Published in: JOURNAL OF ACCOUNTANCY

AICPA Professional Liability SPOTLIGHT

April/May 2015

The importance of tax quality control

By Deborah K. Rood, CPA, MST

Quality control (QC) is of utmost importance when delivering professional services, including tax planning and compliance services. In 2014, 67% of the claims in the AICPA Professional Liability Insurance Program were related to tax planning and compliance services. Unfortunately, almost all of these claims included a failure in quality control. When a professional liability claim is asserted and QC breakdowns have occurred, defense counsel's ability to negotiate a favorable result for the CPA may be compromised.

Rather than several claim stories with seemingly innocent breakdowns in QC, what follows is a combination of real claim scenarios resulting in a disastrous QC collapse. While this scenario may seem unrealistic, any one of these QC breakdowns could compromise the defense of a professional liability claim.

The new private-equity client

The managing partner of XYZ CPAs Inc. said it was the firm's highest priority to obtain new clients in private equity by year end. As a result, when an attorney with whom the firm regularly worked mentioned that one of his private-equity clients operating as a partnership needed tax compliance services, the firm bypassed its customary client and engagement acceptance procedures to obtain the desired business. The firm agreed to prepare the tax returns but failed to issue an engagement letter.

Had the firm followed its customary client and engagement acceptance procedures, it may have discovered that the fund organizer was a convicted felon who previously operated a Ponzi scheme. In addition, the firm may have questioned why a small firm in a neighboring state was performing the fund's audit instead of a specialized firm. Routine client acceptance procedures also may have revealed that the client's CFO was the husband of one of XYZ's audit partners, representing a potential conflict of interest.

The QC problems related to this engagement continued to accumulate. The tax partner was new to XYZ but had worked with the managing partner 20 years before. Based on this relationship, the firm did not confirm the new tax partner's licensure or previous experience. Notably, she had been disciplined by the state board of accountancy due to a conflict of interest on another tax return.

The client demanded the Schedules K-1 be issued to investors by April 10, despite incomplete information regarding Schedules K-1 from the company's investments. The "experienced" tax partner explained that she regularly used estimates and adjusted for final numbers on the following year's return at her old firm so Schedules K-1 could be issued on a timely basis.

The only staff member available to prepare the fund's tax returns was in his second tax season and had primarily worked with C corporations. Since he lacked experience in partnership filings, the staff member did not allocate income based on the partnership agreement. The staff member relied on the computations generated by the tax preparation software. The tax partner's review consisted of confirming the book-income-to-taxable-income reconciliation and discussing the calculation with the client. Moreover, the new tax partner was not supervised on any engagements, including the high-risk returns relating to this matter. The return was finalized and electronically filed—without a Form 8879-PE, *IRS e-file Signature Authorization for Form 1065.*

This series of errors continued for the following six years.

Approximately one month after the firm prepared its seventh tax return for the client, federal agents raided the client's office. The client was operating another Ponzi scheme. Soon after the raid, investors began filing professional liability claims against the CPA firm, alleging the firm should have discovered the fraud. In addition, investors alleged that the firm improperly allocated taxable income to them, causing them to overpay tax, incur additional professional fees, and, in some years, lose the ability to obtain a refund because the statute of limitation had expired.

Elements of a strong QC system

While QC may be difficult to get excited about, its importance cannot be overstated. As a result, tax professionals should consider the following to create a strong QC system:

Circular 230

In June 2014, Treasury Circular 230, *Regulations Governing Practice Before the Internal Revenue Service* (31 C.F.R. Part 10), which addresses practice before the IRS, was revised. Section 10.36, *Procedures to Ensure Compliance*, now requires the person or persons responsible for overseeing a firm's tax practice to take reasonable steps to ensure the firm has adequate procedures in effect to comply with Circular 230. This individual will be subject to discipline for failure to comply with the requirements if, through willfulness, recklessness, or gross incompetence, the individual does not take reasonable steps to ensure the firm has adequate procedures in place to comply with Section 10.36 and a firm member engages in a pattern of failure to comply with this part.

Written tax QC materials represent one of the best tools for complying with Circular 230, Section 10.36.

Tax QC materials

QC materials may consist of (1) a tax QC manual; (2) tax policies and procedures; and (3) voluntary tax practice review.

The tax QC manual and tax policies and procedures should be written, updated regularly, accessible, and communicated to the tax practice through training.

The QC manual provides guidance in developing the tax group the firm desires. It should provide a foundation upon which all decisions for the tax group are based and be referenced when the tax group implements policies and procedures. The AICPA *Tax Practice Quality Control Guide* is based on the AICPA Statements on Quality Control Standards and contains the following six elements of QC (1) leadership; (2) ethical requirements; (3) client acceptance and continuance; (4) human resources; (5) engagement performance; and (6) monitoring.

Policies and procedures

Unlike a QC manual that is more aspirational, policies and procedures are instructional in nature. Tax policies and procedures should delineate every step in preparing a tax return from receipt of the information to electronic filing. In addition, policies and procedures should address all tax services, including planning, research, and consulting.

Voluntary tax practice review

A voluntary tax practice review is one method to monitor compliance with both a firm's tax QC manual and its practices and procedures. In a two-person firm, one partner may review a select set of returns the other partner prepared and vice versa. Some firms may wish to work with a peer firm and review each other's practices. This protocol exposes both firms to different techniques for accomplishing the same tasks, some of which may be an improvement. In a large, multi-office firm, a QC team may visit various offices, selecting returns from each partner to review.

Resources

AICPA Tax Section members have access to the *Tax Practice Quality Control Guide*, which includes sample QC policies for a sole practitioner with limited staff, a firm without a structured tax department, and a firm with a structured tax department. Tax Section members also may access sample engagement letters.

In addition, some professional liability insurers have tax QC manuals and sample engagement letters available to policyholders.

Lessons learned

In the claim scenario presented above, a QC breakdown occurred at every level. The managing partner set the tone at the top, sending the message that the firm valued new business over quality. The managing partner's highest priority was having a private-equity client by year end, not the "right" client.

While the potential conflict of interest did not contribute to the claim, if it had been identified, steps should have been taken to reduce the potential for it to do so. Human resources for the firm generally verified the information on a new employee's résumé, but those steps were bypassed.

Client acceptance procedures were also not observed. A background investigation of the client's management should have revealed the organizer's history of operating Ponzi schemes and the fact that it selected a small firm without expertise in the client's business to conduct an audit. In addition, an engagement letter was not issued.

The engagement was not performed with professional competence, as required by Circular 230, Section 10.35, *Competence*. The preparer lacked relevant experience and was not adequately supervised. In addition, the new tax partner did not adequately review the return in light of the preparer's inexperience, and the new tax partner's work was not reviewed.

An adequate review of the return should have prevented the tax partner from signing an inaccurate return, which included estimates and improperly allocated income. Finally, the firm did not have adequate procedures to ensure returns were not electronically filed without a signed authorization form.

Appropriate monitoring of tax compliance processes may have identified these problems earlier, but the firm did not have a system in place. Firms that emphasize quality over realization are well-positioned in the event of a professional liability claim or investigation by the IRS Office of Professional Responsibility.

***Deborah K. Rood**, CPA, MST (deborah.rood@cna.com), is a risk control consulting director at CNA.*