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Ethics for CPAs

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Printed in the United States of America

Course Information

Course Title: Ethics for CPAs

Learning Objectives:

- Explain the different levels of corporate social responsibility
- Recognize the factors that lead to ethical violations
- Identify sources of pressure that lead to misconduct
- Describe how to reduce ethical risk
- Summarize the principles of professional conduct
- Describe the various types of fraudulent acts
- Discuss the statistical findings regarding fraud
- Differentiate between the different types of financial statement fraud
- Summarize the Sarbanes-Oxley Act of 2002
- Recognize the rules surrounding the ethical and independence requirements for auditors
- Summarize the various violations and charges in the accounting and auditing cases
- List the indicators of tax fraud
- Summarize the Statements on Standards for Tax Services (SSTS)
- Describe the tactics used by abusive tax return preparers
- Recognize the types of corporate tax fraud schemes
- Discuss the types of abusive tax schemes

Subject Area: Ethics

Prerequisites: None

Program Level: Overview

Program Content: This course discusses the ethical concepts surrounding businesses, accountants, auditors, and tax professionals. Presented within the text are ethical surveys and statistics regarding misconduct in the workplace, corporate fraud, and tax fraud. Many of the principles and rules set forth for the accounting profession, along with the penalties for violating these rules, is provided. Also found throughout the text

are court rulings in regards to: whistleblower retaliation, auditor violations, corporate fraud, and tax fraud.

Advance Preparation: None

Recommended CPE Credit: 4 hours

Table of Contents

Chapter 1 - An Overview of Ethics....1

Learning Objectives....1
Introduction....1
Ethical Concepts....1
Ethical Surveys....3
Review Questions....12
Review Answers....13

Chapter 2 - Ethics for Accounting & Auditing Professionals....15

Learning Objectives....15
Introduction....15
Principles of Professional Conduct....15
Fraudulent Acts....22
Statistics Regarding Fraud....24
Types of Financial Statement Fraud....28
Noteworthy Accounting Scandals....31
Sarbanes-Oxley Act of 2002....34
Ethics & Independence Rules for Auditors....38
Review Questions....50
Review Answers....51

Chapter 3 - Accounting & Auditing Cases....53

Learning Objectives....53
Introduction....53
Corporate Fraud Cases....53
Auditor Violation Cases....59
Review Questions....74
Review Answers....75

Chapter 4 - Ethics for Tax Professionals....76

Learning Objectives....76
Introduction....76
Tax Fraud....76
Statements on Standards for Tax Services (SSTS)....78
Tax Preparer Penalties under Title 26 – Internal Revenue Code....80
Abusive Tax Return Preparers....82
Statistical Data – Abusive Tax Return Preparers....83
Case Examples – Abusive Tax Return Preparers....83
Corporate Tax Fraud....85
Statistical Data – Corporate Tax Fraud....85
Case Examples – Corporate Tax Fraud....86
Abusive Tax Schemes....89

Statistical Data – Abusive Tax Schemes 91
Case Examples – Abusive Tax Schemes 91
Review Questions 94
Review Answers 96

Glossary 99
Index 109

Chapter 1
An Overview of Ethics

Learning Objectives

- Explain the different levels of corporate social responsibility
- Recognize the factors that lead to ethical violations
- Identify sources of pressure that lead to misconduct
- Describe how to reduce ethical risk

Introduction

This chapter emphasizes the importance of business ethics and the need for corporate social responsibility. Many factors lead to ethical violations in the workplace, and the surveys provided within the text indicate that company tactics and/or upper management play a significant role in employee misconduct. Whistleblower fear of retaliation is also a prevalent ethical issue, and this chapter explores some recent cases involving this type of retaliation. Finally, the reasons to remain ethical and how to reduce ethics risks is presented.

Ethical Concepts

Business ethics involves the principles, values, and standards that guide how people and institutions should act in the world of commerce. The following are common issues facing businesses today:

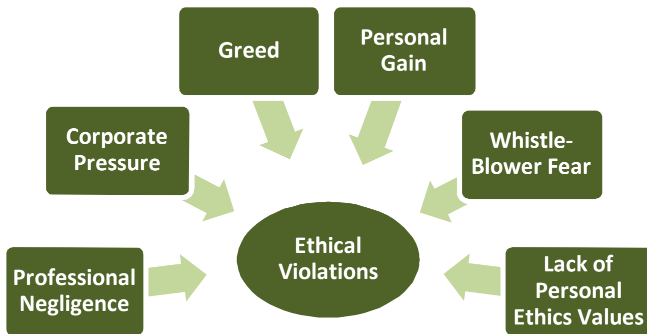
- **Corporate Governance:** The relationship between all stakeholders in an organization. Among these stakeholders are the shareholders, directors, and management of a company, as defined by the corporate charter, bylaws, formal policy and rule of law.
- **Fiduciary Duty:** A legal obligation of one party, someone entrusted with the care of money or property, to act in the best interest of another.
- **Corporate Social Responsibility:** Initiative to assess and take responsibility for the company's effects and impact on social welfare. Encompasses a company's economic responsibility, legal responsibility, ethical responsebility, and philanthropic responsibility.

In light of large corporate scandals that have negatively impacted the economy and further deteriorated investor and public trust, it is imperative that organizations take steps that reflect a positive corporate social responsibility and go beyond what is required by regulators. The following pyramid outlines the four responsibilities businesses should follow in order to fulfill the public's expectations of corporate social responsibility.

Figure 1-1
Pyramid of Corporate Social Responsibility

In order for organizations to achieve corporate social responsibility, there must be an understanding of the factors that lead to unethical acts and a full understanding of employees' perceptions of ethics in the workplace. This understanding is necessary since misconduct by employees in the workplace can negatively impact key stakeholders, such as investors, creditors, employees, customers, suppliers, and the community. The following diagram outlines many of the factors that may lead to ethical violations in the workplace.

Figure 1-2
Factors Leading to Ethical Violations



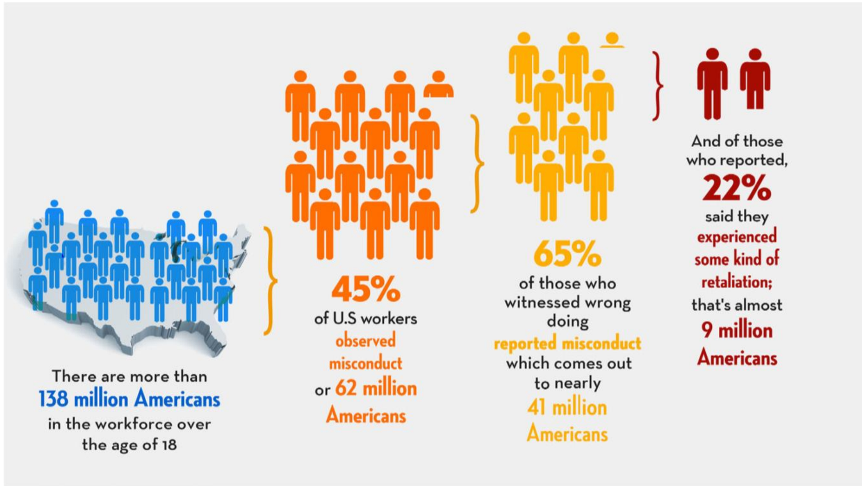
Ethical Surveys

The above mentioned factors leading to ethical violations are common in the workplace, as seen in surveys done by the Ethics Resource Center. Every two years, the Ethics Resource Center releases a national ethics survey concerning business ethics. The 2011 National Business Ethics Survey® (telephone and online survey of 4,683 employees in the for-profit sector and 117 in the government sector; margin of error 1.4%) provides insight into how employees view misconduct in the workplace. The results from these surveys reveal:

- **Source of Pressure**
  - "Keeping your job" was the number one source of pressure for compromising standards
- **Retaliation**
  - Types of retaliation increased from 2009, with being "Excluded from decisions and work activity by supervisor or management" as the most experienced form of retaliation
- **Well-Implemented Programs and Strong Cultures**
  - Organizations with well-implemented ethics programs and strong ethical cultures experience a reduction in various ethical risks, with the largest reduction being in observed misconduct

The following charts reveal the full findings of various ethical surveys conducted by the Ethics Resource Center.

Figure 1-3
Workforce Experiencing Misconduct



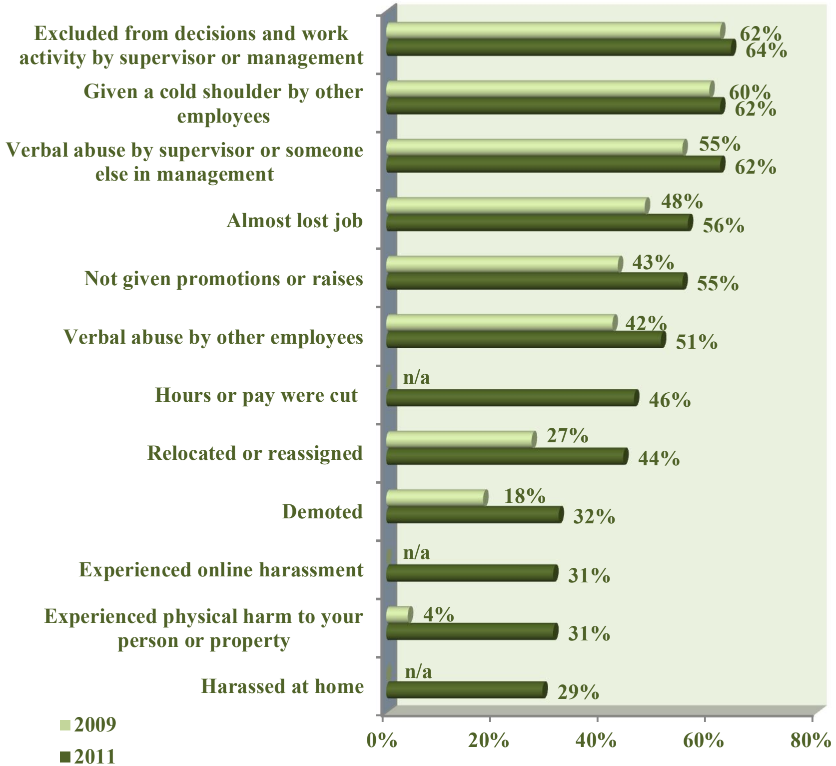
Source: Ethics Resource Center (ERC) – 2011 National Business Ethics Survey ®

Figure 1-4
Sources of Pressure for Committing Unethical Acts

Source of Pressure	2007 Rankings	2009 Rankings	2011 Rankings
Keeping your job	5	2	1
Meeting personal financial obligations**	3	3	2
Financial Stability and success of your company	n/a	1	3
Advancing your career**	3	4	4
Meeting performance goals	6	n/a	n/a
Saving others' jobs	2	n/a	n/a
Supervisor's pressure	4	n/a	n/a
Demands from people who support or invest in your organization	1	n/a	n/a

**These two items were asked as one item in 2007
Source: Ethics Resource Center (ERC) – 2011 National Business Ethics Survey ®

Figure 1-5
Types of Retaliation



**n/a – Question not asked in 2009
Source: Ethics Resource Center (ERC) – 2011 National Business Ethics Survey ®

Whistleblower Retaliation Cases
In order to deter any of the above mentioned retaliation acts or other types of threatening acts towards whistleblowers, protection is provided under state and federal laws, and the Sarbanes-Oxley Act of 2002. The following are court cases in which whistleblowers, protected under the Sarbanes-Oxley Act of 2002, received restitution after experiencing retaliation.

♦ Case Example ♦

Bond Laboratories
OSHA Regional News Release: 11-1352-SAN (SF-222)
Date: September 15, 2011

The U.S. Department of Labor's Occupational Safety and Health Administration has found Bond Laboratories Inc. and former CEO Scott Landow in violation of the whistleblower protection provisions of the Sarbanes-Oxley Act for improperly firing an employee. The company and Landow have been ordered to re-hire the employee and pay approximately $500,000 in back wages, interest and compensatory damages. The findings follow an investigation by OSHA's San Francisco Regional Office, which was initiated after receiving a complaint from the employee.

Landow and Bond Laboratories, formerly based in Solana Beach, allegedly terminated the complainant, an officer, for objecting to the manipulation of sales figures that misrepresented the company's value to potential investors. OSHA determined that the complainant repeatedly objected to this practice between March and October 2008, and that the objections contributed to the decision to terminate the complainant.

"This corporate officer tried to do the right thing when asked to break the law," said Assistant Secretary of Labor for OSHA Dr. David Michaels. "It is essential that America's workers do not have to fear retaliation when reporting wrongdoing. The Labor Department will continue to protect whistleblowers from retaliation by holding corporations, and when appropriate, CEOs, accountable."

The complainant, Bond Laboratories and Landow can appeal the monetary damages to the Labor Department's Office of Administrative Law Judges within 30 days of receiving the findings. Bond Laboratories, now based in Omaha, Neb., manufactures nutritional supplement beverages and related products for public consumption.

♦ Case Example ♦

Bank of America
OSHA Regional News Release: 11-1351-SAN
Date: September 14, 2011

The U.S. Department of Labor's Occupational Safety and Health Administration has found Charlotte, N.C.-based Bank of America Corp. in violation of the whistleblower protection provisions of the Sarbanes-Oxley Act for improperly firing an employee. The bank has been ordered to reinstate and pay the employee approximately $930,000, which includes back wages, interest, compensatory damages and attorney fees. The findings follow an investigation by OSHA's San Francisco Regional Office, which was initiated after receiving a complaint from the Los Angeles-area employee.

"It's clear from our investigation that Bank of America used illegal retaliatory tactics against this employee," said OSHA Assistant Secretary Dr. David Michaels. "This employee showed great courage reporting potential fraud and standing up for the rights of other employees to do the same."

The employee originally worked for Countrywide Financial Corp., which merged with Bank of America in July 2008. The employee led internal investigations that revealed widespread and pervasive wire, mail and bank fraud involving Countrywide em-

ployees. The employee alleged that those who attempted to report fraud to Countrywide's Employee Relations Department suffered persistent retaliation. The employee was fired shortly after the merger.

"Whistleblowers play a vital role in ensuring the integrity of our financial system, as well as the safety of our food, air, water, workplaces and transportation systems," added Michaels. "This case highlights the importance of defending employees against retaliation when they try to protect the public from the consequences of an employer's illegal activities."

Both the complainant and Bank of America can appeal the monetary damages to the Labor Department's Office of Administrative Law Judges within 30 days of receiving the findings.

♦ Case Example ♦

Dana Holding Corporation
OSHA Regional News Release: 12-1805-CHI
Date: September 10, 2012

Dana Holding Corp. has been ordered by the U.S. Department of Labor to reinstate and pay $274,922.47 in back wages and benefits, compensatory damages and attorney's fees to a financial analyst who was fired from the company's Toledo facility in February 2009.

The order resulted from an investigation by the Chicago office of the department's Occupational Safety and Health Administration into alleged violations of the whistleblower protection provisions of the Sarbanes-Oxley Act of 2002. OSHA was able to substantiate a complaint submitted by the employee, who alleged termination for raising concerns about inaccuracies in the company's customer information assessment system database that could be reflected as inaccuracies in the company's annual financial reports.

"The Sarbanes-Oxley Act provides protection to workers who report alleged violations of federal laws relating to fraud against shareholders," said Nick Walters, OSHA's regional administrator in Chicago. "This case clearly shows the department's commitment to ensuring that individuals are provided the protections and relief afforded by the law, and sends a message that retaliatory actions will not be tolerated."

Specifically, OSHA's order requires the company to pay $47,813.72 in back wages, vacation pay, pension and 401(k) contributions; $108,167.60 in compensatory damages; and $118,941.15 in attorney's fees. In addition to immediate reinstatement, the company must expunge any adverse references related to the discharge in the employee's personnel record, post a notice about the Sarbanes-Oxley Act's whistleblower provisions for all employees and train employees on these provisions.

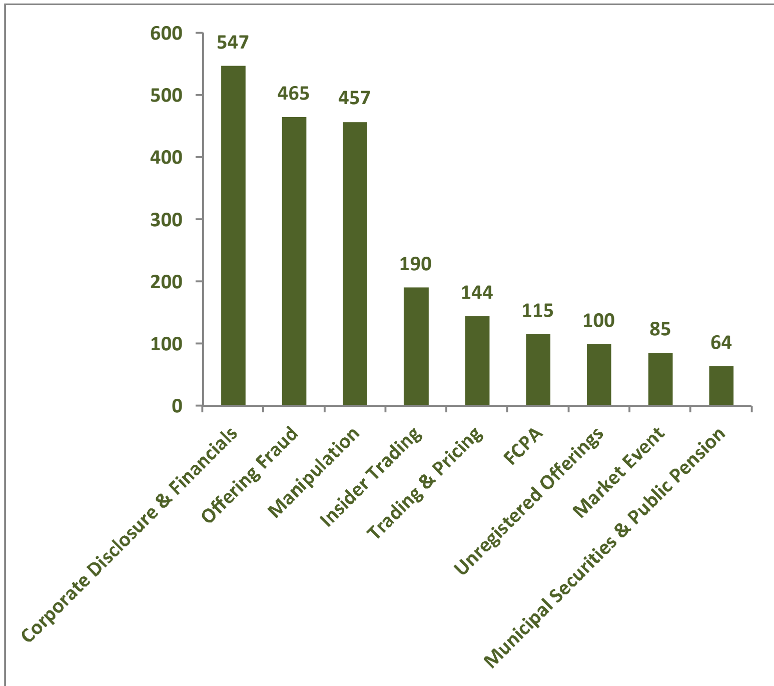
Dana Holding supplies driveline, sealing and thermal management technologies for passenger, commercial and off-highway vehicles. The company is headquartered in Maumee and employs about 25,500 workers worldwide.

Either party to this case may file objections or request a hearing before the Labor Department's Office of Administrative Law Judges within 30 days.

U.S. Securities and Exchange Commission Annual Report on the Dodd-Frank Whistleblower Program

The Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted on July 21, 2010 ("Dodd-Frank"), established a whistleblower program that requires the Commission to pay an award, under regulations prescribed by the Commission and subject to certain limitations, to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action. Dodd-Frank also prohibits retaliation by employers against individuals who provide the Commission with information about possible securities violations. The following chart indicates the types of whistleblower tips for FY 2012. It is important to note that out of all of the direct categories of allegations, corporate disclosure and financials wrongdoings received the most whistleblower tips for the year.

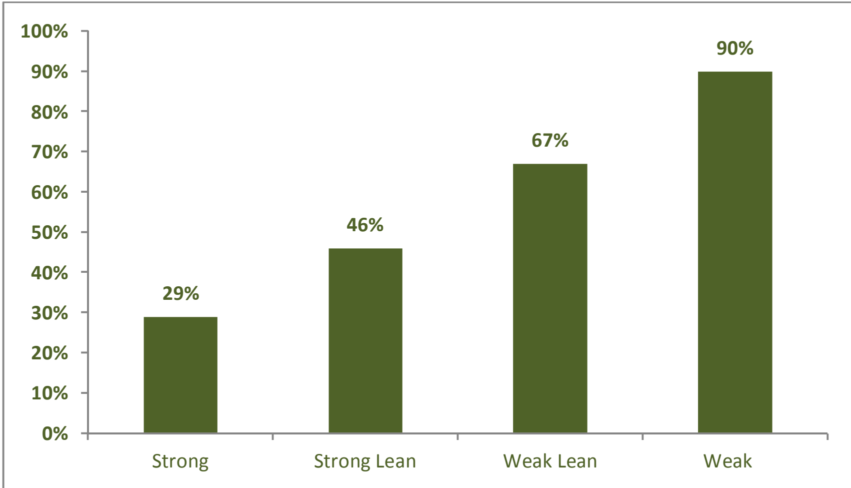
Figure 1-6
Whistleblower Tips by Allegation Type – FY 2012



Source: U.S. Securities and Exchange Commission; Annual Report on the Dodd-Frank Whistleblower Program

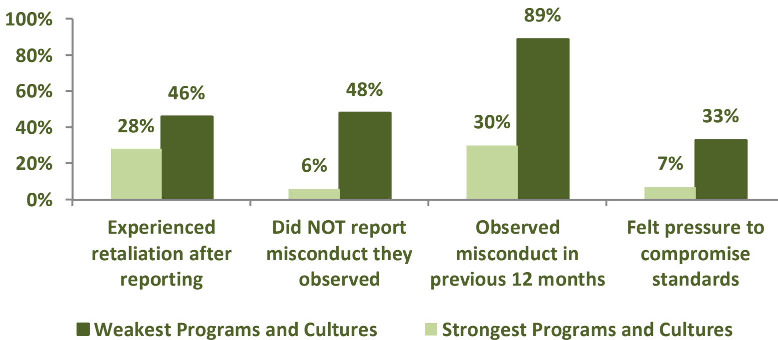
A strong ethical culture combined well-implemented ethics program are both needed in order to reduce the ethics risk within an organization. As noted in the following two surveys, tone at the top and strong ethical cultures are necessary for an ethical workplace.

Figure 1-7
Employees Who Observed Misconduct in Previous 12 Months



Source: Ethics Resource Center (ERC) – 2011 National Business Ethics Survey ®

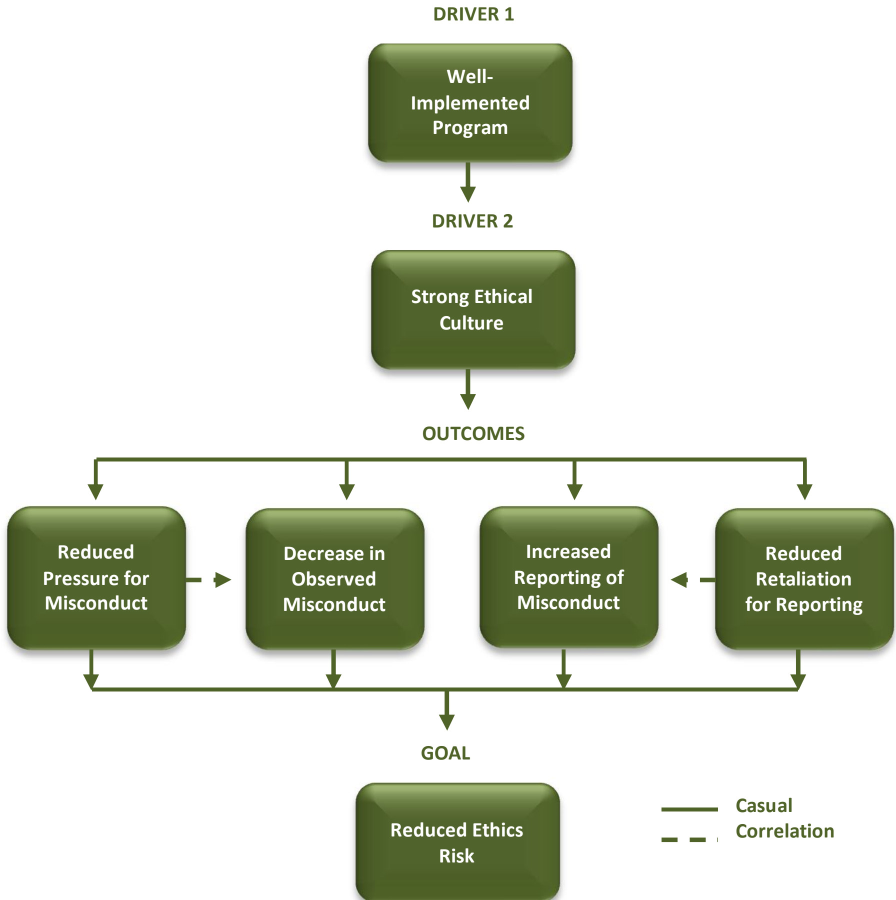
Figure 1-8
Reduction of Ethics Risk



Source: Ethics Resource Center (ERC) – 2011 National Business Ethics Survey ®

The above mentioned surveys demonstrate how pressures from management, company tactics, and/or "tone at the top" play a significant role in employee misconduct, and they further stress the importance of ethical education, guidelines, and policies. Although not every ethical decision will be a direct benefit to an organization's finances, acting ethically will have a greater impact in the long run. The following figures indicate how to reduce ethical risks and how the reductions of these risks benefit the organization.

Figure 1-9
Reducing Ethics Risk



Source: Ethics Resource Center

Figure 1-10
10 Reasons to Remain Ethical

10 Reasons Why a Business Should Remain Ethical

#1 – "The Right Thing To Do"
#2 – Organizational Foundation That Reflects Excellence
#3 – Customer Trust & Loyalty
#4 – Protection of Brand & Reputation
#5 – Investor Confidence
#6 – Employee Recruitment, Retention & Performance
#7 – Business Partner Trust
#8 – Public Acceptance & Recognition
#9 – Ability to Self-Regulate
#10 – Litigation Prevention

Review Questions

1. Which of the following responsibilities in Pyramid of Corporate Social Responsibility contributes resources to the community and improves the quality of life?
    A. Philanthropic Responsibility
    B. Ethical Responsibility
    C. Legal Responsibility
    D. Economic Responsibility

2. Which of the following factors would NOT lead to ethical violations in the workplace?
    A. Corporate pressure
    B. Personal gain
    C. Whistleblower fear
    D. Well-implemented ethical programs

3. According to the 2011 survey, which of the following had the lowest rank as a source of pressure for compromising standards?
    A. Financial stability and success of your company
    B. Advancing your career
    C. Meeting personal financial obligations
    D. Keeping your job

4. What percentage of respondents in the 2011 survey reported that they "Almost lost job" as a source of retaliation after reporting unethical actions in the workplace?
    A. 29%
    B. 32%
    C. 56%
    D. 64%

5. Which of the following statements accurately reflect reducing ethical risks?
    A. There is a direct correlation between reduced pressure for misconduct and a decrease in observed misconduct
    B. There is a casual correlation between reduced retaliation for reporting and increased reporting of misconduct
    C. There is a direct correlation between increased reporting of misconduct and decrease in observed misconduct
    D. There is no correlation between a strong ethical culture and reduced retaliation for reporting

Review Answers

1. A. **Correct.** The philanthropic responsibility reflects being a good corporate citizen by contributing resources to the community and improving the quality of life.
   B. Incorrect. Ethical responsibility involves being ethical and a business's obligation to do what is right, just, and fair.
   C. Incorrect. Legal responsibility involves obeying the law and playing by the rules of the game.
   D. Incorrect. Economic responsibility involves being profitable and is the foundation upon which all others rest.

2. A. Incorrect. Corporate pressure is a factor that may lead to ethical violations in the workplace.
   B. Incorrect. Personal gain is a factor that may lead to ethical violations in the workplace.
   C. Incorrect. Whistleblower fear is a factor that may lead to ethical violations in the workplace.
   D. **Correct.** Well-implemented ethical programs are not a factor that would lead to ethical violations in the workplace. Ethical programs are designed to reduce or eliminate ethical violations.

3. A. Incorrect. "Financial stability and success of your company" did not have the lowest rank as a source of pressure for compromising standards in the 2011 survey. This source of pressure was ranked 3rd on the list.
   B. **Correct.** According to respondents surveyed in 2011, "Advancing your career" was the lowest ranked source of pressure for compromising standards.
   C. Incorrect. "Meeting personal financial obligations" did not have the lowest rank as a source of pressure for compromising standards in the 2011 survey. This source of pressure was ranked 2nd on the list.
   D. Incorrect. "Keeping your job" did not have the lowest rank as a source of pressure for compromising standards in the 2011 survey. This source of pressure was ranked 1st on the list.

4. A. Incorrect. The percentage of respondents in the 2011 survey reported that they "Almost lost job" as a source of retaliation after reporting unethical actions in the workplace was not 29%. "Harassed at home" was experienced by 29%.
   B. Incorrect. The percentage of respondents in the 2011 survey reported that they "Almost lost job" as a source of retaliation after reporting unethical actions in the workplace was not 32%. "Demoted" was experienced by 32%.

C. **Correct.** The percentage of respondents in the 2011 survey reported that they "Almost lost job" as a source of retaliation after reporting unethical actions in the workplace was 56%.
D. Incorrect. The percentage of respondents in the 2011 survey reported that they "Almost lost job" as a source of retaliation after reporting unethical actions in the workplace was not 64%. "Excluded from decisions and work activity by supervisor or management" was experienced by 64%.

5. A. **Correct.** There is a direct correlation between reduced pressure for misconduct and a decrease in observed misconduct is an accurate statement regarding reducing ethical risks.
B. Incorrect. There is a casual correlation between reduced retaliation for reporting and increased reporting of misconduct is not an accurate statement regarding reducing ethical risks. There is a direct correlation between the reduced retaliation for reporting and the increased reporting of misconduct.
C. Incorrect. There is a direct correlation between increased reporting of misconduct and decrease in observed misconduct is not an accurate statement regarding reducing ethical risks. In this situation, there is a casual, not a direct, correlation.
D. Incorrect. There is no correlation between a strong ethical culture and reduced retaliation for reporting is not an accurate statement regarding reducing ethical risks. There is a casual correlation between a strong ethical culture and reduced retaliation for reporting.

Chapter 2
Ethics for Accounting & Auditing Professionals

Learning Objectives

- Summarize the principles of professional conduct
- Describe the various types of fraudulent acts
- Discuss the statistical findings regarding fraud
- Differentiate between the different types of financial statement fraud
- Summarize the Sarbanes-Oxley Act of 2002
- Recognize the rules surrounding the ethical and independence requirements for auditors

Introduction

The accounting profession faces its own set of ethical issues. In order to combat unethical acts in the accounting profession, the AICPA, PCAOB, SEC, and various CPA societies have created their own set of guiding principles and rules. This chapter presents those rules, along with types of fraudulent acts committed for either personal gain or to meet earnings goals and expectations. Statistics regarding fraud cases issued by the Association of Certified Fraud Examiners is provided. Also presented in this chapter are noteworthy accounting scandals and the types of financial statement fraud committed. Lastly, portions of the Sarbanes Oxley Act of 2002 and the ethical and independence standards for auditors are provided.

Principles of Professional Conduct

The AICPA and other CPA societies have created guiding principles for the accounting profession that express the profession's recognition of its responsibilities to the public, to clients, and to colleagues. They guide CPAs in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

Public Interest

A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession‘s public consists of those who rely on the objectivity and integrity of certified public accountants to maintain the orderly function of commerce, which includes:

- Clients
- Credit Grantors

- Governments
- Employers
- Investors
- Business Community
- Financial Community

This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.

In discharging their professional responsibilities, CPAs may encounter conflicting pressures from among each of those groups. In resolving those conflicts, CPAs should act with integrity, guided by the precept that when CPAs fulfill their responsibility to the public, clients‘ and employers‘ interests are best served.

Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services – all in a manner that demonstrates a level of professionalism consistent with these principles.

♦ Case Example ♦

Public Interest Violation

California Board of Accountancy Disciplinary Actions/License Restrictions

Defendant: Stump Davis Greenberg, Accountants Inc., Playa Cel Rey, CA

CBA Action: Revocation stayed with three years' probation, via stipulated settlement; Reimbursement of the CBA in the amount of $12,000 for its investigation and prosecution costs

Accusation No. AC-2009-37 alleges that Respondents were grossly negligent and committed repeated acts of negligence by failing to complete and file requisite financial and tax documents in a timely manner for tax years 2000 through 2006 for a client. Respondents failed to comply with professional standards by issuing financial statements to the same client for the month of July 2007 that did not include a compilation report and Respondents did not have an engagement letter with said client documenting the services to be performed.

Integrity

To maintain and broaden public confidence, CPAs should perform all professional responsibilities with the highest sense of integrity. Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a CPA must ultimately test all decisions.

Integrity requires a CPA to be, among other things, honest and candid within the constraints of client and employer confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a CPA should test decisions and deeds by asking:

- "Am I doing what a person of integrity would do?"
- "Have I retained my integrity?"

Integrity requires a CPA to observe both the form and the spirit of technical and ethical standards. Integrity also requires a CPA to observe the principles of objectivity and independence and of due professional care.

♦ **Case Example** ♦

Integrity Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Silver Sack, Bakersfield, CA
CBA Action: Revocation of CPA certificate, via stipulated settlement

For purposes of settlement, Mr. Sack acknowledges and admits he provided accounting services for a client and the client's business for 28 years. Mr. Sack further admits his services were terminated in early 2003 after the client determined that for several years Mr. Sack had been making check disbursements directly to himself or for his personal benefit and making false entries into the accounting records of his client.

After further inquiry by the client, settlement negotiations were initiated between the client and Mr. Sack. Eventually a settlement agreement was executed that required Mr. Sack to pay the client $200,000 for the conversion and mishandling of the client's funds.

The actions by Mr. Sack were charged as violations for embezzlement, misappropriation of funds, obtaining money by fraud or false pretenses, fiscal dishonesty, and breach of fiduciary duty of any kind.

Objectivity

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

CPAs often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. CPAs render attest, tax, and management advisory services as well as prepare financial statements in the employment of others, perform internal auditing services, and serve in

financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, CPAs should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

All CPAs have the responsibility to maintain objectivity in rendering professional services. CPAs employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as CPAs who perform attest services and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with CPAs who perform external attest services.

♦ Case Example ♦

Objectivity Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Roland Zita, Beverly Hills, CA
CBA Action: Revocation of CPA Certificate and CPA Corporation Permit, via stipulation settlement

Mr. Zita agrees that the charges and allegations in the First Amended Accusation AC-2004-31, if proven at hearing, constitute cause for imposing discipline upon his CPA certificate and on his CPA Corporation permit.

The Board's accusation outlined the circumstances supporting the imposition of discipline related to Mr. Zita's tenure as his client's CPA.

From approximately mid-1993, Mr. Zita assumed sole responsibility as his client's CPA and continued to provide services to her until his dismissal in late 1998. Mr. Zita acted as his client's accountant, tax preparer, and business manager during their professional relationship.

Mr. Zita's sworn testimony or representations constitute the basis of the categorization of monies as fees and gifts, which amounted to $887,000 and $477,757.72, respectively, over the period 1993 to 1998. Total fees included a brokerage account transfer of $500,000 in 1995.

The Board's accusation charged that Mr. Zita had a confidential and fiduciary relationship with his client, occupied a position of trust and owed her a fiduciary relationship duty. Mr. Zita was charged with using his position and influence with his 90-year-old client to his financial advantage and to her detriment as general unprofessional conduct, breach of fiduciary duty, and conflict of interest.

Mr. Zita was charged with fiscal dishonesty and knowing preparation and dissemination of false, fraudulent financial information, by his failure to report on his personal or corporation income tax return the $500,000 that he claimed to be a professional fee earned in connection with his assistance to his client in the settlement of a lawsuit.

Due Professional Care

The quest for excellence is the essence of due professional care. Due professional care imposes the obligation to perform professional services to the best of a CPA's ability with concern for the best interest of those for whom

the services are performed and consistent with the profession's responsibility to the public.

Due professional care also imposes the obligation to seek out and implement best practices when appropriate, as well as requires a CPA to plan and supervise adequately any professional activity for which he or she is responsible. Furthermore, CPAs should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility:

- To render services in a timely fashion
- To be thorough
- To observe applicable technical and ethical standards

♦ Case Example ♦

Due Professional Care Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Anthony Sanchez, Pico Rivera, CA
CBA Action: Suspension of license for 60 days stayed, with two years' probation, via stipulated settlement; 24 hours additional continuing education courses

Accusation AC-2006-5 contains allegations that Mr. Sanchez is subject to discipline for unprofessional conduct including gross negligence, repeated negligent acts, and failure to comply with professional standards and issuing a review report that did not comply with professional standards. The charges are based on Mr. Sanchez's performance of a review of the financial statements for Lanico, Inc., as of and for the year ended December 31, 1999.

The Board's charges include allegations that Mr. Sanchez failed to properly perform the review engagement and failed to exercise due professional care. Allegations also include Mr. Sanchez's failures to modify the accountant's report and to properly date the report in accordance with professional standards.

For purposes of settlement, Mr. Sanchez agrees that the Board could establish a factual basis for the charges and if proven at a hearing constitute cause for discipline upon his license.

Competence

Competence is derived from a synthesis of education and experience. It is a CPA's individual responsibility which begins with a mastery of the common body of knowledge required for designation as a certified public accountant. The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a CPA's professional life. In all engagements and in all responsibilities, each CPA should undertake to achieve a level of competence that will assure that the quality of the CPA's services meets the high level of professionalism required by these Principles.

Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a CPA to render services with facility and acumen. It also establishes the limitations of a CPA's capabilities by

dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a CPA or a CPA's firm. Each CPA is responsible for assessing his or her own competence – of evaluating whether education, experience, and judgment are adequate for the responsebility to be assumed. However, meeting minimum standards of education and experience under applicable laws, regulations and professional standards is generally required to demonstrate competence.

♦ Case Example ♦

Competence Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Nevanna Sacks, La Jolla, CA
CBA Action: Revocation stayed, with three years' probation, via stipulated settlement; License suspended for 45 days; Reimburse the Board $2,116 for instigation and prosecution costs

Ms. Sacks was sanctioned by the Securities and Exchange Commission (SEC), an action subjecting her CPA license to discipline. The SEC entered the decision and order on June 7, 2006.

Without admitting or denying the findings in the SEC order, Ms. Sacks consented to entry of an SEC order that denied her the privilege of appearing or practicing before the SEC as an accountant for two years, effective June 7, 2006, after which she may request that the SEC consider her reinstatement. Arthur Andersen was the auditor for Peregrine Systems, Inc., beginning April 1, 1999, through 2002. Ms. Sacks was the Arthur Andersen audit manager for the Peregrine engagement from September 2000 through May 2002.

Subsequent to the completion of the audits, accounting irregularities in Peregrine's revenue recognition practices were disclosed, requiring Peregrine to restate its financial statements for fiscal years ended March 31, 2000, and 2001 and for the first three quarters of its fiscal year 2002. The restatement reduced Peregrine's financial statement revenue for the restatement period by $509 million dollars.

The SEC order included findings that Ms. Sacks violated professional standards by engaging in improper professional conduct in the context of a revenue recognition fraud being conducted by Peregrine personnel and others, failed to exercise due professional care during her reviews and audits of Peregrine's financial statements, and engaged in improper professional conduct by repeatedly engaging in unreasonable conduct which indicated a lack of competence to practice.

Confidentiality

Accounting professionals depend upon the free transfer of information from clients and employers in order to properly perform their jobs. In order to preserve client trust and provide the best possible service to clients and employers, CPAs should closely guard client and employer information and treat it as confidential.

Confidentiality is the cornerstone of a trusting relationship between a CPA and client or employer. In order to constructively grow that relationship, the

client or employer must have confidence that information provided to the CPA will be treated respectfully, and not disclosed to outside parties. The careful handling of client or employer affairs allows the CPA to develop a more meaningful relationship with the client or employer, and serve them more effectively.

A CPA should be fully informed of all the facts pertaining to an engagement, task, or client relationship in order to obtain optimum results for the CPA‘s client or employer. The fact that information will be kept confidential not only allows the CPA to competently complete the assigned task, but also encourages the public to seek appropriate assistance when necessary.

♦ Case Example ♦

Due Professional Care Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Brenda Michelle Vance, Redwood City, CA
CBA Action: Revocation stayed with three years' probation, via stipulated settlement

Ms. Vance admits the truth of the charge and allegation related to general unprofessional conduct described in the Board's Accusation as her actions of accessing, obtaining, and using confidential tax information of someone who was not her client, without authorization and in violation of law. Ms. Vance also admits that the other charges in the Board's accusation, if proven at hearing, would be grounds for discipline.

Independence

Independence precludes relationships that may impair or appear to impair a CPA‘s objectivity in rendering attestation services.

For a CPA rendering attest services, the maintenance of independence requires a continuing assessment of client relationships and public responsibility. Such a CPA who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a CPA should maintain objectivity and avoid conflicts of interest.

Although CPAs who are employed in industry, academia, or other non-attest practice areas cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services. CPAs employed by others to prepare financial statements or to perform internal auditing, tax, or consulting services are charged with the same responsibility for objectivity as CPAs who provide attest services and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with CPAs who act as third-party auditors.

♦ **Case Example** ♦

Independence Violation
California Board of Accountancy Disciplinary Actions/License Restrictions
Defendant: Jack Rickman Sowell, Solana Beach, CA
CBA Action: License revoked

Respondent was grossly negligent in performing audit work for two entities in that the audit reports were defective and his working papers were deficient. Respondent issued an unqualified audit report and within a few months thereafter, both entities filed for Chapter 11 Bankruptcy. In addition, Respondent performed these audits and prepared the auditor's reports when he was not independent of these two.

Fraudulent Acts

Members of the accounting profession face a unique set of ethical dilemmas due to pressures to meet earnings goals/expectations and may experience temptations to commit fraudulent acts for personal financial gain or to cover-up fraudulent acts of others. Fraudulent financial reporting/activities or "cooking the books" often involves one or more following techniques.

Asset Misappropriation
Asset misappropriation occurs with the use of cash, inventory, and all other assets. The use of cash may involve the theft of cash on hand, the theft of cash receipts, and/or fraudulent disbursements. The following are types of theft regarding cash receipts:

- Skimming – Involves taking money from cash receipts for personal purposes and may involve the following techniques:
    - Unrecorded sales
    - Understated sales
    - Write-off schemes of receivables
    - Unconcealed receivables
    - Lapping schemes – Situation where an employee steals money from a sale and offsets the missing money from the next transaction, and then that transaction is covered by the third transaction, etc.
- Cash larceny – Stealing of cash after it has been properly recorded on the company's books

The following are types of fraudulent disbursements:

- Billing schemes which may involve the use of one or more of the following:
    - Shell company – An inactive or fictitious entity created for the sole purpose of committing fraud

    - Non-accomplice vendor – A vendor that is not directly part of a fraudulent scheme
    - Personal purchases – An individual authorizes false invoices in order to make personal purchases
- Payroll schemes which may involve one or more of the following techniques:
    - Ghost employee – A fictitious employee on payroll for whom another receives the extra paychecks
    - Falsified wages – Falsify the amount of hours worked such as claiming overtime
- Expense reimbursement schemes which involves one or more of the following:
    - Overstated expenses – Involves inflating business expenses in order to receive a greater reimbursement
    - Fictitious expenses – Involves reimbursement for expenses that do not exist
    - Multiple reimbursements – Involves receiving more than one reimbursement for the same business expense
    - Mischaracterized expenses – Involves claiming personal expenses as business related expenses
- Check tampering involving one or more of the following techniques:
    - Forged endorsement
    - Altered payee
- Cash register disbursements where an employee steals cash while involving the following avenues:
    - False voids of transactions
    - False refunds of money

Other types of asset misappropriation involve the following:
- Misappropriation of cash on hand where an employee steals cash that is on the company's premises
- Non-cash misappropriation involves stealing and/or the misuse of non-cash assets (inventory, confidential information, etc.)

Financial Statement Fraud

Financial statement fraud is a type of fraud involving an intentional misstatement or omission of material items on the financial statements. The following are types of schemes involving financial statement fraud:
- Overstatement and/or understatement of assets by using the following techniques:
    - Improper asset valuation
    - Improper disclosures

- Overstatement and/or understatement of revenue by one of the following methods:
  - Fictitious revenues
  - Concealed liabilities and expenses
  - Understated revenues
  - Improper disclosures

Statistics Regarding Fraud

The Association of Certified Fraud Examiners publishes statistics and analysis of occupational fraud and abuse in its *2012 Report to the Nations on Occupational Fraud and Abuse*. Some of the important findings in the surveys provided in this report are presented in the following figure.

Figure 2-1
Occupational Fraud Survey Findings

Organizations lose about 5% of its revenues due to fraud

$140,000 is the median loss caused by occupational fraud

Most fraud reported took around 18 months before being found

Asset misappropriation schemes lead all other types of fraud by 87%

Financial statement fraud has a median loss of $1 million, while asset misappropriation fraud has a median loss of $120,000

Individuals, such as owners/executives, with more authority in an organization caused larger losses compared to managers or other employees

Anti-fraud controls are effective against reducing costs and duration of occupational fraud

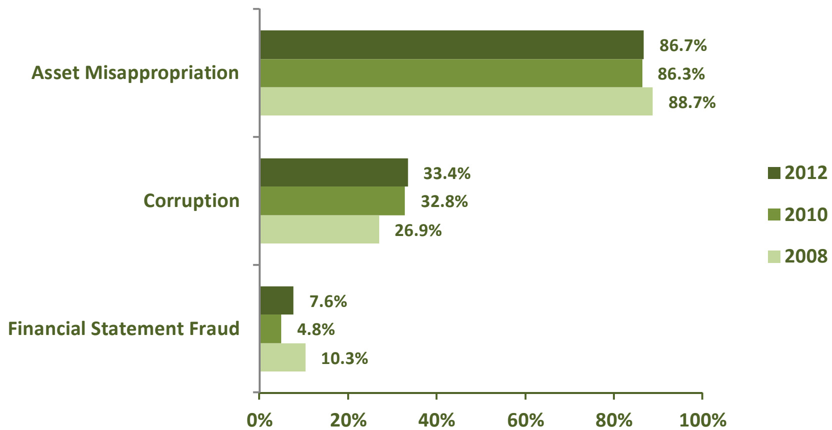
Behavioral red flags were prevalent in 81% of fraudulent individuals

Source: Association of Certified Fraud Examiners – *Report to the Nations on Occupational Fraud and Abuse*; 2012 Global Fraud Study

The following charts highlight some of the types of fraud concerning not only businesses, but also the accounting profession.

The first chart indicates that most frequent type of occupational fraud involves asset misappropriation, followed by corruption, and then financial statement fraud.

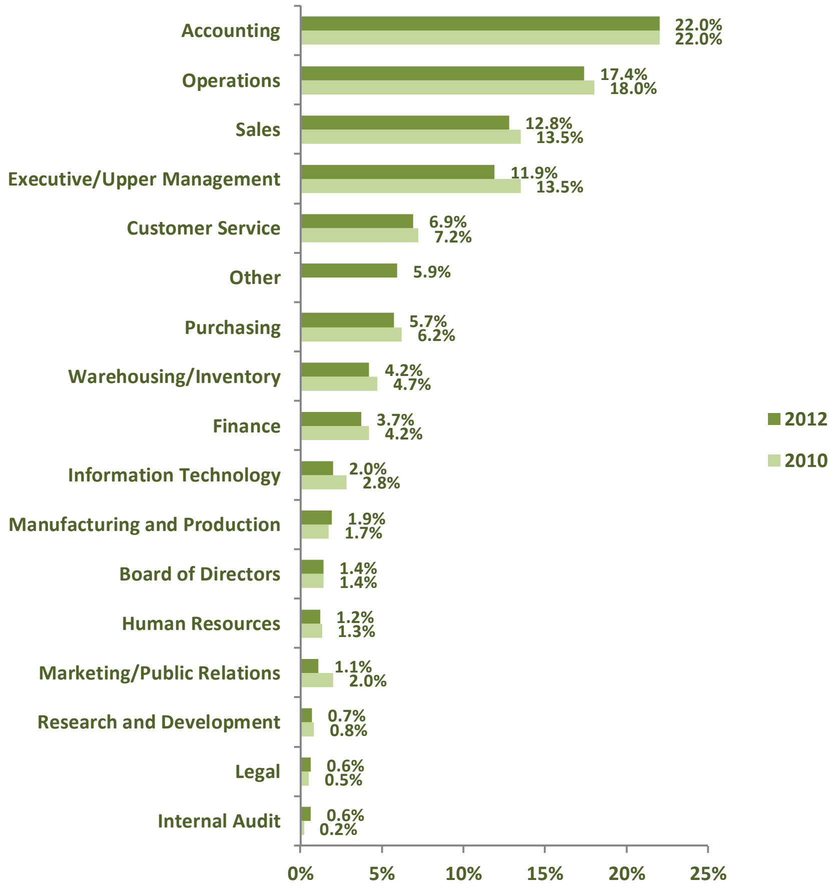
Figure 2-2
Frequency of Occupational Frauds by Category



Source: Association of Certified Fraud Examiners – *Report to the Nations on Occupational Fraud and Abuse*; 2012 Global Fraud Study

As noted in the following chart, the accounting department is the primary department where most occupational fraud occurs.

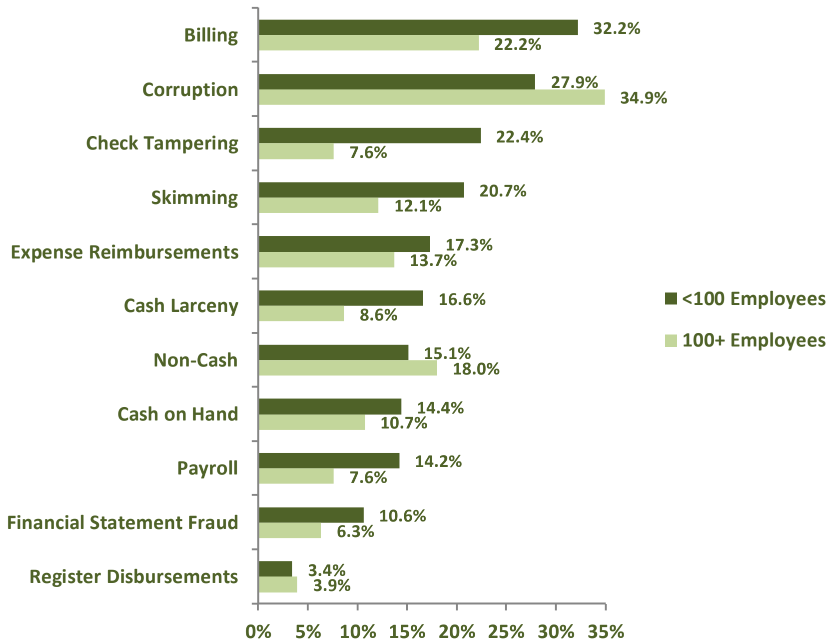
Figure 2-3
Department of Perpetrator



Source: Association of Certified Fraud Examiners – *Report to the Nations on Occupational Fraud and Abuse*; 2012 Global Fraud Study

According to the surveys, the type of fraudulent scheme that most frequently occurs in an organization depends on its size. Billing schemes account for the most of the fraud in organizations with less than 100 employees, while corruption accounts for most of the fraud in organizations with over 100 employees.

Figure 2-4
Scheme Type by Size of Victim Organization



Source: Association of Certified Fraud Examiners – *Report to the Nations on Occupational Fraud and Abuse*; 2012 Global Fraud Study

The report also indicates that two primary internal control weaknesses observed by certified fraud examiners are the lack of internal controls and the override of existing internal controls.

Figure 2-5
Primary Internal Control Weakness
Observed by Certified Fraud Examiners

Source: Association of Certified Fraud Examiners – *Report to the Nations on Occupational Fraud and Abuse*; 2012 Global Fraud Study

Types of Financial Statement Fraud

The following are case examples of various types of financial statement fraud tried by the U.S. Securities and Exchange Commission.

Overstating Revenues

Overstating revenues occurs by accelerating earnings by recording future sales on current financial statements, and recording investment income, proceeds received as loans, or fictitious sales as revenue.

♦ **Case Example** ♦

Overstating Revenues
Case No.: CV11-05316
Defendants: Peter L. Jensen and Thomas C. Tekulve, Jr.

Senior management of Basin Water, Inc. reported revenue which failed to meet generally accepted accounting principles (GAAP). Several of the company's sales were contingent on the customer's acceptance of a treatment system or resale of the system to an ultimate customer. Several sales did not occur in the quarter for which revenue was recognized and other sales were recognized although the company never delivered the systems. The defendants later created two special purposes entities to which Basin purportedly sold systems in sham transactions that had no economic substance. Revenues were materially overstated for Basin in 2006 by 14% and by 75% in 2007.

Overstating Assets

Overstating assets is a means to make a company appear healthy and less risky. An overstatement of assets usually occurs with inventory, accounts receivable, and/or fixed assets.

♦ Case Example ♦

Overstating Assets
Case No. 10-CV-1142-B
Defendants: William G. Mortensen and Feng Zheng

In 2008, William Mortensen instructed Zheng to record false sales to two of AMG's largest customers. By recording these false sales, the earnings and the accounts receivable were materially overstated on AMG's quarterly and annual reports during the period. The inflated accounts receivable were used to obtain greater borrowings under AMG's bank line of credit. These additional borrowings and other funds were used to pay for Mortensen's personal expenses, such as a country club membership, extensive home remodeling, property taxes, and family vacations to Florida, Europe, and elsewhere using private jets.

Understating Liabilities

Understating liabilities is a technique used to make a company appear less risky due to having less debt.

♦ Case Example ♦

Understating Liabilities
Litigation Release No.: 22443
Defendants: Nancy Shao Wen Chu

Nancy Chu served as the CFO of Soyo Group, Inc. between 2002 and 2009. One of the avenues that Nancy Chu and others misled Soyo's investors, primary lending bank, and auditor was by materially understating its liabilities through a $6 million debt-for-equity transaction with a Soyo vendor that was never completed.

Understating Expenses

Understating expenses is a technique of postponing expense recognition by capitalizing costs overtime versus expensing a cost in the current period, capitalizing normal operating costs, and/or failing to either write down or write off impaired assets.

♦ **Case Example** ♦

Understating Expenses
Case No.: CV11-00889
Defendants: Thor Industries, Inc. and Mark C. Schwartzhoff

One of the avenues Mark Schwartzhoff committed fraud is through Dutchman, one of Thor Industries' principal operating subsidiaries. Schwartzhoff's bonuses were paid under a "Management Incentive Plan" while he served as a Vice President of Finance and were calculated as a percentage of Dutchman's pre-tax income. Schwartzhoff therefore devised a plan to overstate Dutchman's pre-tax income by understating Dutchman's cost of goods sold. This earned Schwartzhoff approximately $299,805 in bonuses during the fiscal years 2004 to 2007.

Cookie Jar Accounting

Cookie jar accounting is a method of using reserves from good years to offset losses in bad years.

♦ **Case Example** ♦

Cookie Jar Accounting
Case No.: CV11-22074
Defendant: James O'Leary, CPA

James O'Leary was the former CFO of Beazer Homes USA, Inc. and was charged with failing to reimburse the company for cash bonuses, incentive and equity-based compensation, and profits from his sale of Beazer stock during the 12-month period following the issuance of Beazer's quarterly and annual financial statements for 2006. These statements were required to be reinstated due to a fraudulent earnings management scheme that artificially inflated Beazer's income and earnings for 2006. Part of the misconduct resulted from Beazer's Senior Vice President and Chief Accounting Officer Michael T. Rand directing and supervising a reserve accounting scheme under which reserves for certain future homebuilding expenses were improperly established and inflated so they could later be used to artificially boost income and earnings upon being eliminated.

Channel Stuffing

Channel stuffing is an avenue to inflate sales by sending retailers more products than they can sell by means of distribution channels.

♦ Case Example ♦

Channel Stuffing
Case No.: 10-CIV-9239-JSR
Defendants: Vitesse Semiconductor Corporation, Louis R. Tomasetta, Eugene F. Hovanec, Yatin D. Mody, and Nicole R. Kaplan

California-based integrated circuit maker Vitesse Semiconductor Corporation and four former senior executives of Vitesse — co-founder and former Chief Executive Officer Louis Tomasetta, former Chief Financial Officer and Executive Vice President Eugene Hovanec, former Controller and Chief Financial Officer Yatin Mody, and former Manager and Director of Finance Nicole Kaplan were charged with inflating revenue through channel stuffing. From September 2001 through April 2006, Tomasetta, Hovanec, Mody, and Kaplan engaged in an elaborate channel stuffing scheme in order to improperly record revenue. This caused Vitesse to immediately recognize revenue and record invalid accounts receivable for product shipped at period end to its largest distributer, even though the distributor had an unconditional right to return all of the product.

Improper Disclosure
Improper disclosure is the failing to properly disclose related party transactions, executive compensations, structured financial deals, etc.

♦ Case Example ♦

Improper Disclosure
Case No.: 11-CV-00211-CVE-PJC
Defendant: Brian D. Fox

Brian Fox was involved in making false and misleading public disclosures for Powder River Petroleum International, Inc. In 2006, Powder River reported an asset of its balance sheet as a $1.2 million cash item, which it was in reality a loan receivable made to an undisclosed related party. The following year, Powder River began to record the transaction as a loan receivable and accrued interest on this loan. The company however failed to disclose that the loan receivable as a related party transaction which is required under the Statement of Financial Accounting Standard No. 57 – Related Party Disclosure.

Noteworthy Accounting Scandals

Recent accounting scandals of large corporations not only had an effect on the direct stakeholders of the organizations, but also had a much larger effect on the economy and investor trust in the securities market. Some of the largest scandals of the past decade include:

- Inflation of revenues
- Channel stuffing
- Misrepresentation of assets, liabilities, and/or expenses

- Failure to disclose appropriate material information
- Off-balance sheet transactions
- Insider trading
- Improper accounting practices
- Improper bonus use

The following table outlines the fraudulent activities of high profile litigation cases brought by the U.S. Securities and Exchange Commission in federal court.

Figure 2-6
Accounting Scandals

Corporation	Violations
Aldephia Communications	• Years: 1999-2001 • $2.3 billion in bank debt was excluded from financial statements and was shifted to off-balance sheet, unconsolidated affiliates • Provided misstatements in press releases, earnings reports, and Commission filings inflating information Wall Street uses to evaluate cable companies • Concealed self-dealing with the founder's family using corporate funds for Rigas Family Stock purchases and purchases of luxury condominiums
Bristol-Myers Squibb	• Year: 2000 - 2001 • Inflated revenues from the first quarter of 2000 - fourth quarter 2001 • Accused of "channel-stuffing" in order to meet sales and earnings targets • Improperly recognized $1.5 billion in revenue from sales • Used "cookie jar" reserves to inflate earnings
Enron	• Year: 2001 • Public statements about the company's financial position were false and misleading • Concealed losses incurred by Enron Energy Services (EES) by manipulating business segment reporting • Kenneth Lay (former Chairman & CEO) knew of material nonpublic information and with this information was able to generate unlawful proceeds exceeding $90 million

HealthSouth	• Years: 1999 - 2002 • Overstated earnings since 1999 by at least $1.4 billion to meet Wall Street expectations • Assets overstated by at least $800 million (10%) in 3rd Quarter of 2002 • CEO certified financial statements that were materially false and misleading
K-Mart	• Years: 2001-2002 • Failed to disclose reckless purchase of $850 million in excess inventory which was found materially misleading • Misrepresented liquidity problems and did not pay vendors on time
Lehman Brothers	• Years: 1999 - 2001 • Bonuses of six senior research analysts were linked to revenue from Investment Banking which was generated by companies they covered • The integrity of analysts' ratings, price targets, and research reports were unfavorably affected due to financial incentives and corporate pressure on analysts • The company failed at supervising research analysts and establishing company policies for appropriate ethical conduct
Peregrine Systems	• Years: 2000-2002 • Reported inflated product revenue in filings with the Commission and others • Portrayed the company as having strong sales growth and hiding its failure in order to reach revenue forecasts • Senior officers sold over $11 million and $24 million in Peregrine stock at the expense of public investors • Recorded millions of dollars of revenue improperly on nonbinding agreements with "channel partners"
Tyco International	• Years: 1996 - 2002 • Operating income was inflated by at least $500 million • Performed improper accounting practices in regards to acquisitions • Undervalued acquired assets, overvalued ac-

	quired liabilities, and misused accounting rules in regards to the establishment and utilization of purchase accounting reserves • Used various reserves as adjustments to improve financial results and earnings reported to the public • Connection fees that Tyco's ADT Security Services Inc. subsidiary charged to dealers lacked economic substance and were improperly added to Tyco's income statement • Failure to disclose certain executive compensation, executive indebtedness, and related party transactions of former senior management
WorldCom	• Years: 1999 - 2002 • Materially overstated income by approximately $9 billion • Misled investors by use of undisclosed and improper accounting practices

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002, also known as SOX, was enacted on July 30, 2002 due to the discovery of corporate and accounting scandals that had a major impact on investors and the securities market. One of the primary objectives of the Act is to protect investors and restore public confidence in the securities market. Reforms mandated by the Act serve to improve financial disclosures, reduce corporate and financial fraud, and create the Public Company Accounting Oversight Board (PCAOB). This section outlines pertinent Titles of the Act and the penalties involved with violations of the Act.

Highlights of the Sarbanes-Oxley Act of 2002

SARBANES-OXLEY ACT OF 2002	
Title I – Public Accounting Oversight Board	Establishes five-member board (two members CPAs)
	Public accounting firms that participate in preparing or issuing any audit report for a public company must register
	Audit work papers and other information related to the audit must be retained for seven years
	Requires a second partner review and approval of audit reports
	Annual inspections for public accounting firms providing audit reports for over 100 issuers and at least every three years for fewer than 100 issuers

	Public accounting firms must pay a registration fee and an annual fee
Title II – Auditor Independence	It is unlawful for a registered accounting firm to provide non-audit services that include: • Bookkeeping or other services related to the accounting records or financial statements of the audit client • Financial information systems design and implementation • Appraisal or valuation or services, fairness opinions, or contribution-in-kind reports • Actuarial services • Internal audit outsourcing services • Management functions or human resources • Broker or dealer, investment advisor, or investment banking services • Legal services and expert services unrelated to the audit
	May engage in tax services or other services IF gets preapproval
	Lead or coordinating audit partner or the reviewing audit partner must rotate every five consecutive years
	Reports to the audit committee of the issuer must include: (1) all critical accounting policies and practices used, (2) alternative treatments of financial information within GAAP that have been discussed with management the ramifications of such alternative disclosures and treatments, and (3) other written communications between the firm and the issuer that is material
	The following individuals cannot have been employed by the registered independent public accounting firm and participated in any capacity in the audit during the one year period preceding the date of the initiation of the audit: • Chief Executive Officer • Controller • Chief Financial Officer • Chief Accounting Officer • Any person serving in an equivalent position
	The Comptroller General will review the potential effects of requiring a rotation of registered accounting

	firms
	In regards to small and mid-sized non-registered accounting firms, the state regulatory authorities should make an independent determination as to whether the standards applied by the Board are applicable
Title III – Corporate Responsibility	Each member of the audit committee of the issuer shall be a member of the board of directors of the issuer, and shall otherwise be independent
	In order to remain independent, members of the audit committee must not: • Accept any consulting, advisory, or other compensatory fee from the issuer • Be an affiliated person of the issuer or subsidiary
	Audit committees shall establish procedures for: • Receipt, retention, and treatments of complaints regarding accounting, internal accounting controls, or audit matters • Confidential submission of concerns regarding questionable accounting or auditing matters by employees
	Audit committees shall engage in independent counsel or other advisors in order to properly carry out its duties
	Each issuer must provide appropriate funding for the audit committee
	CEOs and CFOs are required to certify that they have reviewed the annual report and it does not contain false statements or any omissions of material facts
	Any officer or director cannot fraudulently influence, coerce, manipulate, or mislead any independent public or certified accountant engaged in the audit
Title IV – Enhanced Financial Disclosures	Financial reports are to be prepared in accordance with GAAP and reflect all material correcting adjustments that have been identified by a registered public accounting firm
	Financial reports shall disclose all material off-balance sheet transactions, arrangements, obligations, and other relationships that may have a material current or future effect on the financial condition
	Financial information filed with the Commission or any

	public disclosure or press release shall be presented in a manner: • That does not contain false statements of a material fact or may not omit to state a material fact • Reconciles it with the financial condition and the results of operations under GAAP
	Prohibits personal loans to any director or executive officer (or equivalent)
	Requires disclosures of transactions involving directors, officers, and principal stockholders, which includes any person directly or indirectly the beneficial owner of more than 10% of any class of any equity security
	Each annual report shall contain an internal control report that includes: • The responsibility of management for establishing and maintaining adequate internal controls and procedures for financial reporting • An assessment of the effectiveness of the internal control structure and procedures of the issuer

Figure 2-7
Penalties and Fines

Behavior	Sentence
The alteration, destruction, concealment of any records with the intent of obstructing a federal investigation	Fine and/or up to 10 years imprisonment
Failure to maintain audit or review "workpapers" for at least five years	Fine and/or up to 5 years imprisonment
Anyone who "knowingly executes, or attempts to execute, a scheme" to defraud a purchaser of securities	Fine and/or up to 10 years imprisonment
Any CEO or CFO who "recklessly" violates his or her certification of the	Fine of up to $1,000,000 and/or up to 10 years imprisonment

company's financial statements If "willfully" violates	Fine of up to $5 million and/or up to 20 years imprisonment
Two or more persons who conspire to commit any offense against or to defraud the U.S. or its agencies	Fine and/or up to 10 years imprisonment
Any person who "corruptly" alters, destroys, conceals, etc., any records or documents with the intent of impairing the integrity of the record or document for use in an official proceeding	Fine and/or up to 20 years imprisonment
Mail and wire fraud Violating applicable Employee Retirement Income Security Act (ERISA) provisions	Increase from 5 to 20 years imprisonment Various lengths depending on violation

Source: New York State Society of CPAs; www.nysscpa.org/oxleyact2002.htm

Ethics & Independence Rules for Auditors

The AICPA and Public Company Accounting Oversight Board (PCAOB) sets forth auditing and ethics standards for auditors. The PCAOB is a nonprofit corporation established by Congress to oversee the audits of public companies in order to protect investors and the public interest by promoting informative, accurate, and independent audit reports. The Sarbanes-Oxley Act of 2002, which created the PCAOB, required that auditors of U.S. public companies be subject to external and independent oversight for the first time in history. Previously, the profession was self-regulated.

The following are summaries of several of the rules that have been adopted by the PCAOB and approved by the Securities and Exchange Commission and the interim standards the PCAOB has adopted in regards to the ethics and independence of auditors of public firms. The following interim standards ET 101 – Independence, ET 102 – Integrity and Objectivity, and ET 191 – Ethics Rulings on Independence, Integrity, and Objectivity apply to auditors of both public and private companies.

Rule 3500T – Interim Ethics Standards

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with ethics standards, as described in the AICPA's Code of Professional Conduct Rule 102, and interpretations and rulings.

Rule 3502 – Responsibility Not to Knowingly or Recklessly Contribute to Violations

A person associated with a registered public accounting firm shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

Rule 3520 – Auditor Independence

A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period.

Rule 3521 – Contingent Fees

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.

Rule 3522 – Tax Transactions

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction:

- *Confidential Transactions* **–** That is a confidential transaction
- *Aggressive Tax Position Transactions* **-** That was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws

Rule 3523 – Tax Services for Persons in Financial Reporting Oversight Roles

A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the professional engagement period

provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless:

- The person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client
- The person is in a financial reporting oversight role at the audit client only because of the person's relationship to an affiliate of the entity being audited:
    - Whose financial statements are not material to the consolidated financial statements of the entity being audited
    - Whose financial statements are audited by an auditor other than the firm or an associated person of the firm
- The person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are:
    - Provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event
    - Completed on or before 180 days after the hiring or promotion event

Rule 3524 – Audit Committee Pre-Approval of Certain Tax Services

In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall:

- Describe, in writing, to the audit committee of the issuer:
    - The scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service
    - Any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service
- Discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm
- Document the substance of its discussion with the audit committee of the issuer

Rule 3525 – Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall:

- Describe, in writing, to the audit committee of the issuer the scope of the service
- Discuss with the audit committee of the issuer the potential effects of the service on the independence of the firm
- Document the substance of its discussion with the audit committee of the issuer

Rule 3526 – Communication with Audit Committees Concerning Independence

A registered public accounting firm must:

- Prior to accepting an initial engagement pursuant to the standards of the PCAOB:
  - Describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence
  - Discuss with the audit committee of the issuer the potential effects of the relationships
  - Document the substance of its discussion with the audit committee of the issuer
- At least annually with respect to each of its issuer audit clients:
  - Describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence
  - Discuss with the audit committee of the issuer the potential effects of the relationships
  - Affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520
  - Document the substance of its discussion with the audit committee of the issuer

Rule 3600T – Interim Independence Standards

In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards:

- As described in the AICPA's Code of Professional Conduct Rule 101, and interpretations and rulings thereunder
- Standards Nos. 1, 2, and 3, and Interpretations 99-1, 00-1, and 00-2, of the Independence Standards Board, to the extent not superseded or amended by the Board

Rule 101 – Independence

101-1—Interpretation of Rule 101

Independence is considered impaired in the following situations during the period of the professional engagement:

- A covered member:
  - Had or was committed to acquire any direct or material indirect financial interest in the client
  - Was a trustee or any trust or executor or administrator of any estate who had or was committed to acquire any direct or material indirect financial interest in the client
  - Had a joint closely held investment that was material to the covered member
  - Had any loan to or from the client, any officer or director of the client, or any individual owning 10% or more of the client's outstanding equity securities or other ownership interests
- A partner or professional employee of the firm, his/her immediate family, or any group acting together owned more than 5% of a client's outstanding equity securities or other ownership interests
- A firm, partner, or professional employee of the firm was simultaneously associated with the client as a(n):
  - Director, officer, or employee, or in any capacity equivalent to that of a member of management
  - Promoter, underwriter, or voting trustee
  - Trustee for any pension or profit-sharing trust of the client

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if:

- An individual participating on the attest engagement team has a close relative who had:
  - A key position with the client
  - A financial interest in the client that:

        - Was material to the close relative and of which the individual has knowledge
        - Enabled the close relative to exercise significant influence over the client
- 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 key position with the client
    - A financial interest in the client that:
        - Was material to the close relative and of which the individual or partner has knowledge
        - Enabled the close relative to exercise significant influence over the client

101-2 – Employment or Association with Attest Clients

A firm's independence will be considered to be impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by or associated with that client in a key position, unless certain provisions are met.

Considering Employment or Association with the Client

When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the firm.

101-3 – Performance of Other Services

A member or his or her firm ("member") who performs an attest engagement for a client may also perform other nonattest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. The following figure outlines general activities that would impair independence.

Figure 2-8
Activities Impairing Independence

Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so

Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)

Having custody of client assets

Supervising client employees in the performance of their normal recurring activities

Determining which recommendations of the member should be implemented

Reporting to the board of directors on behalf of management

Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent

Source: American Institute of CPAs (AICPA)

Figure 2-9
Impact on Independence of Performance of Other Services

Type of Other Service	Independence Would Not Be Impaired	Independence Would Be Impaired
Bookkeeping	Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger Prepare financial statements based on information in the trial balance Post client-approved entries to a client's trial balance. Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client Provide data-processing services	Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval Authorize or approve transactions Prepare source documents or originate data Make changes to source documents without client approval

Payroll and Other Disbursement	Using payroll time records provided and approved by the client, generate unsigned checks, or process client's payroll Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information Make electronic payroll tax payments in accordance with U.S. Treasury Department guidelines provided the client has made arrangements for its financial institution to limit such payments to a named payee	Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments. Accept responsibility to sign or cosign client checks, even if only in emergency situations. Maintain a client's bank account or otherwise have custody of a client's funds or make credit or banking decisions for the client. Sign payroll tax return on behalf of client management. Approve vendor invoices for payment
Benefit Plan Administration	Communicate summary plan data to plan trustee Advise client management regarding the application or impact of provisions of the plan document. Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member's electronic medium, such as an interactive voice response system or Internet connection or other media. Prepare account valuations for plan participants using data col-	Make policy decisions on behalf of client management When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management's concurrence Make disbursements on behalf of the plan Have custody of assets of a plan Serve a plan as a fiduciary as defined by ERISA

	lected through the member's electronic or other media Prepare and transmit participant statements to plan participants based on data collected through the member's electronic or other medium	
Investment—Advisory or Management	Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc. Perform recordkeeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction	Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments Execute a transaction to buy or sell a client's investment Have custody of client assets, such as taking temporary possession of securities purchased by a client
Corporate Finance — Consulting or Advisory	Assist in developing corporate strategies Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria Assist in analyzing the effects of	Commit the client to the terms of a transaction or consummate a transaction on behalf of the client Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement mem-

	proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources Assist in drafting an offering document or memorandum Participate in transaction negotiations in an advisory capacity Be named as a financial adviser in a client's private placement memoranda or offering documents	oranda or offering documents Maintain custody of client securities
Appraisal, Valuation or Actuarial	Test the reasonableness of the value placed on an asset or liability included in a client's financial statements by preparing a separate valuation of that asset or liability Perform a valuation of a client's business when all significant matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on the results of the valuation	Prepare a valuation of an employer's securities contained in an employee stock ownership plan (ESOP) to support transactions with participants, plan contributions, and allocations within the ESOP, when the client is not in a position to have an informed judgment on the results of this valuation Prepare an appraisal, valuation, or actuarial report using assumptions determined by the member and not approved by the client
Executive or Employee Search	Recommend a position description or candidate specifications Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience) Participate in employee hiring or compensation discussions in an advisory capacity	Commit the client to employee compensation or benefit arrangements Hire or terminate client employees
Business Risk Consulting	Provide assistance in assessing the client's business risks and control processes	Make or approve business risk decisions

	Recommend a plan for making improvements to a client's control processes and assist in implementing these improvements	Present business risk considerations to the board or others on behalf of management
Information Systems—Design, Installation or Integration	Design, install or integrate a client's information system, provided the client makes all management decisions Customize a prepackaged accounting or information system, provided the client makes all management decisions Provide the initial training and instruction to client employees on a newly implemented information and control system	Supervise client personnel in the daily operation of a client's information system Operate a client's local area network (LAN) system when the client has not designated a competent individual, preferably within senior management, to be responsible for the LAN

Source: American Institute of CPAs (AICPA)

Rule 102 – Integrity and Objectivity
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.

Knowing Misrepresentations in the Preparation of Financial Statements or Records
A member shall be considered to have knowingly misrepresented facts in when he/she knowingly:

- Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records
- 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
- Signs, or permits or directs another to sign, a document containing materially false and misleading information

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 profes-

sional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity.

The following figure provides some examples (not all-inclusive) of situations that could be viewed as an impairment of objectivity.

Figure 2-10
Impairment of 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 personal financial planning (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 personal financial planning (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 personal financial planning (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)

Source: American Institute of CPAs (AICPA)

Review Questions

1. Which of the following Principles of Professional Conduct reflects a CPA's obligation to be impartial, intellectually honest, and free of conflicts of interest?
   - A. Integrity
   - B. Objectivity
   - C. Due Professional Care
   - D. Competence

2. __________ is a type of fraud involving an overstatement or understatement of revenue.
   - A. Financial statement fraud
   - B. Asset misappropriation
   - C. Payroll scheme
   - D. Expense reimbursement scheme

3. According to the report published by the Association of Certified Fraud Examiners, corruption accounted for __________ of the 2012 cases.
   - A. 10.5%
   - B. 27.3%
   - C. 33.4%
   - D. 56.7%

4. What type of financial statement fraud is a method of using reserves from goods years to offset losses in bad years?
   - A. Overstating assets
   - B. Improper disclosure
   - C. Understating liabilities
   - D. Cookie jar accounting

5. Which of the following consulting or advisory services would impair independence?
   - A. Maintaining custody of client securities
   - B. Participating in transaction negotiations in an advisory capacity
   - C. Assisting in drafting an offering document or memorandum
   - D. Assisting in the analyzing the effects of proposed transactions

Review Answers

1. A. Incorrect. The Principle of Professional Conduct that reflects a CPA's obligation to be impartial, intellectually honest, and free of conflicts of interest is not integrity. Integrity involves the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.
   B. **Correct.** The Principle of Professional Conduct that reflects a CPA's obligation to be impartial, intellectually honest, and free of conflicts of interest is objectivity.
   C. Incorrect. The Principle of Professional Conduct that reflects a CPA's obligation to be impartial, intellectually honest, and free of conflicts of interest is not due professional care. Due professional care involves the CPA's obligation to perform professional services to the best of the CPA's ability and with having the best interest in mind for those in which the services are performed and consistent with the profession's responsibility to the public.
   D. Incorrect. The Principle of Professional Conduct that reflects a CPA's obligation to be impartial, intellectually honest, and free of conflicts of interest is not competence. Competence involves the CPA's individual responsibility which is the education and experience required for designation as a certified public accountant.

2. A. **Correct.** Financial statement fraud is a type of fraud involving an overstatement or understatement of revenue.
   B. Incorrect. Asset misappropriation is not a type of fraud involving an overstatement or understatement of revenue. Asset misappropriation deals with the use of cash, inventory, and all other assets to commit fraud.
   C. Incorrect. A payroll scheme is not a type of fraud involving an overstatement or understatement of revenue. Payroll schemes involve ghost employees and falsified wages.
   D. Incorrect. An expense reimbursement scheme is not a type of fraud involving an overstatement or understatement of revenue. Expense reimbursement schemes involve overstated employee expenses and/or fictitious expenses.

3. A. Incorrect. According to the report published by the Association of Certified Fraud Examiners, corruption accounted for 33.4%, not 10.5%, of the 2012 cases.
   B. Incorrect. According to the report published by the Association of Certified Fraud Examiners, corruption accounted for 33.4%, not 27.3%, of the 2012 cases.

C. **Correct.** According to the report published by the Association of Certified Fraud Examiners, corruption accounted for 33.4% of the 2012 cases.
D. Incorrect. According to the report published by the Association of Certified Fraud Examiners, corruption accounted for 33.4%, not 56.7%, of the 2012 cases.

4. A. Incorrect. The type of financial statement fraud that is a method of using reserves from goods years to offset losses in bad years is not overstating assets. Overstating assets is a means to make a company appear healthy and less risky by overstating assets, such as inventory, accounts receivable, and/or fixed assets.
   B. Incorrect. The type of financial statement fraud that is a method of using reserves from goods years to offset losses in bad years is not improper disclosure. Improper disclosure involves failing to properly disclose related party transactions, executive compensation, structured financial deals, etc.
   C. Incorrect. The type of financial statement fraud that is a method of using reserves from goods years to offset losses in bad years is not understating liabilities. Understating liabilities is a technique used to make a company appear less risky due to having less debt.
   D. **Correct.** The type of financial statement fraud that is a method of using reserves from goods years to offset losses in bad years is cookie jar accounting.

5. A. **Correct.** Maintaining custody of client securities is a service that would impair independence.
   B. Incorrect. Independence would not be impaired by participating in transaction negotiations in an advisory capacity.
   C. Incorrect. Independence would not be impaired by assisting in drafting an offering document or memorandum.
   D. Incorrect. Independence would not be impaired by assisting in the analyzing the effects of proposed transactions.

Chapter 3
Accounting and Auditing Cases

Learning Objectives

- Summarize the various violations and charges in selected accounting and auditing cases

Introduction

This chapter details various court cases relating to the unethical acts by executives and auditors.

Corporate Fraud Cases

Case 1

Case No.:	11-CV-2016 EFM/JPO & 11-CV-02017
Case Filed:	January 1, 2011
Corporation:	**NIC, Inc.** Delaware Corporation based in Olathe, Kansas
Defendants:	**Jeffery S. Fraser** – Positions held at NIC, Inc.: CEO (1992-1999 & 2002-2008), Chairman of the Board of Directors (Inception-2008), Member of Board of Directors (Inception-2009), Member of NIC Disclosure Committee **Harry H. Herington** – Positions held at NIC, Inc.: COO & President (2002-2006), President (2006-2008), Board Member (2006-Present), CEO (2008-Present), Chairman of the Board (2008) **Eric J. Bur** – Positions held at NIC, Inc.: CFO (2001-2007), Member of NIC's Disclosure Committee **Stephen M. Kovzan** – Positions held at NIC, Inc.: Controller (1999-2000), Vice President of Financial Operations & CAO (2000-2007), CFO (2007-Current)

Facts Presented:

Fraser co-founded NIC, Inc. and later retired in 1999, but continued to serve as Chairman of the Board of Directors. In 2002, NIC, Inc. was close to bankruptcy and the Board requested Frasier return as CEO, in which he agreed to take a nominal salary of $1 (years 2002 and 2003) and $5,500 (years 2004 and 2005). From 2002 until 2005, more than $1.18 million in perquisites to Fraser were not disclosed.

Allegations against Fraser:

- Undisclosed perquisites included:
    - $4,000 per month to live in a ski lodge in Wyoming
    - Monthly cash payments for a rental house owned by an entity Fraser controlled
    - Paid personal expenses including vacations, computers, vehicles, commuting by aircraft, and day-to-day living expenses for Frasier and his family and friends
    - Frazier's use of the company credit card to charge personal expenses and reimbursements for expenses that did not occur

Allegations against Herington

- Was serving as Chief Operating Officer
- Failed to adequately address concerns regarding Fraser's expense reporting
- Reviewed and/or signed public filings that failed to disclose Fraser's perquisites

Allegations against Bur:

- Was serving as Chief Financial Officer
- Allowed NIC, Inc. to pay Fraser's expenses knowing he did not submit proper documentation
- Was alerted from a department employee that Fraser's expenses were not business related
- Reviewed, signed and/or certified public filings that failed to disclose Fraser's perquisites

Allegations against Kovzan:

- Was serving as Chief Accounting Officer
- Authorized NIC, Inc.'s payment of Fraser's personal expenses
- By-passed NIC, Inc.'s internal controls and other policies required of the CEO to document the business purpose of his expenses or was reckless in the fact of not knowing Fraser's expenses were false
- Prepared, reviewed and/or signed NIC, Inc.'s materially false proxy statements, annual reports, and registration that underreported Fraser's compensation
- Made false statements to NIC, Inc.'s independent auditors

Allegations against NIC, Inc.

- Failed to correct known expense reporting problems by Fraser
- Failed to disclose or force repayment of Fraser's perquisites

- Failed to provide accurate material information in public filings regarding Fraser's perquisites
- Failed to disclose to investors that internal reviews concluding that Frasier misclassified expenses

SEC Charges/Fines/Settlement – Litigation Release No. 21809

- NIC, Inc.: $500,000 civil penalty and hiring of an independent consultant to recommend improvements to policies, procedures, controls, and training relating to:
  - Payment of expenses
  - Handling whistleblower complaints
  - Related party transactions
- Fraser: $1,184,246 in disgorgement; $358,844 in prejudgment interest; $500,000 civil penalty; barred from serving as an officer or director of a public company
- Herrington: $200,000 civil penalty
- Bur: $75,000 civil penalty and prohibition of appearing or practicing before the Commission as an accountant (may reapply after one year)
- Kovzan: Commission action is ongoing with the SEC seeking a permanent injunction, disgorgement, civil penalties, prejudgment interest, and officer and director bar

<u>What Went Wrong?</u>

Weak Internal Polices and Controls

- Requirements specifically outlined in the NIC, Inc.'s Code of Ethics, which are referenced in the company's proxy statement and posted on the company's website, were directly violated
- Violation #1: Corporate credit cards were not used solely for business purposes
- Violation #2: CEO, CFO and CAO did not ensure full disclosure in filings with the Commission
- Violation #3: EO, CFO and CAO did not establish adequate disclosure controls to make certain all material information is included in reports and public communications
- Violation #4: CEO, CFO and CAO did not bring any violations of the Code of Ethics and weaknesses/concerns about internal controls to the Audit Committee
- Violation #5: CEO, CFO and CAO did not ensure that independent auditors were aware of material misstatements or omissions in draft reports
- Violation #6: Fraser violated the policy requiring all employees to maintain proper documentation for expenses exceeding $10

Red Flags Ignored

- Mid-2002, NIC's Assistant Controller alerted Bur of Fraser's improper reporting of expenses
- August 2003: NIC's Assistant Controller e-mailed Bur alerting him of Fraser's credit card expenses including personal items (gun vault, toys, and ski lift tickets)
- September 2003: NIC's Assistant Controller provided a detailed list of Fraser's charges of personal items (vitamin supplements and gym membership fees)
- October 2003: NIC's Assistant Controller e-mailed Bur about Fraser's undocumented expenses in excess of $140,000
- October 2003: An e-mail from NIC's Assistant Controller warned Bur that "[a] number of these credit card and other expenses would completely flame employees, our customers, the board, and investors if they were aware. Hopefully, none of this is selected for audit and I won't have to explain the business purpose for these items" and advised that NIC, Inc. "eliminate the personal credit card expenses" and instead provide Fraser with "pay for performance"
- January 2004: Bur received a second copy of the above mentioned e-mail
- June 2004: Bur expresses concern to NIC, Inc.'s CAO and Herington received spreadsheets from the general ledger including Fraser's personal expense items
- November 2004: Herington received an e-mail from NIC executive questioning renewing a lease on Fraser's company-paid condo
- July 2005: The finance department submitted a list of Fraser's expenses to Herington questioning whether they were business related
- April 2006: NIC's Assistant Controller warned Herington in an e-mail about risks of income tax fraud charges due to lack of documentation of business purpose for expenses
- May 2006: Bur sent an e-mail warning Herington that there was a "great concern within the accounting department regarding [Fraser's] expense reports" and concern that someone might "whistleblow this situation" and Bur's concerns addressed in an e-mail to Herington stated that employees "feel that [Fraser] appears to ripping off the company and is not required to follow the same rules that every else (including the execs) has to follow"
- August 2006: NIC's General Counsel warned Herington in an e-mail that "lack of documentation…denies the company the ability to defend itself against any assertions that the amounts charged are perks or additional compensation to Fraser" and "the manner in which these affairs of the company have been allowed to be conducted indicate at least a potential failure of, or absence of, effective internal controls, which may render the

company's financials incapable of certification by our outside auditors, or cause damaging public disclosures, or both"

- September 2006: NIC's Assistant Controller further expressed concerns to Bur about past expenses of Frasers and stated that "[A]s a management team it appears we're going to whitewash the historical issue"

CASE 2

Case No.: 11-CV-00092-DGC
Case Filed: January 13, 2011
Corporation: **NutraCea, et al.**
California corporation based in Phoenix, Arizona
Defendants: **Bradley D. Edson**, former CEO and Member of the Board of Directors
Todd C. Crow, former CFO
Joanne D. Kline, former Controller
Scott Wilkinson, former Director of Financial Services
Margie Adelman, former Senior Vice President & Secretary

Facts Presented:
In 2007, NutraCea materially misstated product sales revenues in order to meet earnings and/or gross sales expectations. The SEC complaint alleges that NutraCea, Edson, Crow and Adelma falsified sales revenues and alleges that Kline and Wilkinson recorded the false revenues, therefore engaging in improper accounting practices.

Allegations against NutraCea, Edson, Adelman, Kline, and Wilkenson:

- Booked $2.6 million in false sales to Bi-Coastal Pharmaceutical Corporation in the 2nd quarter of 2007, which resulted in an overstatement of 35% of product sales revenue
- Bi-Coastal's president (client of NutraCea) was told by Edson to falsify his financial statements to reflect a net worth high enough to support the false sales
- Former COO of NutraCea paid the down payment of the Bi-Coastal's false sale of $2.6 million
- Improperly recorded revenue on a bill and hold transaction of a $1.9 million sale of a product to ITV Global, Inc. in the 4th quarter of 2007, which resulted in an overstatement of 36.8% product sales revenue
- The overstatement of revenues also resulted in a misstatement of operating loss by over 89% in the 2nd quarter of 2007, over 17.6% in the 3rd quarter of 2007, and close to 7% in the fiscal year of 2007

SEC Charges/Fines/Settlement – Litigation Release No. 21819

- **Edson:** $100,000 civil penalty; $350,000 of bonus reimbursement to NutraCea; consented to a permanent officer and director bar
- **Adelman:** Consented to a five year officer and director bar
- **Kline:** $25,000 civil penalty; consented to suspension of appearing or practicing before the Commission as an accountant (may apply for re-instatement after one year)
- **Wilkinson:** $25,000 civil penalty; consented to suspension of appearing or practicing before the Commission as an accountant (may apply for reinstatement after one year)
- **Crow:** Commission action is ongoing with the SEC seeking a permanent injunction, a civil penalty, and an officer and director bar

What Went Wrong?

Improper Accounting Practices

- “Tone at the top" from Edson was to do what is necessary to ensure NutraCea meets earnings goals and expectations
- Sale to Bi-Coastal was improperly booked due to failing to follow the four basic criteria for revenue recognition: (1) evidence that an arrangement exists, (2) delivery has occurred, (3) seller's price to buyer is fixed or determinable, and (4) assurance of collectability (which the collection of the receivable stemming from the transaction in this case could not be classified as reasonably assured)
- Requested that Bi-Coastal's president falsify their financial statements by $15 million more than the net worth originally stated by Bi-Coastal in order to reflect an ability to pay
- Misled auditors by arranging a loan from a former COO of NutraCea to look like a down payment from Bi-Coastal
- In late 2007, NutreaCea improperly booked a sale of 150,000 units of a product to ITV for over $1.9 million when the product was not was not manufactured by the end of 2007 and was not shipped to the buying company
- In August 2007 and in March 2008, Edson, Crow, Kline and Wilkinson misled auditors and the management representation letter related to Perry-Smith's review indicated that "(1) the interim financial information was presented in accordance with accounting principles generally accepted in the U.S.; (2) all financial records and related data were made available to Perry-Smith; and (3) they had no knowledge of any fraud or suspected fraud affecting NutraCea involving management, employees who have significant roles in the internal control, or others where fraud could have a material effect on the interim financial information"

Red Flags Ignored

- Edson informed Bi-Coastal's President (company NutraCea falsified sales) that "he had several avenues of potential distribution for these products and that [Bi-Coastal was] never going to take possession of them and that at a later date [Edson] was going to sell the products to a third party"
- Edson informed Bi-Coastal's president that "the only way that [Edson] could book the sale and the auditors would be able to accept the sale and book the sale for that period of time was if a substantial deposit was made for that amount, because of Bi-Coastal's lack of financial strength..."
- June 2007: NutraCea's former COO attempted to tell Crow of his loan for Bi-Coastal's down payment, in which Crow replied "I don't want to hear this"
- July 2007: Kline attempted to discuss the loan with Crow and stated that Crow covered his ears and said "No, no, no, no, no, no, no, no, no. I don't want to hear it"
- Kline did not discuss the loan with anyone else or with Perry-Smith or the audit committee due to fear of termination
- Adelman began communicating concerns of booking revenue in 2007 on a sale of a product NutraCea could not manufacture by the end of 2007 and was told by Edson "not to worry, that it was common practice to obtain letters like this and we had done it prior"
- Early 2008: Adelman again went to Edson concerned with booking revenue for a product that was not manufactured by the end of 2007 and was told "not to worry" since NutraCea had a letter from the client stating they had taken possession of the product. Adelman also told Edson about conversations with Kline and Edson responded by instructing her "not to have that conversation with Joanne and to be very careful about what [Adelman] said"
- Kline and Wilkenson both discussed concerns about the transactions not amounting to a valid sale
- Kline informed Crow that she was bothered "that [NutraCea was] recording a sale when everything [she] heard and saw led [her] to believe there was not inventory to sell....if this issue were ever to come up, and [she] was under oath and had to testify...that [she] would have to say [she] had strong reasons to believe the sale was not valid"

Auditor Violation Cases

Case 1

PCAOB Release No.:	105-2007-009
Case Filed:	December 14, 2007
Respondents:	Kantor, Geisler & Oppenheimer, P.A. (KGO), Steven M. Kantor, CPA and Thomas E. Sewell

Summary of Violations:
The respondents in the case violated the PCAOB's independence and auditing standards, along with certain violations of the Securities Exchange Act of 1934. Independence standards were violated in the audit of the financial statements of IWT Tesoro Corporation and that of GeneThera, Inc. In both audits, KGO and Sewell failed to perform sufficient audit procedures. KGO and Sewell also violated the Exchange Act by failing to take necessary steps when becoming aware of the possible that GeneThera performed illegal acts.

Facts Regarding Audit of IWT Tesoro Corporation's Financial Statements

- Audit report indicated that it was issued by an independent auditor and expressed an unqualified audit opinion on IWT's consolidated financial statements
- The audit report stated that IWT's financial statements were presented fairly and in conformity with generally accepted accounting principles (GAAP)
- The audit report also stated that it was conducted in accordance with generally accepted auditing standards (GAAS)
- The engagement partner who had final responsibility for the audit was Sewell

<u>Violations Relating to Audit of IWT Tesoro Corporation's Financial Statements</u>

Action	Violation
At the time of the KGO's audit, Sewell's mother owned a material interest of IWT stock and warrants to purchase IWT stock Sewell was aware of the materiality of his mother's IWT holdings	Failure to maintain the required independence
During the planning phase of the audit, KGO and Sewell identified IWT's accounting for "sample boards" listed on the balance sheet as property and equipment involved a significant risk of material misstatement due to fraud The potential for IWT to defer expenses and overstate assets by using lengthy depreciation periods for the boards	Failure to perform appropriate audit procedures

No audit procedures were done to test the initial costs allocated to any of the boards, the existence of the boards, whether any boards had become obsolete, been abandoned, destroyed, stolen, transferred, or otherwise impaired KGO and Sewell relied on management's representations regarding the accounting policies surrounding the boards	
IWT did not conform with GAAP by not recognizing certain amounts as compensation expense when stock options vested for IWT officers KGO and Sewell were aware of this departure from GAAP	Failure to identify and appropriately address GAAP departure
Sewell requested that Kantor sign the audit working paper stating that Kanto had performed certain supervisory duties, reviewed audit work papers, and approved audit procedures and working papers Kantor did not perform the procedures and did not have a significant role in the audit Kantor signed the working papers at Sewell's request due to the fact that Sewell was unable to sign the reports because of a suspended CPA license	Failure to follow PCAOB auditing standards by knowingly creating a working paper reflecting he performed certain audit procedures that he did not perform

Facts Regarding Audit of GeneThera, Inc.'s Financial Statements

- Audit report expressed an unqualified audit opinion on GeneThera's consolidated financial statements
- The audit report stated that GeneThera's financial statements were presented fairly and in conformity with generally accepted accounting principles (GAAP)
- The audit report also stated that it was conducted in accordance with generally accepted auditing standards (GAAS)

- The engagement partner who had final responsibility for the audit was Sewell

Violations Relating to Audit of GeneThera, Inc.'s Financial Statements

Action	Violation
GeneThere's laboratory equipment was more than 65% of its total reported assets, in which the company double-counted some of the assets when determining the value of the equipment KGO and Sewell relied on the management's assigned value for laboratory equipment without performing any audit procedures to test its value	Failure to perform appropriate audit procedures
GeneThera derecognized a $150,000 liability (11% of total liabilities) The $150,000 was reported as "other income" on the financial statements KGO and Sewell did not perform any procedures regarding this $150,000 liability and inappropriately related on the management's representation that they did not owe this amount to a creditor	Failure to perform appropriate audit procedures
KGO had direct access to GeneThera's accounting systems, made journal entries directly in the books and records of GeneThera, generated trial balances for financial statements, generated financial statements and footnote disclosers, made accounting decisions for the issuer, computed depreciation of fixed assets, and performed other services related to keeping the books and records of GeneThera	Violated Exchange Act by performing certain non-audit services including bookkeeping or other services related to the accounting records or financial statements of the audit client

KGO discovered payments from GeneThera to a limited liability company and payments out of the limited liability company that appeared to have been used to pay for GeneThera executives' personal expenses	Failure to take the necessary steps to determine whether it was likely that an illegal act had occurred

Direct Violation of Laws/Rules by KGO, Kantor, and Sewell

Law/Rule	Violated Portion of Rule
15 U.S.C S 78j-1 – Audit Requirements	Each audit of financial statements of an issuer by a registered public accounting firm shall include, in accordance with GAAP: • Procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts
PCAOB Rule 3100 – Compliance with Auditing and Related Professional Practice Standards	A registered public accounting firm and its associated persons shall comply with all applicable auditing and related professional practice standards
PCAOB Rule 3200T – Interim Auditing Standards	In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with generally accepted auditing standards, as described in the AICPA Auditing Standards Board's Statement of Auditing Standards No. 95
PCAOB Rule 3600T – Interim Independence Standards	In connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with independence standards
AU §508.07 – Reports on Audited Financial Statements	The auditor's standard report states that the financial statements present fairly, in all material respects, an entity's financial position, results of

	operations, and cash flows in conformity with generally accepted accounting principles. This conclusion may be expressed only when the auditor has formed such an opinion on the basis of an audit performed in accordance with generally accepted auditing standards
AU §105.02 – Generally Accepted Auditing Standards	The general, field work, and reporting standards approved and adopted by the AICPA as amended by the AICPA Auditing Standards Board (ASB): • The auditor must maintain independence in mental attitude in all matters relating to the audit • The auditor must exercise due professional care in the performance of the audit and the preparation of the report • The auditor must obtain sufficient appropriate audit evidence by performing audit procedures to afford a reasonable basis for an opinion regarding the financial statements under audit
AU §230 – Due Professional Care in the Performance of Work	This standard requires the independent auditor to plan and perform his or her work with due professional care
AU §317 – Illegal Acts by Clients	When the auditor concludes, based on information obtained and, if necessary, consultation with legal counsel, that an illegal act has or is likely to have occurred, the auditor should consider the effect on the financial statements as well as the implications for other aspects of the audit
AU §326 – Evidential Matter	Sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable

	basis for an opinion regarding the financial statements under audit
AU §339 – Audit Documentation	Audit documentation should be sufficient to show that standards of fieldwork have been observed as follows: • The work has been adequately planned and supervised • A sufficient understanding of internal control has been obtained to plan the audit and to determine the nature, timing, and extent of tests to be performed • Sufficient competent evidential matter has been obtained through the auditing procedures applied to afford a reasonable basis for an opinion
ET §101.01 – Independence	A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council
ET §101.02 – Application of the Independence Rules to Close Relatives	Independence shall be considered to be impaired if: • 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 5 percent of a client's outstanding equity securities or other ownership interests

Threats Compromising Ethical Compliance

Unethical Acts	Type of Threat
KGO had direct access to GeneThera's accounting systems, made journal entries directly in the books and records of GeneThera, generated trial balances for financial statements, generated financial statements and	Self-Review Threat – Threat that an individual will not appropriately evaluate the results of services that he/she previously performed Adverse Interest Threat – Threat in

footnote disclosers, made accounting decisions for the issuer, computed depreciation of fixed assets, and performed other services related to keeping the books and records of GeneThera	which an individual will not be objective because of his/her interest in the client Familiarity Threat – Threat that an individual will become too accepting of a client's work due to a long or close relationship with the client
At the time of the KGO's audit, Sewell's mother owned a material interest of IWT stock and warrants to purchase IWT stock Sewell was aware of the materiality of his mother's IWT holdings	Adverse Interest Threat – Threat in which a member will not be objective because of his/her interest in the client Self-Interest Threat – Threat that occurs when an individual may act in a manner adverse to the public as a result of his/her or a close family member's financial interest in the client
KGO and Sewell relied on the GeneThera's assigned value for laboratory equipment without performing any audit procedures to test its value	Familiarity Threat – Threat that an individual will become too accepting of a client's work due to a long or close relationship with the client
KGO and Sewell relied on IWT's representations regarding the accounting policies surrounding the boards	Familiarity Threat – Threat that an individual will become too accepting of a client's work due to a long or close relationship with the client

PCAOB Ruling

*Registration of Kantor, Geisler & Oppenheimer, P.A. is revoked
*Thomas E. Swell is barred from being an associated person of a registered public accounting firm
*Steven M. Kantor is barred from being an associated person of a registered public accounting firm

Case 2

SEC Release No.: 62636
Case Filed: August 4, 2010
Respondents: Thomas P. Flanagan, CPA

Summary of Violations:
Between December 2003 and July, 2008, Thomas P. Flanagan, a partner and Vice Chairman at Deloitte & Touche LLP, made 71 trades in which he purchased stock or options in Deloitte audit clients, 62 of which were in the securities of audit clients for whom Flanagan served on Deloitte's engagement team as the advisory partner. During the time Flanagan owned or controlled these securities, Deloitte issued audit reports to these nine audit clients in which it stated that the financial statements contained in the reports had been audited by an independent auditor. These clients filed with the Commission annual reports and proxy statements, which included these false audit reports.

Facts Surrounding the Case
Between 2003 and 2008, Flanagan made 71 purchases of stock and options in the securities in which he had authority to make trades in all of these accounts for audit clients. During these dates, Deloitte represented that it was independent in the Report of Independent Registered Public Accounting Firm ("audit reports") it provided to the audit clients for the audit years provided in the following table. Deloitte also stated that it had performed the audits in accordance with the standards of the PCAOB. The audit clients of Deliotte also filed annual reports and proxy statements with the Securities Exchange Commission that included the audit reports.

Deloitte also represented to these audit clients that at the end of each affected fiscal year that it was "independent" within the meaning of the federal securities law. The ISB(1) letters (Independence Standards Board Standard No.1, Independence Discussions with Audit Committees) given to the audit clients did not disclose Flanagan's ownership or control of securities in the client. This standard was carried forward as part of the PCAOB's interim standards when the ISB ceased operations.

Client	Dates Served as an Auditor and/or Advisory Partner in Audit Engagements	Dates Owned Stock	Dates Deliotte Represented it was Independent to Clients
Allstate Corp.	2003-2008	7/18/06-7/20/06	2006
Berkshire Hathaway, Inc.	2002-2008	4/21/05-6/9/06	2005 and 2006
Best Buy Co., Inc.	2005-2008	9/9/05 12/9/05-12/14/05 5/25/06-9/21/06 12/11/06-12/12/06 5/1/07-7/13/07	2006, 2007, 2008, and 2009

		12/4/07-12/21/07 2/13/08-3/5/08 4/1/08-5/19/08 6/4/08-7/18/08	
CBOT Holdings, Inc.	2001-2007	9/28/06-7/10/07	2007
CNA Financial Corp.	1994-2008	11/17/03-2/20/04	2003 and 2004
Sears Holding Corp.	2002-2008	12/17/03-4/18/04 6/1/04-10/22/04 2/17/06-3/23/06 5/19/08-5/30/08	2003, 2004, and 2008
ServiceMaster Company	2003-2006	2/3/06-1/19/07	2006 and 2007
USG Corp.	2004-2008	4/12/04-6/8/04 7/12/07-7/26/07	2004 and 2007
Walgreens Company	2003-2008	12/21/03-2/24/04 9/22/05-11/1/05 3/21/06-4/3/06 12/18/06-1/5/07 3/16/07-7/20/07 9/10/07-10/5/07	2004, 2005, 2006, and 2007

Flanagan was a covered person as to the entire audit clients listed above. He lacked independence when he owned securities in the audit clients in accounts he owned, in accounts he controlled for the benefit of family members, and in a family trust account for which he served as trustee. He also violated federal securities laws to GAAS and Regulation S-X when a report was issued stating that the audits were conducted in accordance with PCAOB standards when it was not. As a result of Flanagan's conduct, Deloitte violated PCAOB standards because the audits were not done according to generally accepted auditing standards. The audit clients also were in violation of the Exchange Act due to Flanagan's actions. The clients filed annual reports containing financial statements "certified by independent public accountants," when the reports violated this rule. In summary, Flanagan engaged in improper professional conduct when he intentionally and knowingly owned and controlled securities of Deloitte audit clients while a being a covered person. The following table provides the various rules and laws Flanagan violated.

Direct Violation of Laws/Rules by Flanagan

Law/Rule	Violated Portion of Rule
Rule 2-01(c)(1) of Regulation S-X	An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant's audit client, such as: (i) Investment in audit clients – An accountant is not independent when: (A) … any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, {or} options.; (C) … any covered person in the firm … serves as voting trustee of a trust, … containing the securities of an audit client, unless the …. Covered person in the firm, … has no authority to make investment decisions for the trust or estate
ET Rule 101.02 and Rule 3600T	Independence shall be considered to be impaired if during the period of the professional engagement a covered member had … any direct or material indirect financial interest in the client [or] was a trustee … if such trust … had … any direct or material indirect financial interest in the client and the covered member … had the authority to make investment decisions for the trust …
Rule 2-02(b)(1) of Regulation S-X	Requires accountants' reports to state "whether the audit was made in accordance with generally accepted auditing standards."
Section 13(a) of the Exchange Act and Rules 13a-1 and 13a-13	Requires issues to file annual reports containing financial statements certified by independent public accountants

Section 14(a) of the Exchange Act and Rule 14a-3	Require that proxy statements contain financial statements certified by independent public accountants
Rule 102(e)(1)(iv)(A)	Improper conduct includes "intentional or knowing conduct, including reckless conduct that results in a violation of applicable professional standards"

The main threat compromising ethical compliance in this case is the adverse interest threat, which is a threat that an individual will not be objective because of his/her interest in the client. Flanagan was able to override the safeguards Deloitte had in place to deter threats to compliance.

The following are safeguards Deloitte had in place in order to ensure that its professional personnel maintained their independence relative to its audit clients:

- Deloitte contained its independence policies in its Independence Manual
- The independence procedures required that its professional personnel, including partners, self-report all of their securities holdings and trading activities
- Professional personnel are also required to report all securities trades that they made as a trustee for accounts they controlled
- Deloitte created the Deloitte Entity Search and Compliance system and Tracking and Trading system for employees to use to report securities trades transactions
- The Deloitte Entity Search and Compliance system contained a "Restricted Entity List" which contained the names of all companies, banks, brokerage firms, and other institutions that Deloitte prohibited employees from, among other things, having a financial interest in or maintaining an account
- Prior to making a securities trade, employees were required to access the Deloitte Entity Search and Compliance system and Tracking and Trading system to verify that the company involved in the transaction was not restricted
- Employees had 10 calendar days to report a securities trade to Deloitte via the Tracking and Trading system
- Deloitte also required its employees to file annual Independence Representations in which the employees were to affirm between 20 and 50 specific statements

Securities and Exchange Commission Ruling

*Flanagan shall cease and desist from causing any violations and future violations of Sections 13(a) and 14(a) of the Exchange Act, and Rules 13a-1, 13a-13, and 14a-3 promulgated thereunder and Rule 2-02(b)(1) of Regulation S-X

*Flanagan is denied the privilege of appearing or practicing before the Commission as an accountant

Case 3

SEC Release No.:	53573
Case Filed:	March 30, 2006
Respondents:	Aron R. Carr, CPA

Summary of Violations:

Aron R. Carr is charged with improperly modifying the working papers of the audit of Tenet Healthcare Corporation. He, along with other members of the audit team, modified more than 350 working papers from the FY 2002 audit of Tenet Healthcare Corporation.

Facts Surrounding the Case

Carr was a member of the audit team that conducted audits of Tenet Healthcare Corporation. From the FY 2000 – FY 2002, Tenet's filings to the Commission did not contain any reference to an aggressive pricing strategy of raising gross charges for the purpose of increasing revenue from Medicare outlier payments. No information was disclosed about the growth trend in outlier payments, the impact of gross charges on Tenet's revenue, or sustainability of its aggressive pricing strategy. In 2002, an audit report containing an unqualified opinion that the audit was performed according to GAAS was submitted in Tenet's FY 2002 (ending May 31, 2002) Form 10-K. An audit partner, Clete D. Madden, specifically verified in the working papers that all of the working papers were complete, when in fact they were not complete. In November and December 2002, they began to "clean up" the audit working papers and added comments about the questionable outlier payments that the Department of Health and Human Services and the Commission were investigating.

The audit team, including Carr, spent over 500 hours changing the working papers. They modified more than 350 working papers from the FY 2002 audit, including adding nine references to outlier payments. These changes were made after Madden signed and authorized the release of the audit report. Because of these modifications, it was impossible to determine the actual condition of all the working papers at the time that the FY 2002 audit report was issued.

The modifications of the work papers included the documentation of procedures the audit team performed in November 2002 giving the impression that additional work was done before the issuance of the audit report. An example of this is that in November 2002, a staff member created a working paper documenting an assessment of the risk of material financial statement misstatement due to fraud. The requirement is that this assessment be done before the issuance of the audit report.

In November 2002, Carr also improperly created eight documents that together compromised the Compliance Binder that related to the FY 2001 audit. Carr copied certain working papers from either the FY 2000 or FY 2002 Compliance Binder and placed the copies in the FY 2001 Compliance Binder. Carr misleadingly created and altered the "ethics" document in the FY 2001 Compliance Binder by covering the title of the FY 2002 ethics sheet and pasting FY 2001 over the title. Even though the Compliance Binder was created in November 2002, Carr placed the date of July 2001 on each working paper that made up the binder.

Direct Violation of Laws/Rules by Carr

Law/Rule	Violated Portion of Rule
AU §339	Requirements on working papers are that any addition, deletion, or modification to working papers after they have been finalized in connection with the completion of the audit may be made only with appropriate supplemental documentation, including an explanation of the justification for the addition, deletion or modification.
Rule 102(e)(1)(ii)	The commission may censure or deny, temporarily or permanently, the privilege of appearing or practicing before it to any person who is found by the Commission to be lacking in character or integrity, or to have engaged in improper professional conduct.

Securities and Exchange Commission Ruling

*Carr is denied the privilege of appearing or practicing before the Commission as an accountant

*After three years from the date of the order, Carr may request that the Commission consider his reinstatement by submitting an application to resume appearing or practicing before the Commission as either a preparer or reviewer of any public company's financial statements filed with the SEC or as an independent accountant

Review Questions

1. According to the NutraCea case present in the text, what type of fine was the CEO, Edson, subject to for his part in the falsification of sales revenues?
   - A. $25,000 civil penalty
   - B. $50,000 civil penalty, five year officer and director bar
   - C. $75,000 civil penalty, seven year officer and director bar
   - D. $100,000 civil penalty, $350,000 bonus reimbursement, permanent officer and director bar

2. In the auditing case presented regarding Flanagan, what was the main rule he violated by participating on the audit team for clients in which he owned stock?
   - A. Asset misappropriation
   - B. Financial Statement Fraud
   - C. Independence
   - D. Channel stuffing

Review Answers

1. A. Incorrect. Edson was not subject to a $25,000 civil penalty for his part in the falsification of sales revenues. Instead, Edson was subject to a $100,000 civil penalty, a $350,000 of bonus reimbursement to NutreCea, and a permanent officer and director bar.
   B. Incorrect. Edson was not subject to a $50,000 civil penalty and a five year officer and director bar for his part in the falsification of sales revenues. Instead, Edson was subject to a $100,000 civil penalty, a $350,000 of bonus reimbursement to NutreCea, and a permanent officer and director bar.
   C. Incorrect. Edson was not subject to a $75,000 civil penalty and a seven year officer and director bar for his part in the falsification of sales revenues. Instead, Edson was subject to a $100,000 civil penalty, a $350,000 of bonus reimbursement to NutreCea, and a permanent officer and director bar.
   D. **Correct.** Edson was subject to a $100,000 civil penalty, a $350,000 of bonus reimbursement to NutreCea, and a permanent officer and director bar for his part in the falsification of sales revenues.

2. A. Incorrect. In the auditing case presented regarding Flanagan, the main rule he violated by participating on the audit team for clients in which he owned stock was not asset misappropriation. Asset misappropriation involves the use of cash, inventory, and other assets to commit fraud.
   B. Incorrect. In the auditing case presented regarding Flanagan, the main rule he violated by participating on the audit team for clients in which he owned stock was not financial statement fraud. Financial statement fraud involves an intentional misstatement or omission of material items on the financial statements.
   C. **Correct.** In the auditing case presented regarding Flanagan, the main rule he violated by participating on the audit team for clients in which he owned stock was independence. He violated the independence rules by having direct financial interest in the audit clients in which he was an auditor and/or advisory partner.
   D. Incorrect. In the auditing case presented regarding Flanagan, the main rule he violated by participating on the audit team for clients in which he owned stock was not channel stuffing. Channel stuffing is an avenue to inflate sales by sending retailers more products than they can sell by means of distribution channels.

Chapter 4
Ethics for Tax Professionals

Learning Objectives

- List the indicators of tax fraud
- Summarize the Statements on Standards for Tax Services (SSTS)
- Describe the tactics used by abusive tax return preparers
- Recognize the types of corporate tax fraud schemes
- Discuss the types of abusive tax schemes

Introduction

Tax professionals not only have the responsibility of protecting the interests of their clients, but they also have a responsibility to the government and therefore must comply with the rules and regulations surrounding the field of tax practice. This chapter explores the rules set forth for tax professionals, the penalties for violating IRS regulations, and several types of tax schemes.

Tax Fraud

Tax fraud on tax returns can be committed by means of income, expenses or deductions, books and records, and inappropriate conduct and concealment. The following figure outlines indicators of tax fraud for these categories.

Figure 4-1
Indicators of Tax Fraud

Fraud – Income
• Omissions of specific items where similar items are included • Omissions of entire sources of income • Unexplained failure to report substantial amounts of income identified as received • Substantial unexplained increases in net worth, especially over a period of years • Substantial excess of personal expenditures over reported available resources • Bank deposits from unexplained sources substantially exceeding reported income • Concealment of bank accounts, brokerage accounts, and other property • Inadequate explanation for dealing in large sums of currency, or the unexplained expenditure of currency • Consistent concealment of unexplained currency, especially in a business not routinely calling for large amounts of cash • Failure to deposit receipts to business account, contrary to normal practices • Failure to file a tax return, especially for a period of several years although substantial amounts of taxable income were received • Cashing checks, representing income, at check cashing services and at banks where

the taxpayer does not maintain an account
- Concealing sources of receipts by false description of the source(s) of disclosed income, and/or nontaxable receipts

Fraud – Expenses or Deductions

- Substantial overstatement of deductions
- Substantial amounts of personal expenditures deducted as business expenses
- Claiming fictitious deductions
- Dependency exemption claimed for nonexistent, deceased, or self-supporting persons
- Trust fund loans disguised as expenses or deductions

Fraud – Books and Records

- Keeping two sets of books or no records
- False entries or alterations made on the books and records, back-dated or post-dated documents, false invoices, false applications, statements, other false documents, or applications
- Invoices are irregularly numbered, unnumbered or altered
- Checks made payable to third parties are endorsed back to the taxpayer
- Checks made payable to vendors and other business payees are cashed by the taxpayer
- Failure to keep adequate records, concealment of records, or refusal to make certain records available
- Variances between treatment of questionable items reflected on the tax return, as compared with books
- Intentional under or over footing of columns in journal or ledger
- Amounts on return not in agreement with amounts in books
- Amounts posted to ledger accounts not in agreement with source books or records
- Journalizing of questionable items out of correct account
- Recording income items in suspense or asset accounts
- False receipts to donors by exempt organizations

Fraud – Allocations of Income

- Distribution of profits to fictitious partners
- Inclusion of income or deductions in the tax return of a related taxpayer, when difference in tax rates is a factor

Fraud – Conduct of Taxpayer

- False statement about a material fact involved in the examination
- Attempts to hinder the examination
    - For example, failure to answer pertinent questions, repeated cancellations of appointments, refusal to provide records, threatening potential witnesses, including the examiner or assaulting the examiner
- Failure to follow the advice of accountant or attorney
- Failure to make full disclosure of relevant facts to the accountant
- The taxpayer’s knowledge of taxes and business practices where numerous questionable items appear on the returns
- Testimony of employees concerning irregular business practices by the taxpayer
- Destruction of books and records, especially if just after examination was started

- Transfer of assets for purposes of concealment, or diversion of funds and/or assets by officials or trustees
- Patterns of consistent failure over several years to report income fully
- Proof that the tax return was incorrect to such an extent and in respect to items of such magnitude and character as to compel the conclusion that the falsity was known and deliberate
- Payment of improper expenses by or for officials or trustees
- Willful and intentional failure to execute pension plan amendments
- Backdating of applications and related documents
- Making false statements on Tax Exempt/Government Entity (TEGE) determination letter applications
- Use of false social security numbers
- Submission of false Form W–4
- Submitting a false affidavit
- Attempts to bribe the examiner

Fraud – Methods of Concealment

- Inadequacy of consideration
- Insolvency of transferor
- Assets placed in other names
- Transfer of all or nearly all of debtor's property
- Close relationship between parties to the transfer
- Transfer made in anticipation of a tax assessment or while the investigation of a deficiency is pending
- Reservation of any interest in the property transferred
- Transaction not in the usual course of business
- Retention of possession
- Transactions surrounded by secrecy
- False entries in books of transferor or transferee
- Unusual disposition of the consideration received for the property
- Use of secret bank accounts for income
- Deposits into bank accounts under nominee names
- Conduct of business transactions in false names

Source: Internal Revenue Manual (IRM); Part 25 – Fraud Handbook

Statements on Standards for Tax Services (SSTS)

The American Institute of CPAs (AICPA) issues its own set of tax practice standards called Statements on Standards for Tax Services (SSTS). This section provides a summary of the AICPA's SSTS No. 1 – SSTS No. 7.

SSTS No. 1 – Tax Return Positions

The following are requirements of SSTS No. 1:

- Imposes compliance with reporting and disclosure requirements with recommending tax return positions and the preparing or signing of tax returns

- Outlines the responsibility to advise a taxpayer on penalties of a tax return position and disclosure requirements to avoid those penalties

SSTS No. 2 – Answers to Questions on Returns
The following are requirements of SSTS No. 2:

- Before signing as a tax preparer, all pertinent taxpayer information must be obtained to properly answer questions on the tax return

SSTS No. 3 – Certain Procedural Aspects of Preparing Returns
The following are requirements of SSTS No. 3:

- A preparer is able to rely on the information presented by the taxpayer or by third parties unless the information seems to be incorrect, incomplete, or inconsistent
- Consideration should be made of any information that is actually known even if it is from another related taxpayer

SSTS No. 4 – Use of Estimates
The following are requirements of SSTS No. 4:

- In the case where exact data is not obtainable, reasonable estimates based on facts and circumstances may be used
- Estimates under this statement do not include appraisals or valuations

SSTS No. 5 – Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
The following are requirements of SSTS No. 5:

- Tax treatment that is the result of an administrative proceeding or court decision should be recommended by preparers in later years
- This is not required if the new position satisfies SSTS No. 1

SSTS No. 6 – Knowledge of Error: Return Preparation and Administrative Proceedings
The following are requirements of SSTS No. 6:

- Preparers should advise taxpayers of possible consequences of errors found on a taxpayer's previously filed return, on a return that is subject to administrative proceedings, or on the failure of a taxpayer to file a tax return
- Consideration to withdraw from the engagement should be made in the event the taxpayer refuses to correct the errors

SSTS No. 7 – Form and Content of Advice to Taxpayers
The following are requirements of SSTS No. 7:

- Competent advice that meets the needs of a taxpayer should be provided

- Communication should be in writing for taxpayers when the information is important, unusual, or if a sizable dollar value or complicated transaction is involved
- Unless previously agreed upon, there is no obligation to communicate later developments that may affect previously provided advice

Tax Preparer Penalties under Title 26 – Internal Revenue Code

The following figure outlines the tax preparer penalties for violation of regulations under Title 26.

Figure 4-6
Summary of Tax Preparer Penalties under
Title 26 – Internal Revenue Code

IRC §6694(a) Understatement of Taxpayer's Liability by Tax Return Preparer Due to Unreasonable Positions	→	The penalty is the greater of $1,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
IRC §6694(b) Understatement of Taxpayer's Liability by Tax Return Preparer Due to Willful or Reckless Conduct	→	The penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
IRC §6695(a) Failure to Furnish Copy to Taxpayer	→	The penalty is $50 for each failure to comply with IRC §6107 regarding furnishing a copy of a return or claim to a taxpayer. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year.
IRC §6695(b) Failure to Sign Return	→	The penalty is $50 for each failure to sign a return or claim for refund as required by regulations. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year.
IRC §6695(c) Failure to Furnish Identifying Number	→	The penalty is $50 for each failure to comply with IRC §6109(a)(4) regarding furnishing an identifying number on a return or claim. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a calendar year.
IRC §6695(d) Failure to Retain Copy or List	→	The penalty is $50 for each failure to comply with IRC §6107(b) regarding retaining a copy or list of a return or claim. The maximum penalty imposed on any tax return

		preparer shall not exceed $25,000 in a return period.
IRC §6695(e) Failure to File Correct Information Returns	→	The penalty is $50 for each failure to comply with IRC §6060. The maximum penalty imposed on any tax return preparer shall not exceed $25,000 in a return period.
IRC §6695(f) Negotiation of Check	→	The penalty is $500 for a tax return preparer who endorses or negotiates any check made in respect of taxes imposed by Title 26 which is issued to a taxpayer.
IRC §6695(g) Failure to be Diligent in Determining Eligibility for Earned Income Credit	→	The penalty is $500 for each failure to comply with the EIC due diligence requirements imposed in regulations.
IRC §6700 Promoting Abusive Tax Shelters	→	The penalty is for a promoter of an abusive tax shelter and is generally equal to $1,000 for each organization or sale of an abusive plan or arrangement (or, if lesser, 100 percent of the income derived from the activity).
IRC §6701 Penalties for Aiding and Abetting Understatement of Tax Liability	→	The penalty is $1,000 ($10,000 if the conduct relates to a corporation's tax return) for aiding and abetting in an understatement of a tax liability. Any person subject to the penalty shall be penalized only once for documents relating to the same taxpayer for a single tax period or event.
IRC §6713 Disclosure or Use of Information by Preparers Returns	→	The penalty is $250 for each unauthorized disclosure or use of information furnished for, or in connection with, the preparation of a return. The maximum penalty on any person shall not exceed $10,000 in a calendar year.
IRC §7206 Fraud and False Statements	→	Guilty of a felony and, upon conviction, a fine of not more than $100,000 ($500,000 in the case of a corporation), imprisonment of not more than three years, or both (together with the costs of prosecution).
IRC §7207 Fraudulent Returns, Statements, or Other Documents	→	Guilty of a misdemeanor and, upon conviction, a fine of not more than $10,000 ($50,000 in the case of a corporation), imprisonment of not more than one year, or both.
IRC §7216 Disclosure or Use of Information by Preparers of Returns	→	Guilty of a misdemeanor for knowingly or recklessly disclosing information furnished in connection with a tax return or using

		such information for any purpose other than preparing or assisting in the preparation of such return. Upon conviction, a fine of not more than $1,000, imprisonment for not more than 1 year, or both (together with the costs of prosecution).
IRC §7407 Action to Enjoin Tax Return Preparers	→	A federal district court may enjoin a tax return preparer from engaging in certain proscribed conduct, or in extreme cases, from continuing to act as a tax return preparer altogether.
IRC §7408 Action to Enjoin Specified Conduct Related to Tax Shelters and Reportable Transactions	→	A federal district court may enjoin a person from engaging in certain proscribed conduct (including any action, or failure to take action, which is in violation of Circular 230).

Source: Summary of Preparer Penalties under Title 26; IRS.gov

Abusive Tax Return Preparers

According to the IRS, a Return Preparer is defined "as any person (including a partnership or corporation) who prepares for compensation all or a substantial portion of a tax return or claim for refund under the income tax provisions of the Internal Revenue Code."

Fraud committed by return preparers involves the filing of false income tax returns in which the preparers' clients may or may not have knowledge of. Some of the unethical acts of tax return preparers include:

- Inflated personal or business expenses
- False deductions
- Unallowable credits or excessive exemptions, fraudulent tax credits, such as the Earned Income Tax Credit (EITC)

There are several methods for an unethical tax return preparer to make fraudulent deductions that reduce taxable income. The following are only some of these methods:

- Preparing fraudulent Schedule C, Profit or Loss from Business, claiming deductions for expenses that have not been paid by the taxpayer to offset Form 1099, Miscellaneous Income, or income earned from outside employment
- Including false and inflated itemized deductions on Schedule A, Itemized Deductions, for:
    - Charitable contributions
    - Medical and dental expenses

- Claiming false Schedule E, Supplemental Income and Loss, losses
- Claiming false dependents

Statistical Data – Abusive Tax Return Preparers

The following data provides criminal investigations of abusive tax return preparers from 2009-2011.

Figure 4-2
Abusive Return Preparers – Criminal Investigations

	FY 2011	FY 2010	FY 2009
Investigations Initiated	371	397	224
Prosecution Recommendations	233	202	129
Indictments/Information	176	182	149
Convictions	163	145	115
Sentenced	163	132	136
Incarceration Rate*	87.1%	88.6%	85.3%
Average Months to Serve	25	24	24

*Incarceration includes confinement to federal prison, halfway house, home detention, or some combination thereof

Source: Criminal Investigation Management Information System; IRS.gov

Case Examples – Abusive Tax Return Preparers

The following are actual IRS cases of abusive tax return preparers.

♦ Case Example ♦

Elizabeth Bailey and Patricia Sheard, Beaumont, Texas

Date: August 1, 2012

Penalty: 30 months in prison; $437,984 joint restitution

Crime: According to court documents, Bailey founded Gayle's Taxes in 1999 and employed Sheard as a bookkeeper. The defendants prepared numerous personal income tax returns for clients, deliberately overstating numerous expenses and deductions causing the taxpayers to receive a larger refund or pay less tax than actually owed. The clients were given a copy of an electronic return as it should have been filed, but the defendants actually filed a false return with inflated deductions and expenses and diverted the inflated portion of the refunds into bank accounts controlled by defendants. From 2006 to 2008, the defendants caused the filing of over 100 false personal income tax returns and diverted the fraudulent refund portion to the defendants' bank accounts causing a loss of over $465,000.

♦ Case Example ♦

Delaun Leflore and Carey Herron, Belleville, Illinois

Date: May 11, 2012

Penalty: Leflore - 90 months in prison; 3 years supervised release; prohibited from being in the tax preparation service business in the future; Herron – 46 months in prison

Crime: According to court documents, from at least 2009 through April 2011, Leflore and Herron, dba Prime Time Tax Services, participated in a tax preparation scheme to obtain, and to help others obtain, fraudulent refunds. As part of the conspiracy, they created fraudulent Schedule C information to falsely inflate the tax refund amount taxpayers were entitled to receive. When certain individuals received their refunds, a representative of Prime Time Tax Services would escort them to a check cashing business to cash the refund check and pay the representative an extra fee, generally $500 in cash. Leflore was not authorized to e-file tax returns and used another tax preparer's electronic identification number to file the false returns. Over 460 false federal tax returns were filed as part of the scheme.

♦ Case Example ♦

Debra Davis, Memphis, Tennessee

Date: March 6, 2011

Penalty: 18 months in prison; $175,268 in restitution

Crime: Davis was indicted on April 21, 2010, and charged with 26 counts of aiding and assisting in the preparation of false income tax returns. She pleaded guilty on November 15, 2011, to one count of aiding and assisting in the preparation of a false income tax return. According to the indictment, Davis prepared federal income tax returns for other individuals that were filed with the Internal Revenue Service (IRS) for tax years 2004 through 2007. Many of the returns contained fictitious deductions for medical/dental expenses, cash and noncash charitable contributions, real estate taxes, child care expenses, mortgage interest, uniform expenses, job seeking expenses, gambling losses, personal property taxes, and unreimbursed employee expenses. Other returns reflected that an individual had a Schedule C business when no business existed. Some returns claimed dependents whom the individuals were not entitled to claim.

♦ Case Example ♦

Diane Lipina Tuiono, Oakland, California

Date: February 29, 2012

Penalty: 18 months in prison; 1 year of supervised release; $175,268 in restitution

Crime: Tuiono pleaded guilty on November 23, 2011 to aiding and assisting in the preparation of false tax returns. As part of her plea, Tuiono admitted she prepared tax returns from 2006 through 2009 although she was not a licensed return preparer and did not sign the returns she prepared. Many of her clients

were low income families who were unaware of the details of state and federal tax laws. Sometimes her clients brought Forms W-2, 1098, and 1099 to prepare their tax returns and other times they did not have verifiable income or did not earn income at all during the year, but they would still ask her to prepare their returns. In those situations, Tuiono would input an amount of income on the tax return in order to maximize the amount of the refunds. This resulted in her clients obtaining the Earned Income Credits and/or Child Tax Credits. Tuiono also admitted that she inflated refunds or reduced her clients' tax liabilities by using several methods including: claiming false filing status, ineligible dependents, non-existent Household Help Income, false wages, exaggerated or fictitious Schedule A itemized deductions, false Schedule C businesses and expenses. Sometimes she had the married couples file separate tax returns. Each return unlawfully listed each spouse as "Single" or "Head of Household." In some cases Tuiono split the couples' children between the two parents or listed ineligible dependents and claimed false income on each of the returns. These fraudulent acts allowed each spouse to receive the highest refundable Earned Income Credit. For the tax years 2006 through 2009, Tuiono prepared 33 returns on behalf of 16 different people, resulting in a tax loss of $135,803. Tuiono received between $100 to $300 for the preparation of each tax return, which she did not report on her tax returns.

♦ Case Example ♦

Rebekah Walters, San Antonio, Texas

Date: August 6, 2012

Penalty: 12 months home confinement; 5 years' probation

Crime: According to court documents, Walters was a tax preparer who from 2007 through 2009 prepared false tax returns for clients by claiming deductions they were not entitled to receive. Walters led her clients to believe that she specialized in tax form preparation and that she could maximize their deductions and income tax refunds. She also told her clients she used to work for the IRS and sold them audit insurance. On her client's tax returns, Walters either inflated or fabricated deductions for her clients without her client's knowledge and without explaining those deductions. The deductions included medical and dental expenses, sales tax paid, gifts to charities and unreimbursed employee expenses.

Corporate Tax Fraud

Corporate tax fraud involves violations of the Internal Revenue Code (IRC) and related statutes committed by large, publicly traded (or private) corporations, and/or by their senior executives. These schemes are characterized by their scope, complexity, and the magnitude of the negative economic consequences for communities, employees, lenders, investors, and financial markets. Most corporate fraud investigations are joint efforts involving many federal agencies.

Statistical Data – Corporate Tax Fraud

The following figure presents statistical information from the IRS on the criminal investigations of corporate fraud from 2010-2012.

Figure 47
Corporate Fraud – IRS Criminal Investigations

	FY 2012	FY 2011	FY 2010
Investigations Initiated	80	110	116
Prosecution Recommendations	67	79	91
Indictments/Information	59	81	80
Sentenced	78	82	61
Incarceration Rate*	83.3%	81.7%	77.0%
Average Months to Serve	47	51	48

*Incarceration includes confinement to federal prison, halfway house, home detention, or some combination thereof

Source: Criminal Investigation Management Information System; IRS.gov

Case Examples – Corporate Tax Fraud

The following are actual IRS cases of corporate tax fraud.

♦ Case Example ♦

Elsayed Kazem "Tom" Safiedine and Mary Fawaz, Detroit Michigan

Date: October 17, 2012

Penalty: Safiedine – 21 months in prison; Fawaz – 12 months and one day in prison

Crime: Safiedine and Fawaz were convicted by a jury of conspiring to defraud the United States by impeding and impairing the lawful functions of the IRS. According to evidence at trial, Safiedine was an officer and member of multiple business entities that operated and leased gasoline stations in the Detroit area. Fawaz was an officer of JSC Corporation, a business operated by Safiendine, and also served as a bookkeeper and office manager for several of Safiedine's businesses. From 1998 through 2001, Safiedine and Fawaz arranged for third parties to negotiate checks from Sunoco Incorporated made payable to JSC Corporation. The checks from Sunoco, which totaled $845,000, were not properly reported to the accountant for JSC Corporation and as a result, were not included as income on JSC's corporate tax returns filed with the IRS. In addition, Safiedine and Fawaz participated in the sale of a gasoline station owned by one of Safiedine's businesses, MTK & KLC Partnership. They advised the accountant for MTK & KLC that the gas station sold for $175,000 less than its actual sale price, thus resulting in an understatement of income on the MTK & KLC partnership income tax return.

♦ Case Example ♦

Jeffrey John Wirth, Minneapolis, Minnesota

Date: September 19, 2012

Penalty: 54 months in prison; $6,457,500 in restitution

Crime: Wirth was charged for underpaying his taxes from 2003 to 2005. Wirth pleaded guilty in May 2012 to one count of conspiracy to defraud the United States. In his plea agreement, Wirth admitted that from at least 2003 through October 2006, he conspired with his then-wife, Holly Claire Damiani, and their tax return preparer, Michael James Murry, to defraud the IRS by failing to pay their true tax obligations. Wirth is the sole owner and chief executive officer of The Wirth Companies (TWC), a commercial real estate development and management business. Wirth is also the former owner of the Grand Hotel in downtown Minneapolis, the Grand Rios Hotel & Waterpark in Brooklyn Park, and the Grand Lodge Hotel & Waterpark of America in Bloomington, as well as nearly 30 other businesses. In his plea, Wirth stated that he and Damiani used TWC and the other related businesses to fund their lavish lifestyle, including $2 million to purchase an island in St. Alban's Bay in Lake Minnetonka. He also admitted they often recorded personal expenses as business expenses in an effort to understate the company's income for tax purposes. Wirth agreed that he, Damiani, and Murry caused year-end adjustments to the tax returns for TWC and other related businesses by claiming bogus "management fees," all in an effort to reduce the company's overall taxable income to nearly zero. In addition, Wirth understated his own TWC salary to the IRS. From 2002 through 2005, while managing TWC and receiving substantial monetary distributions from it, he claimed a salary of only $12,000 annually on his Form W-2s. Moreover, from 2003 through 2006, Wirth failed to report on TWC's tax returns substantial amounts of fee income earned by the company during the construction and development of the Grand Rios Hotel & Waterpark and the Grand Lodge Hotel & Waterpark of America. As a result, Wirth caused the amount of adjusted gross income, taxable income, and total tax shown on his individual income tax returns, which he filed jointly with Damiani until 2006, to be grossly understated. Wirth also admitted that the tax loss was between $2.5 and $7 million. On May 3, 2012, Damiani pleaded guilty to one count of filing a false federal individual income tax return. On May 14, 2012, Murry pleaded guilty to one count of preparing a false corporate tax return. They both are awaiting sentencing.

♦ Case Example ♦

Kevin Coleman, Waseca, Minnesota

Date: July 10, 2012

Penalty: 70 months in prison, 3 years supervised release

Crime: Coleman was charged for embezzling approximately $1.7 million from his former employer and for failing to pay more than $740,000 in federal taxes. On February 27, 2012, Coleman pleaded guilty to one count of wire fraud and one count of tax evasion. According to court documents and state-

ments made in court, from approximately November 2005 to December 2010, Coleman was the Chief Executive Officer (CEO) of a Shelton, Conn., company. From approximately October 2008 to November 2010, Coleman and Joanne Osmolik, who served as the company's vice president for human resources, embezzled approximately $3.5 million in corporate funds to pay personal expenses. As part of the scheme, Coleman and Osmolik charged substantial personal expenditures on corporate credit cards. Coleman directed Osmolik to charge personal items to the corporate American Express card of another employee to conceal their expenses from the company's finance department. Coleman also instructed Osmolik to destroy company records to conceal their fraudulent nature from others at the company. Through this scheme, Coleman embezzled approximately $1.7 million from the company and Osmolik embezzled approximately $1.77 million. Coleman also did not file federal income tax returns for tax years 2007 through 2010. During these four years, in addition to his embezzled income, Coleman earned $1,585,128 in wages, resulting in a tax loss to the government of $741,029. The judge also ordered Coleman to pay $1,700,459 in restitution and an additional $450,000 jointly with Osmolik, to compensate the victim company for legal fees and other costs it incurred as a result of this crime. Coleman also was ordered to pay $1,372,711 in back taxes, interest and penalties. Osmolik, of Newtown, Conn., was sentenced on April 26, 2012, to 48 months in prison and ordered to pay full restitution to the victim company. She also forfeited her interest in three residential properties in Vermont, six motorcycles, an all-terrain vehicle, four snowmobiles, vehicle trailers, jewelry and numerous appliances and other home furnishing items.

♦ Case Example ♦

Thomas J. Ernst, McLean, Virginia

Date: December 16, 2011

Penalty: 48 months prison; 3 years supervised release; $4,490,966 in restitution

Crime: According to court documents, between 2000 and 2006, Ernst served as the president and chief executive officer of a health insurance benefits administration company. According to the plea agreement and statement of facts, Ernst admitted that between 2001 and 2007, he corruptly endeavored to obstruct and impede the due administration of the Internal Revenue laws by causing his employer to make payments from its corporate bank account for numerous personal expenses, including a summer rental house; more than $1.5 million in payments to himself, his wife, his sister-in-law, and his sons; his son's private college education; and various property purchases and rentals. In all, these payments totaled more than $3.3 million. Ernst also admitted that he caused his employer company to fail to file corporate income tax returns, despite the fact that the company earned more than $11 million in gross receipts between 2001 and 2006.

♦ **Case Example** ♦

Joseph A. Pingaro, Jr. and Christine A. Scola, Boston, Massachusetts

Date: February 14, 2012

Penalty: Pingaro – 48 months in prison; 2 years supervised release; Scola – 2 years' probation (6 months halfway house); Jointly - $900,000 as forfeiture; $50,000 each in criminal fines; $8,000 each in costs of prosecution; $500,000 in back taxes

Crime: According to court records, Pingaro is the sole owner and operator of J&J Metals, a scrap metal yard in Roxbury where Scola is the bookkeeper. The defendants transferred large amounts of money, totaling millions of dollars, from the J&J business bank account into their personal bank account. Scola then withdrew cash from the personal account in a series of withdrawals, each just under $10,000, over consecutive days. Pingaro and Scola used substantial amounts of the cash to make large personal expenditures. Pingaro then falsely claimed on his income tax returns that almost all of the cash withdrawn had been used for legitimate deductible business expenses for J&J Metals. Pingaro and Scola's scheme was designed to conceal the actual profits of J&J Metals and evade federal income tax. Scola's banking activity was designed to further this evasion by avoiding the requirement that financial institutions must file a Currency Transaction Report with the government for each cash transaction exceeding $10,000. Similarly, Pingaro and Scola conspired to avoid U.S. Postal reporting requirements for the purchase of $3,000 or more in money orders from any one location in a single day, by conducting a series of transactions over consecutive business days and in various locations.

Abusive Tax Schemes

Abusive tax schemes have evolved from simple structuring of abusive domestic and foreign trust arrangements into sophisticated strategies that take advantage of the financial secrecy laws of some foreign jurisdictions and the availability of credit/debit cards issued from offshore financial institutions.

IRS Criminal Investigation (CI) has developed a nationally coordinated program to combat these abusive tax schemes. CI's primary focus is on the identification and investigation of the tax scheme promoters as well as those who play a substantial or integral role in facilitating, aiding, assisting, or furthering the abusive tax scheme (e.g., accountants, lawyers). Secondarily, but equally important, is the investigation of investors who knowingly participate in abusive tax schemes.

What is an Abusive Tax Scheme?

The Abusive Tax Schemes program encompasses violations of the Internal Revenue Code (IRC) and related statutes where multiple flow-through entities are used as an integral part of the taxpayer's scheme to evade taxes. These schemes are characterized by the use of trusts, Limited Liability Companies

(LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

Form over substance are the most important words to remember before buying into any arrangements that promise to "eliminate" or "substantially reduce" your tax liability. The promoters of abusive tax schemes often employ financial instruments such as trusts in their schemes. However, the instruments are used for improper purposes including the facilitation of tax evasion.

Common Abusive Tax Schemes

Tax evasion using foreign jurisdictions is accomplished using many different methods. Some can be as simple as taking unreported cash receipts and personally traveling to a tax haven country and depositing the cash into a bank account. Others are more elaborate involving numerous domestic and foreign trusts, partnerships, nominees, etc. The following schemes are not all-inclusive, but just a sample of abusive tax schemes.

Abusive Foreign Trust Schemes

The foreign trust schemes usually start off as a series of domestic trusts layered upon one another. This set up is used to give the appearance that the taxpayer has turned his/her business and assets over to a trust and is no longer in control of the business or its assets. Once transferred to the domestic trust, the income and expenses are passed to one or more foreign trusts, typically in tax haven countries.

As an example, a taxpayer's business is split into two trusts. One trust would be the business trust that is in charge of the daily operations. The other trust is an equipment trust formed to hold the business's equipment that is leased back to the business trust at inflated rates to nullify any income reported on the business trust tax return (Form 1041). Next the income from the equipment trust is distributed to foreign trust-one, again, which nullifies any tax due on the equipment trust tax return. Foreign trust-one then distributes all or most of its income to foreign trust-two. Since all of foreign trust-two's income is foreign based there is no filing requirement.

Once the assets are in foreign trust-two, a bank account is opened either under the trust name or an International Business Corporation (IBC). The trust documentation and business records of this scheme all make it appear that the taxpayer is no longer in control of his/her business or its assets. The reality is that nothing ever changed. The taxpayer still exercises full control over his/her business and assets. There can be many different variations to the scheme.

International Business Corporations (IBC)

The taxpayer establishes an IBC with the exact name as that of his/her business. The IBC also has a bank account in the foreign country. As the taxpayer receives checks from customers, he sends them to the bank in the foreign country. The foreign bank then uses its correspondent account in the to process the checks so that it never would appear to the customer, upon reviewing the canceled check that the payment was sent offshore. Once the checks clear, the taxpayer's IBC account is credited for the check payments. Here the taxpayer has, again, transferred the unreported income offshore to a tax haven jurisdiction.

False Billing Schemes

A taxpayer sets up an International Business Corporation (IBC) in a tax haven country with a nominee as the owner (usually the promoter). A bank account is then opened under the IBC. On the bank's records the taxpayer would be listed as a signatory on the account. The promoter then issues invoices to the taxpayer's business for goods allegedly purchased by the taxpayer. The taxpayer then sends payment to the IBC that gets deposited into the joint account held by the IBC and taxpayer. The taxpayer takes a business deduction for the payment to the IBC thereby reducing his/her taxable income and has safely placed the unreported income into the foreign bank account.

Statistical Data – Abusive Tax Schemes

The following figure presents statistical information from the IRS regarding the criminal investigations of abusive tax schemes for the years 2010, 2011, and 2012.

Figure 4-8
Abusive Tax Schemes – IRS Criminal Investigations

	FY 2012	FY 2011	FY 2010
Investigations Initiated	149	166	227
Prosecution Recommendations	111	140	125
Indictments/Information	85	86	100
Sentenced	75	95	76
Incarceration Rate*	74.7%	76.8%	71.1%
Average Months to Serve	25	30	35

*Incarceration includes confinement to federal prison, halfway house, home detention, or some combination thereof

Source: Criminal Investigation Management Information System; IRS.gov

Case Examples – Abusive Tax Schemes

The following are actual IRS cases of abusive tax schemes.

♦ **Case Example** ♦

Sean Roberts and Nadia Roberts, Tehachapi, California

Date: July 30, 2012

Penalty: 12 months and one day in prison; $709,675 in restitution; $2.5 million civil liability

Crime: The Roberts hid millions of dollars in secret offshore bank accounts in Switzerland and other banks around the world. They also failed to file the required Reports of Foreign Bank and Financial Reports (FBARs). According to court documents and statements made in court, Sean and Nadia Roberts filed false individual U.S. income tax returns for 2004 through 2008 in which they failed to report that they had an interest in or a signature authority over a secret Swiss financial account at UBS, which was subsequently transferred to the Swiss branch of a Liechtenstein bank. They also failed to report several other foreign accounts in the Isle of Man, Hong Kong, New Zealand and South Africa. The Roberts failed to report any income earned on the foreign accounts and falsely deducted millions of dollars in transfers from their domestic business to the Swiss bank accounts on their corporate tax returns. The false deductions allowed the Roberts to under-report their income on their individual income tax returns.

♦ **Case Example** ♦

Richard Allen Edgar, Los Angeles, California

Date: May 14, 2012

Penalty: 15 months in prison

Crime: Edgar, a former certified public accountant, pleaded guilty late last year to two counts of aiding and assisting in the preparation of false tax returns. According to the plea agreement, from at least 2004 through 2009, Edgar sold false "tax losses" to his clients to offset his clients' income, thereby eliminating or drastically reducing taxes otherwise owed by the clients to the IRS. Edgar typically charged clients approximately 12.5 percent of the losses purchased. The losses Edgar sold were purportedly non-passive partnership losses generated by Creative Financial Solutions, LLC and Why Not Entertainment, LLC, both of which Edgar managed and controlled. The clients whose returns included the losses were not partners of any kind in Creative Financial Solutions or Why Not Entertainment and were unaware of what the companies did. To encourage his clients to buy these sham tax losses, Edgar would prepare and send each client two versions of the client's tax return, one without any claimed tax losses, showing a large tax liability owed to the IRS, and the other with tax losses offsetting all or virtually all of the client's taxable income, showing either no taxes owed or refund due. After a client purchased the losses, Edgar would have the client execute a backdated "Membership Subscription Agreement," purporting to show that the client had become a member of Creative Financial Solutions

or Why Not Entertainment in the tax year at issue. According to documents filed with the court, for the tax years 2004 through 2007, Edgar sold over $1.5 million in fraudulent "tax losses" to his clients, causing losses to the IRS of $358,274.

♦ Case Example ♦

Tom F. Castellanos and Manuel Rivero, Jr., Miami, Florida

Date: April 25, 2012

Penalty: Castellanos – 12 months and one day in prison; 1 year of supervised release; Rivero – 30 months in prison; 1 year of supervised release

Crime: Each defendant pleaded guilty to conspiring to defraud the Internal Revenue Service. According to court documents, between 2001 and 2007, Castellanos operated a roofing business called East Coast Metals, Inc. (ECM) based in Hialeah, Fla. One of Castellanos' return preparers arranged for the creation of a Panamanian corporation called National Steel Processors, Inc. (NSP) and arranged the opening of a bank account for that company in Panama. NSP was a shell corporation that provided no services and had no employees. Court documents state that for income tax purposes, Castellanos claimed that ECM purchased materials from NSP. Acting on instructions from Rivero, Castellanos initially created false invoices purporting to represent his company's purchases from NSP. Later, Castellanos stopped manufacturing false invoices, but continued entering falsified purchases from NSP on the books of ECM. For tax years 2002 to 2007, Castellanos used these fake purchases to claim expenses, or cost of goods sold, that falsely reduced the tax liability of ECM and himself. Rivero prepared tax returns on behalf of ECM and Castellanos with full knowledge that the claims relating to NSP expenses were false. The amount of false purchases claimed during the conspiracy exceeded $10 million. Rivero also knew that Castellanos wrote checks to NSP that were deposited in the Panamanian bank account and that Castellanos had access to these funds. Castellanos used the funds to make loans and to purchase a condominium and boat dock in Bimini.

♦ Case Example ♦

Ricky Dean Hardee, Charlotte, NC

Date: February 8, 2012

Penalty: 21 months in prison; 3 years supervised release; $1,525,150 in restitution

Crime: In June 2010, Hardee pleaded guilty to tax evasion in connection with his scheme to evade approximately $1.5 million in taxes. According to court documents, from about 1997 to 2007, Hardee operated a successful masonry contracting business in Charlotte. From 2002 to 2007, Hardee earned gross receipts of $4.2 million from his business but failed to file income tax returns and engaged in a sophisticated scheme to conceal his income and assets from the IRS. Specifically, Hardee purchased and utilized a system of nominee entities, sham trusts and related domestic and foreign bank accounts, including a bank account in Panama and ten different domestic bank accounts, to hide money from the IRS.

Review Questions

1. Which of the following is an indicator of fraud relating to books and records?
   A. Failure to follow the advice of an accountant
   B. Keeping two sets of books or no records
   C. Failure to file a tax return
   D. Attempts to bribe the examiner

2. In the case where the exact data for a necessary item is not obtainable, according to SSTS No. 4 – Use of Estimates, what is the appropriate course of action?
   A. The practitioner should use estimates that benefit the taxpayer the most
   B. The practitioner should use reasonable estimates based on facts and circumstances
   C. The practitioner should disregard the item altogether and not report it
   D. The practitioner should use any method he/she chooses to estimate the data

3. What is the penalty for the understatement of a taxpayer's liability by the tax return preparer due to willful or reckless conduct?
   A. $50 for each understatement
   B. $1,000 and imprisonment for up to 5 years
   C. Either the greater of $5,000 or 50% of income derived by the preparer
   D. Imprisonment up to 3 years

4. Failure to furnish a copy of a tax return or claim to a taxpayer results in a ___________ penalty for each failure, up to $25,000 in a calendar year.
   A. $25
   B. $50
   C. $75
   D. $100

5. Which of the following is NOT an example of fraudulently preparing a Schedule A in an attempt to reduce taxable income?
   A. Claiming a charitable deduction that did not occur
   B. Inflating the amount of medical expenses claimed
   C. Claiming a large amount of fictitious dental expenses
   D. Claiming dependents that do not exist

6. What is the typical incarceration rate of investigated abusive return preparers?
   A. Under 50%
   B. Between 50% - 60%
   C. Between 80% - 90%
   D. Over 90%

7. The number of IRS criminal investigations initiated for corporate fraud in 2012 was __________.
   A. 80
   B. 90
   C. 100
   D. 110

8. Which of the following is NOT an accurate statement regarding abusive tax schemes?
   A. Abusive tax schemes are typically simple and use basic transactions for the schemes
   B. Abusive tax schemes involve the use of trusts, LLCs, LLPs, international business companies (IBCs), foreign financial accounts, offshore credit/debit cards, etc.
   C. Abusive foreign trust schemes usually start off as a series of domestic trusts layered upon one another
   D. Promoters of abusive tax schemes often employ financial instruments such as trusts in their schemes

Review Answers

1. A. Incorrect. Failure to follow the advice of an accountant is an indicator of fraud by the conduct of the taxpayer, not an indicator of fraud relating to books and records.
   B. **Correct.** Keeping two sets of books or no records is an indicator of fraud relating to books and records.
   C. Incorrect. Failure to file a tax return is an indicator of income fraud, not an indicator of fraud relating to books and records.
   D. Incorrect. Attempt to bribe the examiner is an indicator of fraud by the conduct of the taxpayer, not an indicator of fraud relating to books and records.

2. A. Incorrect. In the case where the exact data for a necessary item is not obtainable, the appropriate course of action should not be to use estimates that benefit the taxpayer the most. Instead, the practitioner should use reasonable estimates if they are based on facts and circumstances.
   B. **Correct.** In the case where the exact data for a necessary item is not obtainable, the appropriate course of action should be for the practitioner to use estimates if they are based on facts and circumstances.
   C. Incorrect. In the case where the exact data for a necessary item is not obtainable, the appropriate course of action should not be to disregard the necessary item altogether and not report it. Instead, the practitioner should use reasonable estimates if they are based on facts and circumstances.
   D. Incorrect. In the case where the exact data for a necessary item is not obtainable, the appropriate course of action should not be for the practitioner to use any method he/she chooses to estimate the data. Instead, the practitioner should use reasonable estimates if they are based on facts and circumstances.

3. A. Incorrect. The penalty for the understatement of a taxpayer's liability due to willful or reckless conduct is not $50 for each understatement. The penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
   B. Incorrect. The penalty for the understatement of a taxpayer's liability due to willful or reckless conduct is not $1,000 and imprisonment for up to 5 years. The penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.

C. **Correct.** The penalty for the understatement of a taxpayer's liability due to willful or reckless conduct is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.
D. Incorrect. The penalty for the understatement of a taxpayer's liability due to willful or reckless conduct is not imprisonment up to 3 years. The penalty is the greater of $5,000 or 50% of the income derived by the tax return preparer with respect to the return or claim for refund.

4. A. Incorrect. Failure to furnish a copy of a tax return or claim to a taxpayer results in a $50, not a $25, penalty for each failure, up to $25,000 in a calendar year.
B. **Correct.** Failure to furnish a copy of a tax return or claim to a taxpayer results in a $50 penalty for each failure, up to $25,000 in a calendar year.
C. Incorrect. Failure to furnish a copy of a tax return or claim to a taxpayer results in a $50, not a $75, penalty for each failure, up to $25,000 in a calendar year.
D. Incorrect. Failure to furnish a copy of a tax return or claim to a taxpayer results in a $50, not a $100, penalty for each failure, up to $25,000 in a calendar year.

5. A. Incorrect. Claiming a charitable deduction that did not occur is a way to fraudulently prepare a Schedule A in an attempt to reduce taxable income.
B. Incorrect. Inflating the amount of medical expense claimed is a way to fraudulently prepare a Schedule A in an attempt to reduce taxable income.
C. Incorrect. Claiming a large amount of fictitious dental expenses is a way to fraudulently prepare a Schedule A in an attempt to reduce taxable income.
D. **Correct.** Although claiming dependents that do not exist may result in reducing taxable income, it is not done on Schedule A.

6. A. Incorrect. The typical incarceration rate of investigated abusive return preparers is not under 50%. The incarceration rate is typically between 80%-90%, with 85.3% in 2009, 88.6% in 2010, and 87.1% in 2011.
B. Incorrect. The typical incarceration rate of investigated abusive return preparers is not between 50%-60%. The incarceration rate is typically between 80%-90%, with 85.3% in 2009, 88.6% in 2010, and 87.1% in 2011.

C. **Correct.** The incarceration rate is typically between 80%-90%, with 85.3% in 2009, 88.6% in 2010, and 87.1% in 2011.
D. Incorrect. The typical incarceration rate of investigated abusive return preparers is not over 90%. The incarceration rate is typically between 80%-90%, with 85.3% in 2009, 88.6% in 2010, and 87.1% in 2011.

7. A. **Correct.** The number of IRS criminal investigations initiated for corporate fraud in 2012 was 80.
   B. Incorrect. The number of IRS criminal investigations initiated for corporate fraud in 2012 was 80, not 90.
   C. Incorrect. The number of IRS criminal investigations initiated for corporate fraud in 2012 was 80, not 100.
   D. Incorrect. The number of IRS criminal investigations initiated for corporate fraud in 2012 was 80, not 110.

8. A. **Correct.** "Abusive tax schemes are typically simple and use basic transactions for the schemes" is not an accurate statement regarding abusive tax schemes. Abusive tax schemes are usually complex and involve multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.
   B. Incorrect. "Abusive tax schemes involve the use of trusts, LLCs, LLPs, international business companies (IBCs), foreign financial accounts, offshore credit/debit cards, etc." is an accurate statement regarding abusive tax schemes.
   C. Incorrect. "Abusive foreign trust schemes usually start off as a series of domestic trusts layered upon one another" is an accurate statement regarding abusive tax schemes.
   D. Incorrect. "Promoters of abusive tax schemes often employ financial instruments such as trusts in their schemes" is an accurate statement regarding abusive tax schemes.

Glossary

A

Abusive Tax Schemes: These schemes are characterized by the use of trusts, Limited Liability Companies (LLCs), Limited Liability Partnerships (LLPs), International Business Companies (IBCs), foreign financial accounts, offshore credit/debit cards and other similar instruments. The schemes are usually complex involving multi-layer transactions for the purpose of concealing the true nature and ownership of the taxable income and/or assets.

Adverse Interest Threat: Threat of member lacking objectivity due to the differing of the member's interest and the client's interest.

Advocacy Threat: Threat of compromising objectivity by promoting a client or employer's position or opinion to the extent that it compromises objectivity.

Asset Misappropriation: A form of accounting fraud that includes manipulating accounts by creating false invoices, theft (cash or equivalent, credit notes, data, and other property), payroll fraud and ghost employees, and false expense claims.

Attest Engagement Team: The attest engagement team consists of individuals participating in the attest engagement, including those who perform concurring and second partner reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists as discussed in SAS No. 73, *Using the Work of a Specialist* [AU section 336], and individuals who perform only routine clerical functions, such as word processing and photocopying.

B

Best Practices: Those procedures and behaviors generally agreed upon by reasonably prudent and competent persons to be the preferred approach to providing a particular professional service. So called "best practices" relevant to a professional service provided by a member may be promulgated by other professional associations or similar organizations. Best practices will vary depending upon the skill level and position of the member, the nature of the engagement, the industry, practicality and cost-benefit among other factors.

Billing Scheme: A fraudulent scheme involving the use of one or more of the following:

- Shell company
- Non-accomplice vendor
- Personal purchases

Business Ethics: The principles, values, and standards that guide how people and institutions should act in the world of commerce.

C

Cash Larceny: Stealing of cash after it has been properly recorded on the company's books.

Channel Stuffing: A form of accounting fraud that involves an avenue to inflate sales by sending retailers more products than they can sell by means of distribution channels.

Check Tampering: A fraudulent scheme involving one or more of the following techniques:

- Forged endorsement
- Altered payee

Client: A client is any person or entity that directly engages a member or a member's firm to perform professional services, or a person or entity with respect to which professional services are performed, other than the member's employer, student or the public.

Client Provided Records: Accounting or other records, including but not limited to photocopies, emails, faxes, computer disc or other electronic formats belonging to the client that were provided to the member by or on behalf of the client.

Client Records Prepared by the Member: 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.

Close Relative: A close relative is a parent, sibling, or nondependent child.

Commissions and Referral Fees: Commission means any compensation paid by a third party to the member, except a referral fee, for recommending or referring any product or service to be supplied by another person. Referral fee

means compensation for recommending or referring any service of a CPA to any person.

Competence: Competence is derived from a synthesis of education and experience. It is a CPA's individual responsibility which begins with a mastery of the common body of knowledge required for designation as a certified public accountant.

Compilation: Compilation means providing a service that presents, in the form of financial statements, information that is the representation of the management or owners of the client without undertaking to express any assurance of the accuracy of the information in the statements, to be performed in accordance with standards.

Confidential Client Information: Any information obtained from current, former, and prospective clients in a professional capacity which is not generally available to the public, whether or not the CPA is actually formally engaged to provide professional services. Information obtained from a person seeking to engage a member to offer professional services falls within this definition.

Confidential Employer Information: Any information obtained during the course of employment if use of such information is restricted by the employer through a written policy, or law, and if such information is not generally available to the public.

Confidentiality: In order to preserve client trust and provide the best possible service to clients and employers, CPAs should closely guard client and employer information and treat it as confidential.

Cookie Jar Accounting: A form of accounting fraud that involves using reserves from good years to offset losses in bad years.

Corporate Governance: The relationship between all stakeholders in an organization. Among these stakeholders are the shareholders, directors, and management of a company, as defined by the corporate charter, bylaws, formal policy and rule of law.

Corporate Social Responsibility: Initiative to assess and take responsibility for the company's effects and impact on social welfare. Encompasses a company's economic responsibility, legal responsibility, ethical responsibility, and philanthropic responsibility.

Corporate Tax Fraud: Involves violations of the Internal Revenue Code (IRC) and related statutes committed by large, publicly traded (or private) corporations, and/or by their senior executives.

Covered Member: A covered member is:

- An individual on the attest engagement team
- An individual in a position to influence the attest engagement
- A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis
- A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement
- The firm, including the firm‘s employee benefit plans
- An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described above or by two or more such individuals or entities if they act together

D

Dodd-Frank Wall Street Reform and Consumer Protection Act: Established a whistleblower program that requires the Commission to pay an award, under regulations prescribed by the Commission and subject to certain limitations, to eligible whistleblowers who voluntarily provide the Commission with original information about a violation of the federal securities laws that leads to the successful enforcement of a covered judicial or administrative action, or a related action. Dodd-Frank also prohibits retaliation by employers against individuals who provide the Commission with information about possible securities violations.

Due Professional Care: The quest for excellence is the essence of due professional care. Due professional care imposes the obligation to perform professional services to the best of a CPA‘s ability with concern for the best interest of those for whom the services are performed and consistent with the profession‘s responsibility to the public.

E

Economic Responsibility: The responsibility of businesses to be profitable, and it is the foundation upon which all other rest.

Ethical Responsibility: The obligation of businesses to do what is right, just and fair and avoid harm.

Expense Reimbursement Scheme: A fraudulent scheme involving one or more of the following:

- Overstated expenses
- Fictitious expenses
- Multiple reimbursements
- Mischaracterized expenses

F

Familiarity Threat: Threat of long/close relationships with clients or employer will cause member to sympathize and/or be accepting of the client's work.

Financial Statement: A presentation of financial data, including accompanying notes, if any, intended to communicate an entity's economic resources and/or obligations at a point in time or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Financial Statement Fraud: A type of fraud involving an intentional misstatement or omission of material items on the financial statements.

Firm: A firm is a form of organization permitted by law or regulation that is engaged in the practice of public accounting. Except for purposes of applying Rule 102: *Independence*, the firm includes the individual partners thereof.

Fiduciary Duty: A legal obligation of one party, someone entrusted with the care of money or property, to act in the best interest of another.

G

Ghost Employee: A fictitious employee on payroll for whom another receives the extra paychecks.

I

Improper Disclosure: A form of accounting fraud involving the failure to properly disclose related party transaction, executive compensation, structured financial deals, etc.

Independence: A CPA who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a CPA should maintain objectivity and avoid conflicts of interest.

Individual in a Position to Influence the Attest Engagement: An individual in a position to influence the attest engagement is one who:

- Evaluates the performance or recommends the compensation of the attest engagement partner
- Directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm's chief executive
- Consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement
- Participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement

Inflating Assets: A form of accounting fraud that involves the net worth of assets being inflated by means of inappropriate depreciation schedules.

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

J

***Joint Closely Held Investment*:** A joint closely held investment is an investment in an entity or property by the member and the client (or the client's officers or directors, or any owner who has the ability to exercise significant influence over the client) that enables them to control (as defined by GAAP for consolidation purposes) the entity or property.

K

Key Position: A key position is a position in which an individual:

- Has primary responsibility for significant accounting functions that support material components of the financial statements
- Has primary responsibility for the preparation of the financial statements
- Has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position
- For purposes of attest engagements not involving a client's financial statements, a key position is one in which an individual is primarily responsible for, or able to influence, the subject matter of the attest engagement, as described above

L

Lapping Scheme: Situation where an employee steals money from a sale and offsets the missing money from the next transaction, and then that transaction is covered by the third transaction, etc.

Legal Responsibility: The responsibility of businesses to play by the rules of the game and recognize that law is society's codification of what is right and wrong.

N

Nonrecurring Expenses: A form of accounting fraud when classifying an expense as nonrecurring and manipulating it to appear as excess reserves that are later used as future income.

O

Objectivity: A state of mind, a quality that lends value to a CPA's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

Off Balance Sheet Transactions: A form of accounting fraud that involves hiding assets or liabilities so they do not appear on the balance sheet.

Overstating Expenses: A form of accounting fraud involving a method of accelerating expenses into the current period through means of depreciation, amortization, and depletion.

Overstating Revenues: A form of accounting fraud involving the acceleration of earnings by recording future sales on current financial statements, and recording investment income, proceeds received as loans or fictitious sales as revenue.

P

Partner: A partner is a proprietor, shareholder, equity or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned.

Period of Professional Engagement: The period of the professional engagement begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, either by the member or the client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement.

Philanthropic Responsibility: Responsibility of businesses to contribute resources to the community and to improve the quality of life.

Professional Services: Professional services include all services performed by a member in the practice of public accountancy.

S

Self-Interest Threat: Threat of a member acting in a manner adverse to interests of the firm/employer/client/public due to the member’s immediate or close family member’s financial interest or other relationship with a client or employer.

Self-Review Threat: Threat of not properly evaluating the results of a service performed, and a member will rely on improperly evaluated results in forming a judgment as part of providing the service.

Shell Company: An inactive or fictitious entity created for the sole purpose of committing fraud.

Skimming: Involves taking money from cash receipts for personal purposes and may involve the following techniques:

- Unrecorded sales
- Understated sales
- Write-off schemes of receivables
- Unconcealed receivables
- Lapping schemes

Stakeholder: The investors, employees, customers, supplier, community, government, and trade associations or others that have a direct interest in an organization.

Supporting Records: 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).

T

Tax Return Preparer: Any person (including a partnership or corporation) who prepares for compensation all or a substantial portion of a tax return or claim for refund under the income tax provisions of the Internal Revenue Code.

U

Understating Expenses: A form of accounting fraud that involves capitalizing costs overtime versus expensing a cost in the current period, capitalizing normal operating costs, and failing to either write down or write off impaired assets.

Understating Liabilities: A technique used to make a company appear less risky due to having less debt.

Undue Influence Threat: Threat of member subordinating judgment to client/employer/3rd party due to (1) reputation or expertise, (2) aggressive or dominate personality, or (3) attempts to exercise excessive influence over member.

W

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.

Index

A

Abusive Foreign Trust Scheme 90
Abusive Tax Return Preparers 82
Abusive Tax Scheme 89, 99
Adverse Interest Threat 65, 66, 99
Advocacy Threat 99
Aldephia Communications 32
Altered Payee 23
Asset Misappropriation 22, 99
Association of Certified Fraud Examiners 24
Attest Engagement Team 99

B

Best Practices 99
Billing Scheme 22, 100
Bristol-Myers Squibb 32
Business Ethics 100

C

Cash Larceny 22, 100
Cash Register Disbursement 23
Channel Stuffing 30, 31, 100
Check Tampering 23, 100
Client 100
Client Provided Records 100
Client Records Prepared by the Member 100
Close Relative 100
Commissions and Referral fees 100
Competence 19, 101
Compilation 101
Concealed Liabilities and Expenses... 24
Confidential Client Information 101
Confidential Employer Information 101
Confidentiality 20, 101
Cookie Jar Accounting 30, 101
Corporate Governance 1, 101
Corporate Social Responsibility..... 1, 2, 101
Corporate Tax Fraud 85, 102
Covered Member 102
Criminal Investigation 83

D

Dodd-Frank Wall Street Reform and Consumer Protection Act...... 8, 102
Due Professional Care 18, 102

E

Economic Responsibility 2, 103
Enron 32
Ethical Responsibility 2, 103
Ethics Resource Center 3
Expense Reimbursement Scheme ... 23, 103

F

False Billing Schemes 91
Falsified Wages 23
Familiarity Threat 65, 66, 103
Fictitious Expenses 23
Fictitious Revenue 24
Fiduciary Duty 1, 103
Financial Statement 103
Financial Statement Fraud 23, 103
Firm 103
Forged Endorsement 23
Fraudulent Acts 22

G

Ghost Employee 23, 103

H

HealthSouth 33

I

Improper Accounting Practices 32
Improper Asset Valuation 23
Improper Bonus Use........................ 32
Improper Disclosure 23, 24, 31, 104
Independence 21, 104
Individual in a Position to Influence the Attest Engagement................... 104
Inflating assets 104
Inflation of Revenues....................... 31
Insider trading................................. 32
Integrity 16, 104

J

Joint Closely Held Investment 104

K

Kantor, Geisler & Oppenheimer, P.A. (KGO)... 59
Key Position 104
K-Mart 33

L

Lapping Scheme 22, 105
Legal Responsibility 2, 105
Lehman Brothers............................ 33

M

Mischaracterized Expenses.............. 23
Misrepresentation of Assets 31
Multiple Reimbursements 23

N

NIC, Inc. 53, 59
Non-Accomplice Vendor 23
Non-Cash Misappropriation............. 23
Nonrecurring Expenses.................. 105
NutraCea, et al. 57

O

Objectivity...............................17, 105
Off-Balance Sheet Transaction ..32, 105
Overstating Assets........................... 29
Overstating Expenses 23, 106
Overstating Revenues...............28, 106

P

Partner... 106
Payroll Scheme............................... 23
Peregrine Systems 33
Period of Professional Engagement 106
Philanthropic Responsibility....... 2, 106
Principles of Professional Conduct ... 15
Professional Services 106
Public Accounting Oversight Board (PCAOB) 34
Public Interest 15

R

Report to the Nations on Occupational Fraud and Abuse 24
Rule 101... 42
Rule 102... 48
Rule 3500T 39
Rule 3502....................................... 39
Rule 3520....................................... 39
Rule 3521....................................... 39
Rule 3522....................................... 39
Rule 3523....................................... 39
Rule 3524....................................... 40
Rule 3525....................................... 41
Rule 3526....................................... 41
Rule 3600T 42

S

Sarbanes-Oxley Act of 2002 .... 5, 34

Self-Interest Threat 66, 106
Self-Review Threat 65, 106
Shell Company..........................22, 107
Skimming 22, 107
SSTS No. 1 78
SSTS No. 2 79
SSTS No. 3 79
SSTS No. 4 79
SSTS No. 5 79
SSTS No. 6 79
SSTS No. 7 79
Stakeholder.................................. 107
Statements on Standards for Tax
Services (SSTS)............................ 78
Supporting Records 107

T

Tax Fraud 76
Tax Preparer Penalties..................... 80
Tax Return Preparer 82, 107
Tyco International 33

U

U.S. Securities and Exchange
Commission 32
Understated Revenues 24
Understating Expenses 30, 107
Understating Liabilities 29, 107
Undue Influence Threat................. 107

W

Whistleblower Retaliation 5
Working Papers............................ 108
WorldCom....................................... 34