A framework for maintaining ethics compliance

By Sarah Beckett Ference, CPA

Defending a professional liability claim can be complicated. The plaintiff and CPA firm defendant often disagree about the scope of service, the amount of damages, the firm's compliance with the applicable standard of care, and more. Resolving these differences becomes more difficult if the firm's independence, integrity, or objectivity is brought into question. Indeed, the mere suggestion of a potential independence violation or conflict of interest can negatively affect or thwart an otherwise good defense.

Consider the following claim made against a CPA firm in the AICPA Professional Liability Insurance Program:

A CPA firm performed an audit of a fund of funds for many years. The attest client's CFO had previously worked for the CPA firm and had started on the same day as the firm's engagement partner. The attest client invested in a number of hedge funds. During the 2008 economic downturn, many of these hedge funds failed and were discovered to be Ponzi schemes. The client subsequently declared bankruptcy, resulting in a complete loss to its investors. The investors filed a $20 million claim against the audit firm, asserting that more information about the funds should have been disclosed in the financial statement notes. Had these disclosures been made, the investors asserted they would have redeemed their shares prior to the bankruptcy.

An expert hired by the CPA firm's insurance company opined that the firm's audit work and documentation appeared to comply with the applicable standard of care. However, concern was raised regarding emails between the audit partner and the attest client CFO that suggested the CFO leveraged his relationship with the partner and firm to modify disclosures related to the hedge funds. The claim ultimately settled.

The AICPA *Code of Professional Conduct* (the Code), state board of accountancy rules, and other sources identify situations that may impair independence or threaten a CPA's integrity or objectivity. However, the standards do not, and cannot, address and provide an answer for every situation.

Values first

87%

Portion of ethics and compliance or legal professionals who say their company's ethics and compliance program has increasingly focused on values over rules.

Source: LRN survey of large company ethics and compliance and legal personnel.

Enter the conceptual framework (see the "Conceptual Framework for Members in Public Practice" (ET §1.000.010)) and its application to independence (see the "Conceptual Framework for Independence" (ET §1.210.010)) and conflicts of interest (see the "Conflicts of Interest for Members in Public Practice" interpretation (ET §1.110.010)). This framework provides a methodology for identifying, evaluating, and addressing threats to compliance with the Code resulting from a specific relationship or circumstance not otherwise explicitly addressed in the Code. The structured thought process provided by the conceptual framework helps CPAs to reflect upon a set of facts and arrive at a reasoned conclusion.

EASY AS 1-2-3 (AND 4)

The Code lays out a simple, three-step approach. From a professional liability perspective, an additional step is suggested.

Step 1: Identify threats

The Code recognizes that most threats to compliance can be categorized into seven types:

- **Adverse interest:** When the CPA's interests are in opposition to the client's.
- **Advocacy:** Promoting the client's interests or position.
- **Familiarity:** Being too sympathetic to the client's interests due to a long association between the CPA and the client.
- **Management participation:** Taking on a management role or assuming management responsibilities for a client.
- **Self-interest:** Benefiting, financially or otherwise, from an interest in or a relationship with a client.
- **Self-review:** The inability to appropriately eval ate evidence, judgments, or services performed l the CPA or the CPA's firm.
- **Undue influence:** Subordination of the CPA's judgment to a client or third party.

Professional liability claims include allegations of familiarity threats more than other threats. Longtime clients, casual emails, and an engageme team with multiple years of experience with the client all may pose familiarity threats. Management participation and/or self-review threats may exist when nonattest services are delivered to an attest client. A self-interest threat may exist if client fees constitute a significant portion of the firm's revenue. An engagement team brainstorming session may help identify threats not previously considered.

Step 2: Evaluate the significance of identified threats

Evaluate the significance of each identified threat to determine if it is at an acceptable level. For many threats, the Code provides specific guidance regarding which threats cannot be reduced to an acceptable level and, thus, impair independence or result in a conflict of interest. For all other threats, the evaluation of their significance should be viewed in the context of a "reasonable and informed third party who is aware of the relevant information" (see paragraph .07 of the "Conceptual Framework for Members in Public Practice") and include both qualitative and quantitative factors. To help mitigate professional liability risk, consider evaluating the significance of the threats from the perspective of a plaintiff's attorney and potential jurors. A plaintiff's attorney will use all available evidence, including emails, to discredit the CPA. Jurors will be influenced by other factors beyond the expert testimony, such as their own perception of what a CPA should be responsible for. Unfortunately, hindsight does not typically favor the CPA.

Step 3: Identify, evaluate, and apply safeguards

If the identified threat is not at an acceptable level, safeguards — actions or other measures that may eliminate the threat or reduce it to an acceptable level — should be identified and applied. For some threats, a single safeguard may be appropriate. For others, multiple safeguards may be more effective. The Code identifies several examples of safeguards created by the profession or that can be implemented by the firm or client. The effectiveness of a particular safeguard depends upon many factors, including how it is applied and who applies it, whether the client is a public interest entity, and more. CPA judgment is involved in making this determination.

Step 4: Document and share

Documentation, one of a CPA firm's most important allies in claim defense, is especially important in areas involving CPA judgment, including the evaluation of independence threats and potential conflicts of interest. Therefore, in addition to the Code's documentation requirements, consider documenting the firm's evaluation *process*, not just the outcome. Documentation could include *how* the evaluation was performed and the factors considered when evaluating the significance of a threat or the appropriateness of a safeguard. In a claim situation, a CPA firm's judgment and conclusions may be questioned or challenged. A lack of documentation allows a plaintiff's attorney to draw his or her own conclusions, which may differ from the CPA's.

Share the evaluation and conclusion with engagement team members and even the client, especially if these parties are responsible for implementing safeguards. Consider including the client's responsibilities regarding any safeguards under their purview in the engagement letter or other client communication.

APPLYING THE CONCEPTUAL FRAMEWORK TO OTHER ETHICS CONSIDERATIONS

Questions of independence are problematic in defense of attest claims. Questions of integrity or objectivity, especially those related to conflicts of interest, are problematic in defense of claims related to nonattest services. To help mitigate this risk, consider applying the conceptual framework approach to any relationship or circumstance that threatens the CPA's compliance with the Code.

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RESOURCES

To assist a CPA's application of the conceptual framework steps, the AICPA Professional Ethics Division created the following publications: *Conceptual Framework Toolkit for Independence* and *Conceptual Framework Toolkit for Members in Public Practice* (both available at tinyurl.com/y5agknjs).

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Case Study 3 — Confidential information available during a tendering process

Outline of the case

You are head of internal audit in a public sector organisation which is about to put out for tender the contract for the internal audit service. It will be an open tender process, for both external and internal providers.

The newest member of your team was recruited from the department responsible for devising the tender process. He is now a support administrator in your department. Although he took no part in establishing the tender process, a former colleague (and personal friend) of his was heavily involved in drawing up the tender specification document and will be involved in the evaluation process.

The support administrator has had sight of some of the evaluation criteria, and has offered to share with you information that may be of use when preparing the tender. However, this information is confidential and should not be seen by any of the tendering parties. Bids from external providers are being encouraged, and the evaluation process has been designed with this in mind.

If the contract is awarded externally, you will be unsure of your future position in the organisation. You understand that the use of any insider knowledge of the tendering process would be inappropriate when preparing the tender proposal, but you would have a better chance of success if you used the confidential information.

Key fundamental principles

Integrity: If you use the confidential information being offered to you, the tendering process may be undermined. What must you do to act with integrity and be seen to be acting with integrity?

Objectivity: If you receive information that could benefit your department's tender, can you retain your objectivity? If third parties were made aware of the connection between your support administrator and the department responsible for devising the tender process, would you still be perceived as acting with objectivity?

Confidentiality: Confidential information acquired as a result of professional and business relationships should not be used to your personal advantage.

Professional behaviour: You must avoid any action that may discredit you, the organisation you work for or the accountancy profession.

Considerations

Identify relevant facts:

As head of internal audit, your future position within the organisation is uncertain if the internal audit contract is awarded to an external provider. Therefore, there is a significant self-interest threat. This threat needs to be carefully managed, and the perception of integrity needs to be maintained, as well as actual integrity.

Identify affected parties:

Parties that may be affected by the integrity of the tender process are you, other members of your department, the head of the department that devised the tender process, and third parties tendering for the contract. The reputation of your organisation might also be affected.

Who should be involved in the resolution:

You should consider raising the matter with your line manager, but you will also need to involve the support administrator and the head of his former department in the resolution.

Possible course of action

Your future role within the organisation (if any) is unclear. If you had more information about this, you might be less anxious about your career, and your objectivity might not be so threatened.

However, it currently appears that there is the potential for personal gain from using the evaluation information. You should not use this confidential information in your tender document. You should state clearly to the support administrator that his offer of assistance cannot be acted upon, and you should try to prevent him from communicating further with you about the tender process.

In offering you information about the tender process, your support administrator may already have passed relevant information to you. In any event, it is likely that the perception of third parties (if they were well informed regarding the relationship between the support administrator and the department responsible for devising the tender process) would be that you may have already received confidential information. You need to take decisive action to protect your reputation and that of the organisation for which you work.

You should disclose to the tendering department the relationship between a member of your staff and a member of theirs, and specifically make them aware of any confidential information already in your possession. You might suggest to the tendering department that they make the same information available to other bidders. You may further reduce the threats to your objectivity by disclosing the situation to your line manager.

You must also make the support administrator aware that you will not be using any confidential information, and that any further communication between him and his former colleague regarding the tender process would be a breach of confidentiality. By openly stating your intentions, you are also demonstrating to others within the organisation a level of expected ethical behaviour. You may also be able to refer your staff to the organisation's internal code of ethics if one exists.

You should document, in detail, the steps that you take in resolving your dilemma. Keep records of meetings and conversations, in case the integrity of the tender process or your ethical judgement is challenged in the future.

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Case Study 6 External auditor of a public body and being subject to intimidation

Outline of the case

You are the external auditor of a hospital trust. The trust is hoping, and expecting, to receive enhanced status in the near future, which will afford it more autonomy and provide opportunities to pursue a number of exciting projects.

As the trust passed its financial year end, some unforeseen liabilities came to light. The trust's director of finance and chief executive had reported to the board of trustees and the regulator that the trust would break even for the year. The director of finance then made a number of accounting adjustments in order to ensure that the trust would meet its financial responsibilities, including the requirement to break even each and every year.

The adjustments required changing the accounting policy in respect of stock, which had previously been valued on a 'first in, first out' basis as specified by International Financial Reporting Standards. In addition, certain salaries have been capitalised, and the trust has failed to account for its share of liabilities under a partnership agreement with a local authority, which has yet to prepare the memorandum account.

The adjustments come to your attention during your audit process, and you do not accept that they are correct. As they are material, if the trust does not amend its accounts, you will have to qualify your audit opinion on the year end accounts. When you discuss the issues with the director of finance, he is emphatic that his view represents a legitimate interpretation of accounting policy. He indicates that if you do not accept it, he will ensure that the trust appoints different auditors next year. He also threatens to tell the local newspaper that your firm is determined to make the trust's financial position look worse than it is.

Key fundamental principles

Integrity: Would you be acting with integrity if you were influenced by the finance director's threats, and accepted his year end adjustments?

Objectivity: How can you maintain your professional objectivity in the face of the threats made by the finance director? If your firm's local reputation and continued engagement by the trust affect your own position, how can you avoid self-interest influencing your ethical judgement?

Professional competence and due care: You must observe relevant auditing and accounting standards, policies and procedures, so that you demonstrate your professional competence.

Professional behaviour: You are required to perform your work in accordance with applicable law and regulations, including relevant auditing standards. How should you act so as not to discredit yourself, your firm or your profession?

Considerations

Identify relevant facts:

The director of finance has adjusted the year end financial statements primarily in the interests of the trust and those working within it. You are being intimidated by the director of finance, who is asking you to compromise your objectivity. You must research the relevant accounting requirements to ensure that your technical knowledge is accurate and

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up to date.

Identify affected parties:

Key affected parties are you, your firm, the director of finance, the chief executive, the trust and the general public. Others employed within the trust may also be affected.

Who should be involved in the resolution:

Within the trust, you should involve the director of finance, the audit committee and, if necessary, the chief executive. However, you should also involve senior members of your firm, as the firm will take responsibility for the audit report and its reputation is being threatened in terms of both competence and ethics.

Possible course of action

You should ensure that your technical knowledge is accurate and up to date by reviewing the relevant accounting standards, guidance and manuals issued by the government health department and discussing the technical issues with appropriate members of your firm and, if necessary, your professional body. You will then be able to discuss the issues further with the director of finance and the chief executive, if appropriate, and refer them to the relevant accounting standards and the ethical requirements of your professional body.

If this fails to persuade the directors to make the changes to the financial statements that you consider necessary, you should formally report the implications of this to the trust's audit committee, setting out the requirements of the accounting and auditing standards concerned, and the necessary amendments to the financial statements. You should explain the consequences for your report – a qualified audit opinion – if the trust fails to amend the financial statements.

You should make senior members of your firm aware of the accounting issues and the threats – to objectivity and to the firm's reputation. They should be involved in the drafting of the report to the audit committee, and then kept informed of developments.

You and your firm should consider whether the intimidation from the director of finance should be reported to the chief executive and the chair of the audit committee. You should document, in detail, the steps that you take in resolving your dilemma, in case your ethical judgement is challenged in the future. In particular, if you conclude that the financial statements continue to be materially misstated, your firm must issue a qualified audit opinion, and it is essential that you document fully the reasons for doing so.

Case Study 5 *Personal financial interest in a proposal*

Outline of the case

You are finance director in a public sector organisation that has experienced difficulty attracting and retaining skilled staff. To assist in overcoming this problem, the board has engaged a consultant to recommend an improved benefits structure, to apply to all staff. The consultant has produced his report, and you have been asked to consider the proposed staff benefits structure, and make appropriate recommendations to the board.

You study the report, conduct appropriate research, and assess the costs involved. You conclude that it will be necessary to increase staff costs, but you believe these will be offset by the efficiencies brought about by recruiting and retaining high-quality staff. The report contains the following recommendations:

Benefits should be related to the length of service of members of staff.

After one year of continuous employment, a member of staff will qualify for private health insurance.

Private health insurance should cover the member of staff and his or her spouse, but no other members of the employee's family.

Enhanced pension benefits will accrue to all staff after one year of service.

You decide to advise the board that the consultant's recommendations should be adopted in full.

You are pleased with your work on this assignment, and feel confident that the proposed package of benefits should serve as a strong motivator to all staff.

Your personal circumstances mean that you will benefit greatly if the board accepts the consultant's report. You have been with the organisation for eleven months. You have recently become engaged to your girlfriend, who works in a different department. She has handed in her notice, as you both decided that it was inadvisable to work so closely together after you are married. Her new job will provide a slightly lower salary, and you are both saving hard to buy your first home. The date of your wedding is only two months away, but you do not intend to start a family in the near future. You have been concerned about starting to provide for your pension, and neither you nor your fiancée have been able to afford health insurance.

Key fundamental principles

Integrity: In view of your personal interest in the proposed benefits structure, how will you ensure that you are perceived as straightforward and honest?

Objectivity: Can you remain unbiased and consider only the relevant facts and the interests of the organisation, despite your personal interest in the proposed benefits package?

Professional behaviour: How should you proceed so as not to discredit yourself or your profession?

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Considerations

Identify relevant facts:

An independent consultant has produced a report, and you are required to express your opinion on the recommendations made within it. These recommendations, if adopted by the board, would benefit you greatly. Are there ethical policies and procedures within the organisation that could help you? You must manage the reasonable perception of third parties, as well as your actual objectivity.

Identify affected parties:

Key affected parties are you, your fiancée, other staff within the organisation, and the board. Other possible affected parties are the organisation's personnel department and the consultant (whose reputation might be tainted if your own ethics are questioned).

Who should be involved in the resolution:

Before involving the board, you might discuss your dilemma with a senior member of the personnel department. The consultant's report concerns staff remuneration, and so you should take care if you decide to involve any other colleagues. You may seek independent, objective advice from your professional body.

Possible course of action

It is important that any personal interest you have in the consultant's recommendations is disclosed before your advice is considered by the board. As a member of staff yourself, it will be clear that you have a personal interest in the organisation's benefits package. However, the extent of your interest in accepting the recommendations (in view of your marriage plans and impending eligibility for the major benefits) may not be known to the board.

You should discuss the issue with an appropriate member of the personnel department before reporting to the board. You should attempt to present the board with a solution to the perceived threat to objectivity. The quality of the report provided by the consultant is not thought to be an issue, and you are required to provide the board with an opportunity to consider the proposals within it. Those proposals may well be in the best interests of the organisation.

In arriving at this stage, you should consider who else within the organisation would be able to review the report objectively. If nobody within the organisation has the necessary skills and independence, you might think it appropriate to procure a second opinion from another consultant.

You should be prepared to explain to the board how you approached the assignment, and who else has been involved in your discussions. Also, you should provide the board with information concerning the qualifications and independence of the consultant. When preparing your presentation to the board, including your costings, you should declare your interest in the consultant's recommendations being accepted.

If possible, you might arrange for the proposal to be presented to the board by someone other than yourself. This might be the chief executive or the most senior member of the personnel department. When the item arises for discussion at the meeting, you should refer to your personal interest, and leave the room until a final decision has been reached.

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During the resolution process, it may be helpful to consult with your professional body. Finally, you should ask yourself whether the process of reviewing the consultant's report has met the relevant quality assurance procedures laid down by the organisation.

You should document, in detail, the steps that you take in resolving your dilemma, in case your ethical judgement is challenged in the future.

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Case Study 4 *Disclosing personal information*

Outline of the case

You are the finance director of a district council. The chairman of the finance committee approaches you asking to see all the information the housing benefits section holds about the financial and personal affairs of a councillor.

The chairman of the finance committee insists on seeing this information (saying that he will not disclose how he acquired it), even though he cannot identify any legitimate reason. The chairman is not willing for you to contact the councillor about this.

Key fundamental principles

Integrity: Can you be straightforward and honest in your dealings with the people concerned?

Confidentiality: Are there proper grounds for disclosing the information?

Professional behaviour: What should you do to safeguard your reputation?

Considerations

Identify relevant facts:

Consider the organisation's policies, procedures and guidelines, applicable laws and regulations, and the code of ethics of your professional body. You should attempt to establish other relevant facts, including any allegations of fraud or impropriety on the part of the councillor, whether in the public domain or not.

Identify affected parties:

Key affected parties are you, the chairman, the councillor, and possibly the council. Other possible affected parties are the finance committee, members of council staff responsible for housing benefit, and the officer responsible for data protection.

Who should be involved in the resolution:

This appears to be a sensitive matter, and so you should consider not just whom you should involve, but also when to involve them and the reasons for their involvement. You will have to involve the chairman of the finance committee. Others may include the data protection officer, legal officers and internal auditors.

Possible course of action

You must engage effectively, but diplomatically, with the chairman of the finance committee. You should explain to him the ethical dilemma you are facing, and make your concerns clear. If possible, obtain from the chairman a formal, reasoned request in writing.

If this is not forthcoming, ensure you make detailed notes of the request and any reasons given or implied. Impress upon the chairman your duty of confidentiality, and any legal implications of complying with his request, as well as the ethical ones. You should obtain specialist legal advice if necessary, as meeting the request might infringe data protection legislation in some jurisdictions. You may refer the chairman to any information in the public domain, but you must deny him access to other information.

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If the request is formally made in writing by the chairman, you should try to establish whether there is a basis for investigating the councillor. This might be suspected impropriety, and again you are likely to need legal advice to establish any such basis for investigation. Your professional body will also be able to provide you with advice, as more facts come to light.

Try also to establish any reasons why the councillor should not be asked for his consent to the release of information about his affairs. Determine whether, in the light of any such reasons, an internal or external investigation may be appropriate (and by whom it should be conducted). It may be advisable to inform the councillor of any ensuing investigation at the relevant time, bearing in mind the need for confidentiality surrounding the investigation.

You should document, in detail, any discussions that you have with the chairman and any advisors, and the steps that you take in resolving your dilemma, in case your ethical judgement is challenged in the future.

ETHICAL DILEMMA 1: DIVORCING COUPLE

John and Jane Doe are getting a divorce. John and his longtime CPA, Andre, are old friends; Andre has provided tax and accounting advice to him for over 15 years, and to the couple since they wed 10 years ago. As part of his high-touch client service philosophy, Andre has met quarterly with the couple to discuss their tax needs as individuals and owners of a successful real estate agency. John and Jane trust Andre implicitly and ask him to assist them in this troubling time. Given their long relationship, and impressed by their desire to settle the divorce amiably, Andre agrees. Not anticipating difficulties, Andre does not request that they sign a conflict of interest waiver.

Over the following months, however, negotiations between John and Jane steadily deteriorate, and they eventually communicate with each other only through their attorneys. Andre is in the process of finalizing the preparation of their joint federal and state personal income tax returns, when John sends him an e-mail stating that his attorney has advised him to file separately on his return instead of jointly, as he and Jane had agreed. John also says, "Jane will need to figure out her own tax situation with her attorney. You are my advocate, not hers." Andre is not sure what John means nor, more importantly, how it may impact the services he has agreed to provide both John and Jane.

ETHICAL DILEMMA 2: BUSINESS PARTNERS

Barbara provides tax services for a general partnership client with two partners. One partner has a 70% share of the partnership, and the other has the remaining 30% share. The majority partner also engages Barbara separately to provide individual tax preparation services. Barbara has worked for the partnership and its majority partner for the past three years.

One day the majority partner requests Barbara's confidential advice and guidance regarding how to finance some large debts he has accumulated. Without hesitation, she provides him with some preliminary advice. However, the partner later leaves her a voice message suggesting that she come up with some "creative financing" regarding the partnership to help deal with this debt. He also reminds her not to share any of his problems with the minority partner.

The request troubles Barbara and puts her in an awkward position: maintaining confidentiality of the information could jeopardize her obligation to the minority partner.

ETHICAL DILEMMA 3: FORMER FRAUDSTER

One of Steve's tax clients, a small dental practice, e-mailed him to introduce its new office manager, Josephine Smith. As Steve reads the e-mail, he realizes that he knows Josephine Smith. Several years back, Josephine was the office manager of a pediatric group for almost four years, using her position to embezzle nearly $60,000. She occasionally had one of the pediatricians sign blank checks, which she would then make payable to her creditors, including her credit card accounts, utility companies, and others that mirrored her employer's. She would also sometimes forge a doctor's signature. She then booked the expenditures under utilities and other miscellaneous expense categories.

At first, Josephine stole small amounts—$200 one month, then $400—but the amounts increased as she grew bolder. The pediatricians fired her upon discovering the embezzlement, but they never pursued legal action. Josephine was a single mother caring for a special needs child, and out of sympathy, the doctors agreed to accept small monthly payments in restitution and forgo legal proceedings.

Steve became the pediatricians' accountant shortly after this incident. The doctors have occasionally mentioned the embezzlement in passing. Without asking, he is fairly certain that the pediatricians would not be willing to allow him to disclose this information to a third party.

Steve's knowledge of Josephine's previous embezzlement, and its implications for his dental practice client, concerns him. The dentist had worked with the former office manager, Kathy, for over 20 years, trusted her implicitly, and had her handle most of the practice's financial affairs, including preparing checks for signatures, making entries on day sheets, and taking deposits to the bank. If the dentist expects Josephine to fill that same role, he may be assuming risks greater than he realizes.

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Bidding on an Audit Engagement Proposal

Topic: Client/Engagement Acceptance

Characters: Joyce, Manager at a new audit firm
Gary, In-Charge Accountant
George and Sheila, Partners

Due to the economic downturn, George and Sheila were laid off by a larger audit firm. They established a new audit firm and were able to attract a few clients in the first year. They also hired Joyce and Gary, who had been laid off by the same firm. Joyce had been a manager for the past three years. She has been told that she can make partner if she can quickly attract new clients. Gary was a staff accountant for three years and was promoted to In-Charge Accountant this past year.

A prospective client in the construction industry contacted Joyce to bid on the company's audit work. The client was upset over the audit fees charged by its present auditors. They were unhappy with the present auditors' tax work and their delay in delivering a proposal on a new computerized accounting system. Joyce sees this situation as a perfect chance not only to secure a new audit client for the firm, but also to receive credit for bringing in more tax and consulting revenue.

Joyce asks Gary to prepare a draft of the bid which will be submitted to the prospective client. Gary develops the bid based on a similar client in the same industry and his assessment of the risk associated with a new client. Joyce is concerned that the bid is too high. Joyce suggests that they may be able to hire interns from a local college accounting program to use on the audit. Gary is concerned about using inexperienced staff on the audit of a new client. He also read in a recent Audit Risk Alert published in the *AICPA's CPA Letter* that auditors should be alert to cash flow problems for clients in the construction industry. Gary argues that the risk of loss could be higher than normal if they do not perform a quality audit.

Joyce tells Gary not to worry or say anything to George about his concerns with the bid. She will handle any problems that come along, either with George or the client. Joyce argues that George will not complain about the lower audit fee because of the potential for the new tax and consulting work. By using lower-paid staff members and eating a little time, they could even come in at budget. Joyce also points out to Gary that once she makes partner, there will be a position open for him at the manager level. Joyce tells Gary to finish up the proposal based on her suggestions, since she needs to work on a bid for another prospective client.

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Irrevocable Election

Topic: Client Services

Characters: Steve, Second-year staff accountant in small CPA firm
Partner, One of the firm's partners

Steve graduated from college about a year and a half ago and has been progressing rapidly as a staff member of a local CPA firm. Now, in Steve's second year at his firm, one of the partners has just stopped by to visit with him about a tax return Steve had prepared several months earlier. While looking at the client's file, the partner happened to notice that the firm should have attached to the return an irrevocable election that would have affected the timing of recognition of certain income the client had received and would continue to receive over the next several years. The election had to have been filed on a "timely" basis with the original return. Now the client faces a significant additional tax burden for a number of years to come.

"It's not really your fault, Steve," said the partner. "This was a fairly obscure election, and I wouldn't have expected you to have discovered it. I was out of town, and the return simply slipped through our review process without the election attached. Now it's too late, but I hate to see the client have to pay all this additional tax because of our mistake. Of course, she'll never realize what happened unless we tell her, but maybe we can avoid the problem entirely."

"Here's my idea," the partner continued. "I'd like you to prepare the election and attach it to our file copy of the return. Then, we'll prepare next year's return as if the election had been filed on time. If any questions come up, we'll pull out our file copy, show it to the auditor, and suggest that the election must have been lost during processing at IRS. Give it some thought, and I'll get back to you in a couple of days."

As the partner leaves, Steve is already nervously reviewing the conversation. Although thankful for some time to think, he is concerned that this could be a "no-win" situation. He has a sense of loyalty to the firm, and he doesn't want the client or anyone else to suffer for his mistake. On the other hand, he has misgivings about complying with the partner's suggestion.

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