interprets the statute in accordance with the proposed technical correction.

Conclusion. Return positions based on either the existing statutory language or the taxing authority pronouncement satisfy the realistic possibility standard.

Example 5. The facts are the same as in illustration 4 except that no taxing authority pronouncement has been issued.

Conclusion. In the absence of a taxing authority pronouncement interpreting the statute in accordance with the technical correction, only a return position based on the existing statutory language will meet the realistic possibility standard. A return position based on the proposed correction may be recommended if it is appropriately disclosed, since it is not frivolous.

Example 6. A taxpayer is seeking advice from a member regarding a recently amended statute. The member has reviewed the statute, the legislative history that specifically addresses the issue, and a recently published notice issued by the taxing authority. The member has concluded in good faith that, based on the statute and the legislative history, the taxing authority's position as stated in the notice does not reflect legislative intent.

Conclusion. The member may recommend the position supported by the statute and the legislative history because it meets the realistic possibility standard.

Example 7. The facts are the same as in Example 6 except that the taxing authority pronouncement is a temporary regulation.

Conclusion. In determining whether the position meets the realistic possibility standard, a member should determine the weight to be given the regulation by analyzing factors such as whether the regulation is legislative or interpretative, or if it is inconsistent with the statute. If a member concludes that the position does not meet the realistic possibility standard, because it is not frivolous, the position may nevertheless be recommended if the member also recommends appropriate disclosure.

Example 8. A tax form published by a taxing authority is incorrect, but completion of the form as published provides a benefit to the taxpayer. The member knows that the taxing authority has published an announcement acknowledging the error.

Conclusion. In these circumstances, a return position in accordance with the published form is a frivolous position.

Example 9. A taxpayer wants to take a position that a member has concluded is frivolous. The taxpayer maintains that even if the taxing authority examines the return, the issue will not be raised.

Conclusion. The member should not consider the likelihood of audit or detection when determining whether the realistic possibility standard has been met. The member should not prepare or sign a return that contains a frivolous position even if it is disclosed.

Example 10. A statute is passed requiring the capitalization of certain expenditures. The taxpayer believes, and the member concurs, that to comply fully, the taxpayer will need to acquire new computer hardware and software and implement a number of new accounting procedures. The taxpayer and member agree that the costs of full compliance will be significantly greater than the resulting increase in tax due under the new provision. Because of these cost considerations, the taxpayer makes no effort to comply. The taxpayer wants the member to prepare and sign a return on which the new requirement is simply ignored.

Conclusion. The return position desired by the taxpayer is frivolous, and the member should neither prepare nor sign the return.

Example 11. The facts are the same as in Example 10 except that a taxpayer has made a good-faith effort to comply with the law by calculating an estimate of expenditures to be capitalized under the new provision.

Conclusion. In this situation, the realistic possibility standard has been met. When using estimates in the preparation of a return, a member should refer to SSTS No. 4, Use of Estimates.

Example 12. On a given issue, a member has located and weighed two authorities concerning the treatment of a particular expenditure. A taxing authority has issued an administrative ruling that required the expenditure to be capitalized and amortized over several years. On the other hand, a court opinion permitted the current deduction of the expenditure. The member has concluded that these are the relevant authorities, considered the source of both authorities, and concluded that both are persuasive and relevant.

Conclusion. The realistic possibility standard is met by either position.

Example 13. A tax statute is silent on the treatment of an item under the statute. However, the legislative history explaining the statute directs the taxing authority to issue regulations that will require a specific treatment of the item. No regulations have been issued at the time the member must recommend a position on the tax treatment of the item.

Conclusion. The member may recommend the position supported by the legislative history because it meets the realistic possibility standard.

Example 14. A taxpayer wants to take a position that a member concludes meets the realistic possibility standard based on an assumption regarding an underlying nontax legal issue. The member recommends that the taxpayer seek advice from its legal counsel, and the taxpayer's attorney gives an opinion on the nontax legal issue.

Conclusion. A member may in general rely on a legal opinion on a nontax legal issue. A member should, however, use professional judgment when relying on a legal opinion. If, on its face, the opinion of the taxpayer's attorney appears to be unreasonable, unsubstantiated, or unwarranted, a member should consult his or her attorney before relying on the opinion.

Example 15. A taxpayer has obtained from its attorney an opinion on the tax treatment of an item and requests that a member rely on the opinion.

Conclusion. The authorities on which a member may rely include well-reasoned sources of tax analysis. If a member is satisfied about the source, relevance, and persuasiveness of the legal opinion, a member may rely on that opinion when determining whether the realistic possibility standard has been met.

SSTS-2 Answers to Questions on Returns

SSTS-2 outlines when a CPA may sign a client's tax return as a paid preparer when one or more questions on the return have been left blank. The term "questions" means "requests for information on the return, in the instructions, or in the regulations whether or not stated in the form of a question."

SSTS-2

A preparer should make a reasonable effort to obtain from the client, and provide, appropriate answers to all questions on a tax return before signing as a preparer.

Questions on tax returns are not of uniform importance and often are not applicable to a particular taxpayer. A preparer must make a reasonable effort to obtain all of the requested information. The AICPA gives three reasons for the CPA to want to comply:

- a. "The question may be of importance in determining taxable income or loss, or the tax liability shown on the return."
- b. A request for information may require a disclosure necessary for a complete return or to avoid penalties.
- c. "The CPA must sign the preparer's declaration stating that the return is true, correct and complete."

Nevertheless, reasonable grounds may exist for omitting an answer. The AICPA gives several examples of when a question may be omitted:

- a. "The information is not readily available and the answer is not significant in terms of taxable income or loss, or the tax liability shown on the return."
- b. "Genuine uncertainty exists regarding the meaning of the question in relation to the particular return."
- c. "The answer to the question is voluminous; in such cases, assurance should be given on the return that the data will be supplied upon examination."

When reasonable grounds exist for omitting an answer, the CPA is not required to state on the return the reason for the omission. However, the CPA must "consider whether the omission may cause the return to be deemed incomplete or result in penalties."

The mere fact that an answer to a question may be detrimental to the client (e.g. triggering an audit) does not justify omitting an answer.

SSTS-3 Certain Procedural Aspects of Preparing Returns

SSTS-3 outlines the "responsibility of the preparer to examine or verify certain supporting data or to consider information related to another client when preparing a client's tax return." In other words, does the information pass the CPA reasonableness test?

SSTS-3

- I. In preparing or signing a return, the CPA may in good faith rely without verification upon information furnished by the client or by third parties. However, the CPA

should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the CPA. In this connection, the CPA should refer to the client's returns for prior years whenever feasible.

- II. Where the Internal Revenue Code or income tax regulations impose a condition with respect to deductibility or other tax treatment of an item (such as taxpayer maintenance of books and records or substantiating documentation to support the reported deduction or tax treatment), the CPA should make appropriate inquiries to determine to his or her satisfaction whether such condition has been met.
- III. The individual CPA who is required to sign the return should consider information actually known to that CPA from the tax return of another client when preparing a tax return if the information is relevant to that tax return, its consideration is necessary to properly prepare that tax return, and use of such information does not violate any law or rule relating to confidentiality.

The paid preparer must sign the declaration on the tax return that the information therein is true, correct and complete "based on all information of which the preparer has any knowledge". This applies to information supplied by third parties to the CPA. The preparer is not required to examine or verify supporting data. A preparer may rely on client supplied data unless it appears to be incomplete, incorrect or inconsistent.

The AICPA explanation states "the CPA should encourage the client to provide supporting data where appropriate". This allows the CPA to consider all of the relevant data when looking for additional deductions. It also allows the CPA to "tie out" information to 1099 Series information returns and avoid bothersome IRS notices in the future.

When reviewing K-1s from pass-through entities the CPA may advise the client to further investigate his dealings with the pass-through entity. However, "the CPA may accept the information provided by the pass-through entity without further inquiry unless there is reason to believe it is incorrect, incomplete, or inconsistent...".

The AICPA recommends that CPAs make good use of prior year tax returns. By analyzing the client's current tax situation with that reported on prior year returns, the CPA can avoid the omission or duplication of items. Reviewing prior year returns also aids in reporting similar items on a consistent basis.

From a practical standpoint this comparison is very easy. Most tax preparation programs print multi-year comparisons of tax return line items. Utilizing such a feature will not only aid your compliance with the ethical standards but will help you identify "missed deductions."

SSTS-4 Use of Estimates

SSTS-4 details when and under what circumstances client estimates may be used in preparing tax returns. "The CPA may advise on estimates used in the preparation of a tax return, but responsibility for estimated data is that of the client". The client should provide the estimated data. Appraisals are not considered estimates.

SSTS-4

A CPA may prepare tax returns using the taxpayer's estimates if it is impracticable to obtain exact data, and the estimated amounts are reasonable under the facts and circumstances known to the CPA. When the taxpayer's estimates are used, they should be presented in such a manner as to avoid the implication of greater accuracy than exists.

Accounting requires the exercise of judgment and at times the use of approximations based on judgment. The exercise of such judgment is not considered an "estimate" for purposes of this statement. The AICPA cites, for example, year-end income and expense accruals as judgment items, not estimates.

When it is necessary to use estimates, the "estimated amounts should not be presented in a manner that provides a misleading impression as to the degree of factual accuracy." This can be illustrated by the client who estimated his business auto mileage as 30,000 miles but says use 29,958 miles so that "it looks more accurate."

The AICPA points out that disclosing that an estimate was used in a return is usually not required. However, there are unusual circumstances where such disclosure is needed to avoid misleading the IRS regarding the degree of accuracy of the return.

Some examples of unusual circumstances include the following:

- a. The taxpayer has died or is ill at the time the return must be filed.
- b. The taxpayer has not received a K-1 for a flow-through entity at the time the tax return is to be filed. Consider filing Form 8082.
- c. There is litigation pending (for example, a bankruptcy proceeding) that bears on the return.
- d. Fire, computer failure, or natural disaster has destroyed the relevant records.

SSTS-5

Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision

When may a CPA recommend a tax return position that departs from a court decision or IRS ruling?

SSTS-5 provides surprising guidance. Remember, SSTS-1 provides that a CPA's primary duty is to his client.

SSTS-5

The position to be taken concerning the tax treatment of an item in the preparation or signing of a tax return should be based upon the facts and the law as they are evaluated at the time the return is prepared or signed by the CPA. Unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement, the treatment of an item as part of concluding an administrative proceeding or as part of a court decision does not restrict the CPA from recommending a different tax treatment in a later year's return. Therefore, if the CPA follows the standards in SSTS-1, the CPA may recommend a tax return position, prepare, or sign a tax return that departs from the

treatment of an item as concluded in an administrative proceeding or a court decision with respect to a prior return of the taxpayer.

The IRS as well as most CPAs strive for consistency in the treatment of similar items in different years. SSTS-5 notes that there are many valid reasons why a CPA could recommend a position that differs from that agreed to in prior years with the IRS. Perhaps the taxpayer lacked the required documentation to substantiate a deduction in the prior year. The taxpayer may have simply given in to IRS upon audit to avoid the time and expense of litigation. Also, more favorable court cases or administrative rulings may have occurred. However, the AICPA warns:

The consent in an earlier administrative proceeding and the existence of an unfavorable court decision are factors that the CPA should consider in evaluating whether the standards in SSTS-1 are met.

SSTS-6 Knowledge of Error: Return Preparation and Administrative Proceedings

SSTS-6 considers the applicable standards for a CPA who becomes aware of:

- a. An error in a taxpayer's previously filed tax return;
- b. An error in a return that is under audit; or
- c. A taxpayer's failure to file a required tax return.

An error includes anything that would fail to meet the standards of SSTS-1. An error also includes a position taken on a prior year's tax return that no longer meets SSTS-1 due to changes in legislation, judicial decisions or regulations. An error does not include immaterial items. SSTS-6 applies to errors on returns prepared by other preparers.

SSTS-6

The CPA should inform the client promptly upon becoming aware of an error in a previously filed return or upon becoming aware of client's failure to file a required return. The CPA should recommend the corrective measures to be taken. Such recommendation may be given orally. The CPA is not obligated to inform the Internal Revenue Service, and the CPA may not do so without the client's permission, except where required by law.

If the CPA is requested to prepare the current year's return and the client has not taken appropriate action to correct an error in the prior year's return, the CPA should consider whether to withdraw from preparing the return and whether to continue a professional relationship with the client. If the CPA does prepare such current year's return, the CPA should take reasonable steps to ensure that the error is not repeated.

When the CPA discovers an error in a prior return, the AICPA advises that:

- a. The CPA should advise the client of the error and the measures to be taken. It is the client's responsibility to decide whether to correct the error.
- b. In cases where the IRS could assert the charge of fraud, the CPA should advise the client to consult legal counsel.
- c. The CPA should take reasonable steps to ensure that the error is not repeated.
- d. If the tax return is under audit, the CPA should ask for permission to disclose the error.
- e. If the CPA believes that fraud has occurred, the CPA should advise the taxpayer to consult with an attorney before taking any action.

The author believes that great care should be taken with clients who refuse to correct errors or particularly to file required returns. The simple reason is that if they are content with cheating the government, what will keep them from cheating you? Do yourself a favor and consider withdrawing from the engagement.

Former SSTS-7 Knowledge of Error: Administrative Proceedings (Deleted)

Note: Former SSTS-7 has been incorporated into SSTS-6.

SSTS-7 Form and Content of Advice to Clients (Formerly SSTS-8)

SSTS-7 details "standards concerning certain aspects of providing tax advice to a client and considers the circumstances when subsequent developments affect advice previously provided."

SSTS-7

In providing tax advice to a client, the CPA should use professional judgment to ensure that the advice given reflects competence and appropriately serves the client's needs. The CPA is not required to follow a standard format or guidelines in communicating written or oral advice to a client, but must comply with Circular 230 standards.

In advising or consulting with a client on tax matters, the CPA should assume that the advice will affect the manner in which the matters or transactions considered ultimately will be reported or disclosed on the client's tax return. Thus, for all tax advice the CPA gives to a client, the CPA should follow the standards in SSTS-1 relating to tax return positions. The CPA should also consider disclosure standards and potential penalty consequences.

A CPA has no obligation to communicate with a taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided or when a member undertakes this obligation by specific agreement.

Because the range of services and advice is so extensive, no uniform set of guidelines or format can be established. Written advice is generally better than oral advice. However, the CPA should use prudent judgment and common sense in deciding how to communicate advice.

SSTS-9 Quality Control

In December 2005, the AICPA proposed SSTS-9 covering quality control contemplating completion in 2009. The proposed SSTS is based on the “best practices” outlined in Circular 230, Section 10.33. The AICPA has decided not to move forward with it as an enforceable standard.

REVISIONS TO SSTSs

In 2008, the AICPA released exposure drafts of revised SSTSs. SSTS No. 6 and No. 7 were combined into a new SSTS No. 6. Various changes in federal and state laws have impacted SSTS No. 1 and No. 8. The new SSTSs with redline changes can be found at www.aicpa.org. The new standards are effective January 1, 2010, and are included in this course.

IRS SANCTIONS

The Internal Revenue Code and Regulations contain a number of provisions that impose criminal, civil, and regulatory sanctions on tax practitioners.

Of the approximately 150 penalty provisions a CPA could run afoul of, one of the most relevant is section 6694. Section 6694 provides for a penalty of \$250.00 against the preparer for each return involving an understatement of tax liability due to a position taken on a return for which there is not a realistic possibility of being sustained on its merits. This penalty does not apply if the preparer acted in good faith. For a discussion of what constitutes “good faith”, see Rev. Proc. 80-40. Better yet – follow the advice in this course.

CHAPTER 5 – REVIEW QUESTIONS

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

We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.

1. 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 non-compliance and notify the IRS if the client refuses to file
 - c) advise the client promptly of the fact of non-compliance
 - d) ignore the fact of non-filing provided the current year return is filed timely
2. Circular 230 Section 10.22 requires a practitioner to be diligent as to accuracy in most situations. In which of the following is diligence as to accuracy not required:
 - a) preparing tax returns
 - b) year-end tax planning
 - c) preparing letters to the IRS regarding a taxpayer under audit
 - d) preparing amended tax returns
3. Under Circular 230 Section 10.27, a practitioner is prohibited from charging certain fees. Which of the following fees is prohibited:
 - a) fees in excess of \$300 per hour
 - b) contingent fees
 - c) an unconscionable fee
 - d) fees based on the number of forms and schedules contained in a tax return
4. 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

5. Under Circular 230 Section 10.28, a practitioner must return certain client records under various circumstances. Which of the following is true under section 10.28 regarding returning client records:
- a) a practitioner may withhold the client's current year completed tax return pending payment of fees
 - b) a practitioner may withhold all client records pending payment of fees
 - c) a practitioner must return all client records upon request
 - d) federal law gives a practitioner the right to place a lien on client records
6. Circular 230 Section 10.30 imposes numerous restrictions on solicitation and advertising. Which of the following is true:
- a) hourly fee information must be included in all ads
 - b) although ads may include a fee schedule, rates can be changed at any time
 - c) a copy of all direct mail advertisements must be retained for at least 36 months
 - d) when accepting a new client, the practitioner must give the client a good faith estimate of the cost of the services contemplated
7. Circular 230 Section 10.51 outlines items that may constitute incompetence or disreputable conduct. Which of the following would not be considered disreputable conduct:
- a) using abusive language with an IRS auditor in order to get the auditor to delete an item from the audit report
 - b) having one's CPA license revoked for cause
 - c) being subject to a preparer penalty for negligence in the preparation of a state tax return by that state's tax authority
 - d) conviction of a crime relating to the filing of a state tax return

CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. 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 non-compliance.

D: Incorrect. A practitioner may not ignore the non-compliance.

(See Section 10.21 of Circular 230 in the course material.)

2. A: Incorrect. Although a practitioner must exercise due diligence when preparing tax returns, tax planning alone does not entail filing anything with the IRS and is not covered under Section 10.22.

B: Correct. Since nothing is being filed with the IRS, due diligence is not expressly required. Section 10.22 relates to items provided to the IRS.

C: Incorrect. Although a practitioner must exercise due diligence when preparing letters to the IRS, tax planning alone does not entail filing anything with the IRS. Section 10.22 relates to items provided to the IRS.

D: Incorrect. Although a practitioner must exercise due diligence when preparing any federal tax return, tax planning alone does not entail filing anything with the IRS. Section 10.22 relates to items provided to the IRS.

(See Section 10.22 of Circular 230 in the course material.)

3. A: Incorrect. There is no limit on the hourly rate charged as long as the fee is not unconscionably high.

B: Incorrect. There are significant restrictions on contingent fees, but they are not prohibited in all circumstances.

C: Correct. Although subject to interpretation, an unconscionably high fee is prohibited.

D: Incorrect. Generally, the more schedules required in a tax return, the more time and effort required by the practitioner. Accordingly, charging a greater fee for a more detailed return is not prohibited.

(See Section 10.27 of Circular 230 in the course material.)

4. 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 tax returns while permitting contingent fee arrangements in many other situations.

(See Section 10.27 of Circular 230 in the course material.)

5. **A: Correct.** A completed tax return is the practitioner’s work product and is not a client record.

B: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Section 10.28 does not expressly require the return of other client records allowing practitioners to consider remedies under state law.

C: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Some states permit the practitioner to withhold records that are not required to compute federal tax liability.

D: Incorrect. All client records necessary to calculate a client’s federal tax liability must be returned promptly upon request. Some states permit the practitioner to withhold records that are not required to compute federal tax liability. Federal law does not afford that option.

(See Section 10.28 of Circular 230 in the course material.)

6. A: Incorrect. Ads may include a schedule of fees, but publishing the fee schedule is not mandatory.

B: Incorrect. Rates may not be increased for at least 30 days after the last date the fee schedule was published.

C: Correct. In addition, a list or description of the intended recipients must also be retained for 36 months. This also applies to e-mail solicitations.

D: Incorrect. Although sound business practices suggest the use of an engagement letter that includes fee information, Circular 230 does not require giving the client a fee estimate.

(See Section 10.30 of Circular 230 in the course material.)

7. A: Incorrect. Using abusive language with an IRS agent is unprofessional and may subject you to disciplinary action.

B: Incorrect. Having one's CPA license revoked is considered disreputable conduct.

C: Correct. Section 10.51 is primarily concerned with the preparation of federal tax forms. Being assessed of a preparer penalty is not a crime, and is not considered disreputable conduct.

D: Incorrect. Section 10.51 is primarily concerned with the preparation of federal tax forms. However, conviction of a state tax crime would be disreputable.

(See Section 10.51 of Circular 230 in the course material.)

GLOSSARY OF ETHICS TERMS

The terms included in this glossary are related to the ethics area in general, but may not be specifically used in this material. They are provided for greater clarification and educational purpose.

TERM	DEFINITION
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 process	The analytical approach applied in performing a consulting service. The process typically involved some combination of the following: <ul style="list-style-type: none"> • Determining the client's objective • Fact-finding • Defining problems or opportunities • Evaluating alternatives • Formulating proposed actions • Communicating results • Implementing • Following up

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: <ul style="list-style-type: none"> 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.

INDEX

A

AICPA ethics pyramid, 3-2

C

Circular 230, 5-1, 5-2, 5-3, 5-30, 5-32,
5-33, 5-43, 5-44

code of professional conduct, 1-2, 1-5,
3-1, 3-2, 3-3, 3-4, 3-5, 4-1, 4-11,
4-22

conflict of interest, 4-8, 4-9, 5-8, 5-10

contingent fees, 3-4, 3-12, 3-13, 4-14,
5-8, 5-32

F

fictitious names, 4-22

N

natural laws, 1-1, 1-2

non-attest services, 4-3

non CPA ownership, 3-16

P

peer review, 3-7

positive laws, 1-1, 1-2

Public Company Accounting Oversight
Board, 3-1, 4-18

U

utilitarianism, 1-1