What Happens When CPA Ethics Go Out The Window? A Short Case Study!

June 1, 2016

Robert L. Ramey, P.C.
Certified Public Accountant
El Paso, TX 79925

For those old enough to remember, there was a time when the CPA professional was at or near the top of the heap, year after year, of trusted professionals. That's not true today. Scandals have tarnished that image and it's unlikely that any government oversight and industry cleanup will restore the luster to the profession. But CPAs are people, just like everyone else, (See Real Estate Agents, Part 2) and they're subject to the same incentives as everyone else. And sometimes those incentives get in the way of doing the right thing. Consider the following, based on discussions with a very good friend ("David"), a retired public school district CFO, now deceased.

In 2012 David took on a bookkeeping client referred to him by a large local CPA firm ("CPA Firm"). The client was a personal injury attorney who operated his practice ("Attorney Corp") as an S Corp. As a cash basis "S" Corp, all corporate income is pass-through to the shareholder when cash is received by the corporation. The client had a real problem on his hands as his corporate returns were two years in arrears and consequently, his personal returns were also in arrears. The last corporate return he had filed was 2009 and David's job was to catch him up. Prior to David doing the bookkeeping work, the attorney had used another CPA recently retired from CPA Firm and prior to that he had used a local non-CPA bookkeeper.

Accounting for attorneys is not typical, especially for a personal injury attorney. On a given case, the attorney pays all bills, expert witnesses, depositions, travel for depositions or expert witnesses, X-rays, everything, from his corporate funds. Those costs are recorded as assets and they accumulate until the case is settled. When the case is settled, if the case has merit and the client prevails, then the attorney's costs are reimbursed first from the settlement. Then the settlement pays the attorney's fees, typically one third of the remaining settlement after reimbursing the attorney for his costs, and the client gets the rest. When the case is settled, funds are typically forwarded to the attorney by the defendant's insurance company, etc., and the attorney deposits those funds into a separate trust account until disbursed. Simply depositing the settlement funds into the trust account does not generate revenue for the attorney. The funds are held "in trust" until disbursed to the client and to the attorney and to whomever else, expert witness and so on, has a valid claim on the funds. Only when the funds are disbursed from the trust account and deposited into the attorney's operating account are revenues recognized by the attorney. Because the attorney wants to be sure that no costs are "hiding", he gives all potential debtors adequate time and there may be a significant time lag, perhaps up to two to three years, between the deposit of funds into the trust account and the disbursal of those funds to the attorney for fees.

During his work on the 2010 records, David determined the following;

<u>2008</u>

1. The attorney's in-house bookkeeper incorrectly recorded, in December 2008, a $300,000 "journal entry" in the accounting records of Attorney Corp that accrued "Attorney fees" and set up a receivable from the trust account related to settlement funds deposited into the trust account in 2008 and not yet disbursed.
2. The 2008 corporate return, Form 1120S, was prepared by CPA Firm and incorrectly included the $300,000 in gross receipts.
3. The attorney's personal income tax return, Form 1040, was prepared by CPA Firm and as a result of No. 1 and No. 2, corporation pass-through income to the attorney was overstated by $300,000 and the attorney overpaid his personal income tax in 2008 by approximately $102,000.

<u>2009</u>

1. By December 31, 2009, no funds had been disbursed from the trust, either to the client or to Attorney Corp, related to the 2008 cases. Thus, Attorney Corp had not earned fees related to the 2008 cases.
2. CPA Firm, while preparing the 2009 Attorney Corp, Form 1120S, incorrectly reversed the 2008 accrual, reducing the accrued receivable to $0 and reducing attorney fees revenue for 2009 by $300,000.
3. The attorney's personal income tax return, Form 1040, was prepared by CPA Firm and as a result of No. 2, Attorney Corp pass-through income to the attorney was understated by $300,000 and the

attorney underpaid his personal income tax for 2009 by approximately $102,000.

2010

1. Satisfied that the cases were truly settled and that no further costs would occur, the attorney properly disbursed funds to a) Attorney Corp to reimburse Attorney Corp for its costs associated with the case, b) Attorney Corp to pay Attorney Corp's attorney fees, and c) to the client for his portion of the settlement.
2. Attorney Corp recorded as, "Attorney fees", the attorney fee portion of the funds received, thus overstating revenue by $300,000 in 2010.
3. Attorney Corp's federal income tax return, Form 1120S, was two years in arrears and was prepared by CPA Firm in 2012. Corporate pass-through income to the attorney included the $300,000 on which taxes had been "early paid" in 2008.

In summary, 1) The attorney overpaid his 2008 taxes due to his own bookkeeping error, 2) the attorney underpaid his 2009 taxes due to CPA Firm's error, 3) the attorney overpaid his 2010 taxes due to CPA Firm's error, and 4) the attorney paid approximately the correct taxes for the three years if all three years are blended. To be sure, the IRS probably wouldn't object to the overpayment of taxes in 2008. Why would they? However, because CPA Firm prepared the 2010 two years in arrears (due to attorney caused delays), late payment interest and the higher late filing penalties were levied. And they were levied on revenue on which the attorney had already paid tax in 2008. And the penalties and interest were levied because CPA Firm did not go back and amend the 2009 1120S and 1040 which were understated due to CPA Firm's error. The additional late filing penalty was approximately $27,000. Had the 2009 return been amended and the 2010 return correctly filed, 2010 would have shown a tax loss and thus, no penalties or interest on tax owed would have been incurred.

None of this changes the fact that the attorney owes $102,000 tax for 2009 no matter who caused the error. His income was underreported and he underpaid his tax. Although the error didn't cause him to owe $102,000 it did cause him to not pay it timely. So he owes $102,000 tax. But does he owe failure to file penalty on that amount? Why would he? Had CPA Firm not made an error in 2009 he would have paid his taxes as soon as he became aware that he owed tax and if he was paying late, he would have paid all appropriate late payment penalties. But he certainly doesn't owe late payment interest for the period after his return was filed. And he certainly doesn't owe late payment interest or penalties for 2010 since, without CPA Firm’s "incorrect correction" of 2009, he has a loss.

If CPA Firm had done the "right thing", they would have amended the 2009 1120S and the 2009 1040 and had the attorney pay the tax owed. And to make the attorney "whole", since the 2009 error was a "CPA Firm error", CPA Firm should have paid all interest and penalties incurred from the date the return was filed until the taxes and penalties and interest were paid. Instead, CPA Firm pushed the income into the subsequent year in which the returns were in arrears and would incur significant interest and penalties and it would appear that client caused delays were responsible for the penalties and interest. And because CPA Firm is the expert, the attorney didn't question this "bad" advice.

When all was said and done, the attorney paid at least $27,000 in late filing penalties and more in interest that, had CPA Firm done the right thing ethically, should have been paid by CPA Firm.

This is not an indictment of all CPAs. I am a CPA and I'm proud of that. But sometimes, some CPAs don't always do the right thing. The premise of this is "Why people shouldn't always trust their CPA." The answer is, because not all CPAs put their client's interests ahead of their own and clearly, in this situation, that was the case.