

Professional & Legal Responsibilities

Civil Liability: from codified *Common Law*: Contracts, Negligence, Fraud; **and Statutory Laws**: Securities Acts of 1933 & 1934
When Liable to All 3rd Parties Relying on Statements: accountant's Fraud, *Constructive* Fraud, or Gross Negligence

CPA-Client's Agreement usually spelled out in **Engagement Letter**

Duty Standard of Conducting Work: with the **same reasonable care** as an **average accountant**

CPA-Client Communications & Working Papers: generally **NOT** Privileged Communication (unless granted by a *State Law*)

State Boards have their *own* codes of **Ethics** * **also** most Boards *mirror* AICPA's *Code* or are *similar* (thus, *dual* violations)

AICPA Code provides *Minimum levels of Acceptable Conduct* for services ** non-members *expected* to follow *Code*

Auditing Public Firms: **CPA** in charge of audit needs *Permit* by state board, and **Firm** registered with state board & PCAOB

Disciplinary Systems

- AICPA *Code* enforced by **PEEC** (Pro Ethics Executive Committee) * **State boards** enforce their own *Ethics*

- *Professional Ethics Division* for less severe violations of AICPA ethics

- **CPA State Societies** have agreements with AICPA for *Joint Ethics Enforcement Programs* (JEEP): *excl.* competitive bidding

- AICPA member has burden of *justifying* Departures from AICPA rulings and interpretations

Disciplinary Actions * Dismissal (no violation) * *Public Admonishment* * Requirement of Corrective Action

* Suspension from AICPA *up to* 2 years * Expulsion from AICPA

** if valid state license, *can still* practice even if *expelled*; **however** *Code* violation is probably also violation of state board

Automatic Expulsion or Suspension without Hearing * CPA certificate/license/permit revoked by state (disciplinary)

* conviction of a crime *punishable* by imprisonment for *over* 1 year

* Filing or *aiding* in filing a Fraudulent tax return for client or *Self* * *Intentionally* failure to file *required* tax return

SEC Sanctions: can revoke/suspend *from* practicing before the SEC due to * Conviction of Felony or Misdemeanor (*morality*)

* *Willful* violation of Federal securities laws/regulations **or** from Unprofessional, Unethical actions

- Penalties of Civil Fines & Mandates to pay the profits gained from securities violations

Discipline of CPA Firms * State boards can *Bar* a CPA firm from practicing in the state * SEC can suspend/revoke (issuers)

* *PCAOB Registered Firms*: violations of *Standards of Performance*; Alleged violations lead to hearings to investigate

* PCAOB Inspections: **(1)** Firms with **over 100 public clients**: *annually* **(2)** **100 or fewer public clients**: *every 3 years*

- Suspend/revoke a firm's registration - Prohibit an Individual from associating with Registered firm - Civil penalties

* PCAOB *remedial measures*: must improve Quality Control or Training; or Independent monitoring of *audit work*

Breach of Contract – CPA fails to perform *substantially* as agreed under contract (e.g. *Orally* or *via* engagement letter)

- *Implied* contract duties: need to be performed in a *non-negligent manner*

- *Expressly stated*: perform under terms of contract

Best practices: Engagement Letter *signed by Client*; detailed; indicate responsibilities & limitations (non-responsibilities)

Exceptions when Liable for Failure to Detect Fraud: when a “normal/typical” Audit or Review *would have* detected it

* agreement specifies such a responsibility (e.g. fraud audit) * wording of Audit Report *indicates* greater responsibility

Audit/Review Duty to Investigate beyond Mgmt's explanations: when CPA *discovers or becomes aware of* Suspicious items

Breach Consequences: Client may recover for Damages (even if CPA *unpaid*) ** **NOTE:** generally **NO** punitive damages

No Breach when due to Client Interference/Preventing CPA from performing: e.g. late report due to Client supplied info

Major Breach of Contract -> CPA is **NOT** entitled to any Compensation

Minor Breaches (e.g. minor errors) -> CPA *entitled* to payment **but** Client may *deduct* Damages caused by breach

Negligence – failure to perform with **same degree of skill & judgment possessed by an Average/Reasonable accountant**

- **Above refers to Elements of Ordinary Negligence:** also “due care,” “duty of skill,” “prudent” when referring to accountant

Standards of Duty: Legal Statutes, Court decisions, Client Contract; and Customs, GAAS, and GAAP (last 3 *persuasive only*)

* i.e. following any of 3 *persuasive* standards does not *rule out* negligence, **but** it is *strong evidence* for proving due care

Damages from Negligence (aka “Breach of duty owed of an average reasonable accountant”)

- *limited* to Actual Losses that *would have been avoided* if accountant used Reasonable care

!* *normally* no Punitive damages allowed for *Ordinary Negligence*

Contributory Negligence defense: Client’s own negligence *substantially contributed* to CPA failure to perform adequately

-> typically defense will *reduce* CPA’s liability * **however** in some states, CPA may not be liable *at all*

EX: repeatedly warn client to correct IC weakness, but ignored; so CPA fails to detect material fraud *due to Client*

Negligence Requirements: (1) Casual Relationship between CPA’s *Fault* and Client’s *Damages*, and

(2) Cause of Damages must be *Proximate/foreseeable* (qualifying damages only if *close/directly related* to negligenc)

No Liability based solely on Honest Errors of Judgment: must be *at least* negligence under common law for liability

CPA Fraud Elements: * Misrepresentation of Material Fact or CPA’s Expert Opinion * Actual Damages

* Reasonable/Justifiable reliance * **Scienter** by Intent to Mislead (knowledge of falsity) **or** Reckless disregard of Truth

Constructive Fraud or Gross Negligence when *Scienter via* Reckless Disregard of the truth (rather than knowledge of falsity)

EX: Fraud when CPA *knows* Investments don’t exist; *Constructive* when CPA doesn’t know & skips Audit of Investments

Gross Negligence and (Constructive) Fraud Particulars * Allowable Punitive damages

* Contributory Negligence is *NOT* an acceptable defense * Privity of Contract *not* required for plaintiff to sue

Third-party Liability

Significant Minority rule: Ordinary Negligence *limited* to Client and *Primary Beneficiaries* (e.g. audit to obtain BofA loan)

Majority Rule – Ordinary Negligence includes *Foreseen Third Parties* that a CPA *knew* would rely on statements

!* *foreseen* third parties *do not have to be* specified (e.g. audit to obtain a bank loan; unnamed bank = *foreseen*)

Gross Negligence & (Constructive) Fraud: liable to *all third parties* (whether or not *foreseen*)

Foreseeable Parties – any party that a CPA could *reasonable foresee* would receive and use statements (*not known* to CPA)

-> *NOT* included in Majority Rule; *however* some courts have allowed liability claims for Ordinary Negligence

3rd Party Damages Requirements: (1) actual losses (2) negligence by CPA (3) Proximate cause (relied on CPA’s work)

Joint Liability: defendants *each* are *fully liable*

Several (Proportionate) Liability: only obligation to *respective share* of damages based on *degree of responsibility* for losses

Joint and Several Liability: each fully liable and **may** seek reimbursement from other liable parties (sue others to share)

Legal Responsibilities

Working Papers – owned by CPA (custodial) unless agreed otherwise; keep confidential unless client consent; must allow access if *enforceable* subpoenas (and *no* privilege); also if agreement with client to provide WP to government agency

Clarifications on when Privileged Communication – when CPA is *hired by* someone possessing privilege (e.g. lawyer)

- Requirements for States granting CPA-Client privilege: *intended* to be Confidential at time of Comm & *not waived* by Client

- Existence of Privilege = valid basis for CPA *to refuse to testify* in court (for benefit of the client)

!* if *any* part of privileged communication is *allowed*, then *all* privilege is *lost* ** *Tax Accrual* files *not* privileged **

AICPA Code Exceptions for disclosing confidential data * Client *consent* (if partnership, *each* partner must consent)

* to comply with GAAP and/or GAAS * Enforceable Subpoena (lack of privilege) * *Peer review* of firm’s quality

* investigation by ethics division or trial board

* 3rd party *service providers* (w/o consent) **iff** *Contractual* agreement for confidentiality & CPA is reasonably assured

Privacy Laws – cannot disclose Client’s *Nonpublic* Personal info to *Non-affiliated* third parties

- FTC requires a comprehensive information *security program* that *outlines* the ways client info is protected

- CPAs *responsible* for maintaining Confidentiality of *outsourced* information-processing

Illegal Acts by Clients –Responsibilities to Potentially Disclose

- Form 8K for *Change in Auditors*; must disclose (dis)agreement with Mgmt's reason for change (if disagree, explain *how*)
- Predecessor Communications (fully respond) - Responding to Subpoenas
- to *Funding agency* for entities receiving govt. financial assistance

CPAs responsible for Acts of Employees in the course of employment; covered by Prof liability insurance (malpractice)
Audits cannot be delegated unless Client agrees to Delegation – because engagement is a contract for *personal services*

Liability & Insurance Stuff – Unpaid Liabilities from security-law violations *are NOT dischargeable* in Bankruptcy by a CPA
- Client *Fidelity Bonds* protects from CPA Fraud & the insurer has *Subrogated Rights* (to recover against a CPA; like Client)

Subsequent Events/Discovery – *generally not* liable for *effects* of events *subsequent* to Audit Report Date

- Subsequent Discovery of *facts existing as of* Report Date: potential CPA liability *unless* Immediate investigation; Prompt *Revision of Statements is possible*; and users *known* to be *relying* on statements (incl. SEC) are *notified*
- Potential Liability if Auditor assumes *greater* responsibility, like assuring *no material changes* exist after Report Date

Liability from Unaudited Statements – generally from CPA's *failure* to follow engagement standards (or cover own ass)

- * not marking each page as "Unaudited" or "See Accountant's Report" * Failure to Disclaim or incorrect wording report
- * not following SSARS * not *informing* client of discoveries *indicating* major issues (e.g. potential fraud)

Partnership Taxation Status – *includes* Syndicates, Joint Ventures, and Unincorporated Businesses

Entity Self-Classification by Eligible Entities – able to *choose* whether taxed as a Corporation -OR- Partnership

- > if no filing, then *default rules* = **2+ owners** = Partnership ** **1 Owner** = Sole Proprietorship ** **even LLC as Partnership**
- !* *elections* are irrevocable for 5 years unless majority change in ownership/IRS consent

Electing Large Partnerships – simplified reporting (less detailed) * e.g. Charity deducted *by Partnership* * S-179 not passed
-> *at least* 100 partners *file election * *not* Service company * *not* Commodity trading ** **lost if under 100 partners in year**

Publicly Traded Partnerships – *generally* taxed as C Corporations

Partnership Formation – *generally No gains/losses recognized on Contributions* for a Partnership Interest (**3 exceptions**)

- 1) **Encumbered Property & Liability exceeds Interest basis**: Capital Gain = Excess of Pro Rata *Liability Decrease* over Basis
* *Ordinary* if subject to Depreciation Recapture **EX2**: Partnership *assumes* 80% of 20K Liability=> \$16K decrease
EX1: transfer Equipment for 20% (Basis 10K; Liability 20K; FMV 25K) => Cap. Gain = 16K assumed – 10K basis => \$6K gain
 - 2) **Gain recognized when the Partnership if incorporated would be an Investment company** => Gain = FMV - Basis
 - 3) **Compensation recognized by Partner who renders service in exchange for Interest** => Comp = Basis = FMV of Interest
- Basis of Partnership Interest from Contribution**: *same* as Adj. Basis of property given up
Holding Period of Partnership Interest: *same* as property contributed

Partnership's Basis of Contributed Property: Transfers over from Contributing Partner

Partnership's Holding Period of Contributed Property: *carries over/continues* from partner who contributed

!* **SMRY: Contributions** – Holding Period & Basis **all carry over** for both Property & Partnership Interest

Organizational/Start-up Expenditures – *up to* \$5K deductible when business begins (phase out after \$50K in spending)
-> excess/disallowed expenditures amortized over 180 months starting in *month* that business begins

Partnership Income & Loss Allocations – must keep detailed records on Tax *Characteristics & Net Ordinary items*

- * e.g. Ordinary Biz Income/Loss items = Business Exp. & Bad Debts * Guaranteed Payments * Depr. Recapture * Org. Exp.

- 1) **Character of Partnership's Gains & Losses** – *generally* determined by *nature* of property under Partnership's use
- 2) **Gain/Loss character of Contributed Property** – depends on nature of property under Partner *before* contribution
EX: contribution of Unrealized Receivables & Inventory -> usually *Ordinary* Income/Loss upon disposition by partnership
- 3) **Losses on Contributed Capital Assets** – *only* Capital Loss to extent of Partner's *Unrecognized* Cap. Loss upon contribution
EX: Contribute Basis 40K, FMV 30K (=unrecognized 10K loss) -> Partnership sells for 25K => 10K Cap. Loss & 5K Ord. Loss

Book -> Ordinary Income = *remove* all non-business & special tax treatment items

* e.g. ALL capital gains/losses (even short-term) * Charity contributions * Tax-exempt Income * S-1231 Gains (=Capital)

Ordinary -> Book Income = starts as all business, so need to *include* all non-biz & special tax treatment items (everything)

Limitations on Partners' Deductibility of Partnership Losses – Interest Basis * At-Risk * Passive Activity Loss Limits

1) **Up to Interest Basis** existing at end of tax year ** **first** incl. all *Positive* adjustments to Basis *then* deduct Loss * **Carryover**

2) **At-risk Basis**: generally same as Interest; **except** if personally liable for Liabilities & Qualified Nonrecourse= **add to At-Risk**

3) **Passive Activity Loss Limits**: only when Partner *does not materially participate* => Deduction *limited* to Passive Income

* Limited Partner = Passive * if Partnership has *Rental Real Estate* income => need 10%+ Ownership for **\$25K Deduct**

Partnership Allocations Agreements

* **Special Allocations** must have **substantial economic effect**: affect capital * sufficient capital for Distr. * *pay back* deficits

* **No Specific Allocation** => use Profit & Loss Ratio

* **Items derived from Contributed Property** => allocation *must* reflect the difference between tax basis & FMV @ transfer

* Built-in Gains when contributed *must* first be given to the Partner, and *remaining* Gain allocated among all partners

* Built-in Losses, too * if distributed to *different* Partner within 7 years, *Contributor* must recognize *pre-contribution* G/L

Change in Ownership of Interests – *must pro-rate* distributions by an appropriate daily basis of Partnership's taxable year

EX: new 25% partner admitted on July 1 => Ordinary Income allocated to New Partner = $\$X * 25\% * 6/12$ months

Distributable Income & Guaranteed Payments – *all items* are deemed to pass at end of Partnership's taxable year

-> so Partnership has \$40K income & ends on May 31, a Calendar-year Partner will *only* report his share of the \$40K

Guaranteed Payments – *deductible* by Partnership regardless of income & reported as *Income* by Partners

* **Partner's Fringe benefits** = Guaranteed payments, because Partners *are not employees*

Family Partnerships – special rules to prevent tax avoidance * if primarily a *Service* business, allowed as Partner *only* if person performs Management **or** the *actual services* * if Capital is *material* to income-production, the Asset Owner=Partner

Basis in a Partnership Interest – *generally* determined by *how* the Interest was acquired (purchase, inherited? etc.)

1) **Increases**: Adjusted Basis of subsequent contributions + *Share* of All Income, *including* Tax-Exempt & *Excess* Depletion

2) **Decreases**: Adj. Basis of Distributions to Self + *Share* of All Expenses, *even if* Non-deductible & Depletion of Oil/Gas Wells

3) **Changes in Liabilities**: also affect Basis of *depending* on *whether* change is in the *Partnership or Partner's* Liability

Change in Partnership's Liabilities = *direct* change in each Partner's basis *according to share* (loans, increase in Payables)

EX: PShip gets a loan => Partners' basis *increases*

* **Liability Reduction** = "Distribution" to Partners => *Reduces* Basis

Change in Partners' Individual Liabilities = *direct* change in basis (i.e. assumption of liability between Partner-Partnership)

-> *treated* as a Contribution or Distribution of money to whomever is *relieved* of the liability

EX: Partner assumes PShip debt => "Contribution" = Partner's Liability & Basis *increase* * PShip assumes debt => opposite

Order of Adjustments to a Partner's Interest Basis – (1) *increased* by *all* Income items (2) Distribution *decreases*

(3) *decreased* by *all* deductions & losses (even non-deductible items *not charged* to Partner's Capital)

_Transactions with Controlled Partnerships – i.e. when a Partner owns *over 50%* (*even* Constructive Ownership)

1) **Non-Deductible Losses Rule on Sales & Exchanges** – on transactions *between* Partnership & over 50% Owner of *profits OR capital* * *ALSO* if between two partnerships *owned by same person* over 50% of profits or capital

=> Gains on subsequent sale *reduced* by extent of any *Disallowed Loss* from the *original* transaction

2) **Party related to Partner & transacts with Non-controlled Partnership** – *as if* Related Party transacted with *each* Partner

EX: P controls XCorp & owns 49% of PShip => XCorp sells at loss to PShip => treated as sale to *each* of PShip's partners

-> therefore, XCorp treated as selling 49% to P (related parties) => so 49% of Loss *disallowed* to XCorp bcuz related

3) If Property is *not a Capital Asset* in hands of *Recipient*, Gains treated as **Ordinary** (same transactions as #1)

4) If Depreciable Property in hands of Recipient, Gains treated as Ordinary – between PShip & over 50% Owner of P/Cap.

Partnership's Tax Year Rules

Generally, must adopt tax year of Partner(s) *owning* an Aggregate Interest of *over 50%* in Profits & Capital (i.e. *same* tax yr)

* if above Aggregate Partners *do not have the same* tax year, then must adopt tax year used by all Principal Partners

* if Principal Partners have different tax years, then must adopt year with *least aggregate deferral* of income to partners

Business Cycle Tax Year: IRS approval & Valid Business Purpose (25%+ of gross receipts in last 2 months, *for past 3 years*)

Fiscal Year Election: only if resulting "Deferral Period" is *at most 3 months or less than* currently-in-use deferral period

* *Deferral Period* = End of *Required* Tax Year – End of *Elected* Tax Year (e.g. req'd calendar; fiscal Nov 31=> 1 mo.)

!* must make "required payments" on May 15 to compensate government for revenue lost due to deferral (election)

Withdrawn & Deceased Partners' respective Tax Year Period – *ends upon* said events (i.e. stop accruing/allocating items)

Partnerships & Cash-basis – **generally Prohibited** if Major Inventories, Tax Shelter, or C Corporation as a partner

* **generally Allowed** if AAGR *up to* \$5m for past 3 years + *no* Inventory & *not* a Tax Shelter

* **Small Partnerships** allowed cash-basis & *exempted* from Inventory & Accrual (i.e. AAGR *up to* \$1m for past 3 years)

Termination/Continuation of a Partnership – *need 2+* partners otherwise termination

* PShip & Tax Year terminates for *all* partners when *over 50%* of *Total* Interests in P&Cap. are sold/exchanged in any 12 mo.

Partnership Mergers – *only a Continuation* for the Partnership that *ends up* with *over 50%* in the *resulting* partnership

EX: X merges with Y => X partners will get 60% and Y 40% => Continuation for X Partners & Termination for Y as of date

Division of a Partnership – *Continuation only* for the *resulting* Partnership whose partners *owned over 50%* of *original* PShip

EX: X splits to X1 & X2 => the partners of X2 *had owned 66%* of *original* X, so X2=Continuation & X1=new partnership

Sale of a Partnership Interest – *generally* Capital Gain/Loss = Proceeds + *Share* of Partnership Liabilities – Adjusted Basis

-> include selling partner's share of PShip liabilities in *Amount Realized* because the partner is *relieved* of such liabilities

Exception: Ordinary Gain treatment *up to* share of *Unrealized* A/R (cash-basis), Un-recaptured items & *Appreciated* Inventory

* e.g. Partner's Gain \$30K on 20% Int. sale | PShip has *potential* Recapture \$100K (x20%) => \$20K Ordinary & \$10K Cap. Gain

Pro Rata Distributions from Partnership => **Partnership never recognizes G/L on distributions** * **Partners may have to**

1) **Distribution of several properties reduces Partners' basis in Order**: Money, Unrealized A/R & Inventory, *Other* Property

2) **Partners' Gain Recognition**: *to extent* that *Money* received (and *Relief* of Liabilities) **exceeds** Basis in Partnership

* **only Money & Liability Relief** causes Gain Recognition * Receipt of *other* properties *do not*, even if in excess of basis\

!* **Capital Gains** *except for portions* resulting in *Ordinary treatment* (i.e. *share of* Unrealized A/R & appreciated Inventory)

3) **Partner Loss Recognition only upon Complete Liquidation of Partnership Interest via Money, Unrealized A/R, Inventory**

* Capital Loss = Interest Basis – Money – *Partnership's* Adj. Basis in the A/R & Inventory given to liquidated partner

-> i.e. leftover Interest basis after receipt of items = worthless = loss

4) **Partner's Basis in Non-liquidating/Current Distributions** = *Partnership's* Adjusted Basis in property – Money received

5) **Distributions with Basis in excess of Partner's Interest Basis**: *limited* to Interest Basis *before* the distribution

6) **Payments to Liquidate a Retiring/Deceased Partner's Interest** = treated as distributions & *generally* Capital Gains/Losses

* if Capital is *not material* to Partnership's *income-production* (i.e. Services firm), then partial *Ordinary Gains* treatment

* Ordinary portion is *deductible* by Partnership as Guaranteed Payments

Disproportionate Partnership Distributions – *related* to Unrealized Receivables & Substantially Appreciated Inventory

-> i.e. Partner receives *more* or *less* than fair share of Partnership assets mentioned above

Loss -OR- Gains Recognized by Partner & limited to the *disproportionate* amount of UR or SAI received/given up

- 1) Gain/Loss = FMV received – Adj. Basis given up
- 2) G/L *limited* (see right above)
- 3) *Character* of Gain/Loss *depends* on property *given up*

Election to Adjust Basis of Partnership Property - *only upon* Distribution to Partners -OR TransX in Partnership Interest

-> adjusts basis of *Partnership's* Assets to *prevent any Inequities* that might otherwise occur

-> *applies to all similar, future transactions* unless IRS *approves* revocation of the election

1) Distributions => basis of all remaining Partnership property is adjusted for *all Partners*

* **Increased by** * Gains recognized by recipient(s) **and** Excess of *Partnership's* basis *over* Basis in hands of recipient

* **Decreased by** * Losses recognized by recipient(s) **and** Excess of Basis *in hands of Recipient* over Partnership's basis

2) Sale/Exchanges => basis of partnership property *to the Recipient-Partner* adjusted by following:

* **Increased by** * excess of Recipient's Interest basis *over* the Recipient's *Share* of Adj. Basis of *Partnership* property

* **Decreased by** * excess of Recipient's *Share* of Adj. Basis of *Partnership* property *over* Recipient's Interest basis