The Accountant/Attorney Liability Reporter

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AICPA Issues Exposure Draft of Proposals for Financial Reporting Framework for Small and Medium Sized Entities

By John B. Connarton, Jr., P.C.

ON NOVEMBER 1, 2012, THE AICPA ISSUED AN EXPOSURE DRAFT and requested comments on its proposed new Financial Reporting Framework For Small And Medium Sized Entities. According to the AICPA this FRF for SMEs is designed for privately owned, for-profit smaller enterprises that are not required to produce financial statements in accordance with U.S. GAAP. It is intended to be a self-contained financial reporting network and draws upon a blend of traditional accounting principles and accrual income tax methods of accounting.

Having heard from many privately held businesses and their accountants and bankers about their request for financial reporting relief, the AICPA's FRF for SMEs was proposed to provide a less complicated and less costly system of accounting for SMEs that do not need US GAAP based financial statements. According to the AICPA, the FRF for SMEs is a cost-beneficial solution for management, owners, and others who require financial statements that are prepared in a consistent and reliable manner in accordance with a framework that has undergone public comment and professional scrutiny. The accounting principles comprising the FRF for SMEs are intended to be the most appropriate for the preparation of small and medium sized entity financial statements based on the needs of the financial statement users and cost and benefit considerations. It is expected that this FRF for SMEs will provide a system much more attuned to and responsive to the financial reporting needs of SMEs and their financial statement users while producing reliable financial statements that are based upon comprehensive and consistently applied accounting principles.

It is expected that, when finalized, the FRF would be best used by management and owners who rely on a set of financial statements to confirm their assessments of performance and what they own and what they owe. These statements often are also used to support applications for bank financing when the banker does not base a lending decision solely on the financial statements but also on available collateral or other evaluation mechanisms not directly related to the financial statements.

Although accounting for transactions under the FRF for SMEs may be similar to that under US GAAP, there may be definite differences at times, i.e., measurement of the value of assets and liabilities at fair value in fewer instances than US GAAP. The current exposure draft is 252 pages long. The use of the FRF for SMEs will require the exercise of professional judgment on the part of owners, management and their respective accounting professionals.

The use of the FRF for SMEs by entities is premised on the concept that owners and management have no intention of going public. It is expected that those with an intention of going public should continue using GAAP in preparing their financial statements.

Since the AICPA has no authority to require the use of the FRF for SMEs, its use is optional. As such, there is no effective date for its implementation. The AICPA intends to review and propose amendments to the FRF for SMEs every three or four years with any such amendments being based upon input from stakeholders and developments in accounting and financial reporting.

The comment period for this exposure draft ends on January 30, 2013.

New Jersey Supreme Court Provides Guidance on the Application of N.J.S.A. 2A:53A-35: The Accountant Liability Act's Limitation on Third Party Lawsuits Against Accountants

By Matthew P. Tuller, Esq.

PRIOR TO THE ENACTMENT OF N.J.S.A. 2A:53A-25: THE ACCOUNTANT LIABILITY ACT, New Jersey had followed the expansive, accounting professional unfriendly foreseeability test to determine when third parties could bring an action for professional malpractice/negligence against an accountant. Under the foreseeability test, an accountant could be liable to any third party that the accountant could "reasonably foresee as recipients from the company" of the statements for a legitimate business purpose. *See Rosenblum v. Adler,* 461 A.2d 138 (1983). This approach expressly rejected the requirement that privity exist for liability to be imposed upon an accounting professional.

In 1995, the New Jersey legislature passed the Accountant Liability Act which set forth three scenarios or conditions that must be met before a Court could impose liability against an accountant:

> *Notwithstanding the provisions of any other law, no accountant shall be liable for damages for negligence arising out of and in the course of rendering any professional accounting service unless:*
>
> 1. *The claimant against the accountant was the accountant's client; or*
> 2. *The accountant:*
>   a. *Knew at the time of the engagement by the client, or agreed with the client after the time of the engagement, that the professional accounting service rendered to the client would be made available to the claimant, who was specifically identified to the accountant in connection with a specified transaction made by the claimant;*
>   b. *Knew that the claimant intended to rely upon the professional accounting service in connection with that specified transaction; and*
>   c. *Directly expressed to the claimant, by words or conduct, the accountant's understanding of the claimant's intended reliance on the professional accounting service; or*
> 3. *In the case of a bank claimant, the accountant acknowledged the bank's intended reliance on the professional accounting service and the client's knowledge of that reliance in a written communication.*

The first scenario test restated what was already the law which was that a client could bring a claim against an accountant for negligent performance of professional services. The third scenario extended protection to banks that were expressly stated recipients of the information produced as part of the engagement.

The second subsection of the act set forth a three-part test for determining whether liability could be imposed upon an accountant by third parties. This section of the act did not provide definitive answers as to the limits of potential third party liability.

In *Cast Art Industries, LLC v. KPMG LLP,* 36 A.3d 1049 (2012), the New Jersey Supreme Court weighed in on the scope of potential liability for accounting professionals to third parties. The plaintiffs were Cast Art and its shareholders. Cast Art manufactured and sold collectible figurines and giftware.

In 2000, Cast Art began acquisition discussions with Papel Giftware, a competitor based in New Jersey. Cast Art's interest in Papel was based in part on Papel's large number of existing accounts, production facilities, and skilled sales force.

Cast Art retained the usual team of investment bankers, attorneys, and accountants to advise it on the acquisition of Papel. Because Cast Art did not have the financial resources to accomplish the transaction, Cast Art sought out and obtained financing from PNC Bank in the amount of $22 million. PNC set two conditions on the financing transaction:

1. Papel must provide audited financial statements; and
2. Cast Art's principal shareholder was required to guarantee $3.3 million of the loan.

Beginning in 1997, three years prior to the merger discussions, Papel had retained KPMG to audit Papel's financial statements. KPMG had begun the audits of the 1998 and 1999 financial statements prior to the merger discussions between Cast Art and Papel. The audits had been delayed due to lack of information from Papel. In September 2000, KPMG delivered to Papel the completed audits for 1998 and 1999 which included KPMG's statement that Papel "was not in compliance with certain financial covenants with its lenders" which KPMG characterized as raising substantial doubt as to Papel's ability to "continue as a going concern". *Id.* at 1052.

Shortly after the merger was consummated, Cast Art began to have difficulties in the collection of some of Papel's accounts that had been listed as outstanding prior to the merger. After an internal investigation, Cast Art discovered that the 1998 and 1999 financial statements were inaccurate based on Papel's practice of accelerating revenue recognition. The notes to the financial statements stated that Papel did not recognize revenue until the items had been shipped and invoices issued. However, Cast Art's investigation determined that Papel would routinely book revenue upon completion of the order, prior to shipping or invoicing the customer. In some instances, the revenue was booked while the goods sat packaged in storage units on the property.

Because of the debt load taken on through the transaction, Cast Art was not able to generate sufficient revenue to continue operations post-merger which resulted in a bankruptcy filing. Cast Art and its shareholders brought suit against KPMG alleging that KPMG's negligent audit had failed to uncover the accounting irregularities at Papel. Cast Art sought recovery for the loss of its business as damages from KPMG. KPMG defended this action in part on the basis that:

1. Cast Art had not retained KPMG to conduct the audit of Papel;
2. Cast Art was not its client; and
3. Cast Art's claim was therefore barred by the Accountant Liability Act.

The trial and intermediate appellate courts found against KPMG and an appeal to New Jersey Supreme Court was filed. KPMG argued that the rulings of both the trial court and the Appellate Court essentially reinstated the foreseeabilty test which had been rejected when the Legislature had passed the Accountant Liability Act.

The Supreme Court of New Jersey agreed with KPMG and focused its decision on the language in the statute that the auditor must know "at the time of the engagement, by the client." The Supreme Court concluded that KPMG did not know at the time it was engaged by Papel that its audited financial statements would be provided to Cast Art, or any other entity in regards to potential merger discussions. The Court held:

> *Our conclusion with respect to the proper construction of the Accountant Liability Act is fortified by the nature of an engagement letter, for an auditor's liability must be defined by the scope of the engagement it entered. An auditor is entitled to know at the outset the scope of the work it is being requested to perform and concomitant risk it is being asked to assume.*

The Court's ruling demonstrates the importance of a well defined scope of services provision in the engagement letter, including provisions limiting the use of the accountant's work-product. A firm should protect itself by expressly stating in its engagement letter that:

1. what parties it knew would be relying on its work at the time of the engagement;
2. what parties, if any, to transactions with its clients it knows will be relying on the accountant's information; and
3. document in writing, any parties that it has acknowledged post-engagement will be relying on its information.

By following these simple steps, an accountant can potentially limit the scope of its liability to third parties who might receive its information.

Accounting Firm as Taxpayer Brought Up Short on Difference Between Compensation and Dividends

By John B. Connarton, Jr., P.C.

THE ISSUE BEFORE THE U.S. COURT OF APPEALS FOR THE 7TH CIRCUIT in Mulcahy, Pauritsch, Salvador & Co., Ltd. V. Commissioner was not unique. The C corporation taxpayer was appealing a decision of the IRS, affirmed by the U.S. Tax Court , that certain compensation paid to three founding shareholders and deducted from its taxable income was not all reasonable compensation for personal services rendered as required by 26 USC § 162(a)(1) but, instead, amounted to non-deductible dividends. The unique aspect of the adverse decision resulted from the taxpayer's being an accounting firm.

In addition to the usual accounting services, the firm also provided its clients with various adjunct consulting services through three entities owned by the founding shareholders who also owned approximately 80 percent of the stock of the accounting firm. During the three years in question, the firm paid salaries to each of the founding shareholders and paid "consulting fees" totaling more than $850,000 to the three consulting entities which, in turn, passed the money on to the founding shareholders. In each of the years the firm reported either negligible or no net taxable income.

The IRS did not question the salary deductions, however, it did disallow the consulting fees and reclassified them as dividends resulting in a deficiency in corporate income tax. The Tax Court in affirming the IRS decision added to the deficiencies a 20 percent statutory penalty for substantial understatement of income tax pursuant to 26 USC § 6662(a),(b)(2). The 7th Circuit further affirmed the IRS and Tax Court decisions.

According to the 7th Circuit, even if the firm had established that the consulting fees paid to the founding shareholders were reasonable compensation for something, to be deductible from corporate income the fees had to be compensation for "personal services actually rendered". 26 USC § 162(a)(1). The firm initially argued that the consulting fees were not for services rendered to the firm by the related entities (as its tax returns would suggest) but, instead, reflected accounting and consulting services provided by the founding shareholders to the firm's clients and, thus, amounted to additional salary. Interestingly enough, the firm justified this method of payment on the basis that it was done to conceal from the firm's other employees how much of the firm's income was being appropriated by the founding shareholders. Unfortunately for the firm it did not keep documents appropriate to establish this point including any records that matched the consulting fees to the work performed by each founder.

The firm also argued that it should not have been subject to the substantial understatement penalties since it relied upon reasonable good faith efforts to determine its tax liability and it was a CPA firm with numerous employees knowledgeable in income tax matters. As noted by the 7th Circuit, however, there was a huge conflict with this argument since the reasonable efforts made resulted in the firm's simply relying upon its own advice, i.e., taking tax advice from oneself.

According to the Court, situations may exist where a typical, small professional services firm's only significant input is the services rendered by its owner-employees, it has few, if any, other employees and only minimal assets. In such a circumstance there is no real reason to distinguish a return on capital from a return on labor. In this case, however, the firm had some 40 employees and the physical capital to support them. It also had revenues during the three years in question of between $5 million and $7 million.

The firm argued that the additional salaries were justified by the fact that the three founding shareholders left funds in the firm over the years to fund working capital. The court replied that " Remarkably, the firm's lawyers (in their brief) appear not to understand the difference between compensation for services and compensation for capital. . . . Contributing capital is not a personal service. . . . . [W]hen a thriving firm that has nontrivial capital reports no corporate income, it is apparent that the firm is understating its tax liabilities."

As a final note, the Court concluded by stating that it could not understand why the firm continued as a C corporation and sought to avoid double taxation by overstating deductions for business expenses, when reorganizing as a pass-through entity (i.e., LLCs, LLPs, LPs, S-corps) would have achieved the same result without the risk of incurring legal challenges. Not having done so, however, the Court ruled that the disallowance of the deductions and the imposition of the 20% penalty were both correct.

The practice of small or closely held firms to balance out income with shareholder salaries is a common one so as to avoid double taxation. The avoidance of taxation is itself not a wrongful concept. However, as seen in this decision, there are limits to this practice which should carefully be considered by both the business firm and its accountant/attorney consultants.

Following The Saying That If You Don't Succeed, Try, Try Again, The U.S. District Court For The Western District Of Pennsylvania Recently Issued A Decision Denying A Motion To Dismiss An Amended Complaint Filed Against An Accounting Firm Where Seven Months Earlier The Court Had Allowed A Motion To Dismiss The Original Complaint

By Justin M. Jagher, Esq.

IN BANCROFT LIFE & CASUALTY ICC, LTD. V. INTERCONTINENTAL MANAGEMENT LTD., ET AL. (2012 WL 2150744), decided in June, 2012, the plaintiff, Bancroft Life & Casualty ICC, Ltd. ("Bancroft") survived a motion to dismiss filed by defendants Dernar & Associates, LLC and David K. Dernar, CPA (collectively, the "Dernar Defendants"). In November, 2011, the same court had allowed a motion to dismiss to original complaint since Dernar's engagement letter clearly was limited to only a compilation level of service and the original complaint did not allege any "red flags" that Dernar should have noted and that would have provided a basis for professional liability. Bancroft thereafter filed an amended complaint attempting to provide sufficient "red flag" factual allegations.

Background

Bancroft is an international insurance company headquartered in St. Lucia. In October of 2004, Bancroft entered into an agreement with defendant Intercontinental Management Ltd. d/b/a International Captive Management Company, Ltd. ("Intercontinental"). Intercontinental was entrusted with handling all of Bancroft's regulatory compliance and tax issues. Intercontinental subsequently hired the Dernar Defendants to provide accounting services for the Bancroft account. Specifically, the Dernar Defendants were to provide Bancroft's quarterly and annual balance sheets and related statement of income and retained earnings for 2008; Bancroft's quarterly statements for 2009; and other quarterly statements and annual balance sheets for 2008 and 2009 for some of Bancroft's single parent incorporated cell captives ("ICs").

Intercontinental's services to Bancroft were subpar, and Intercontinental billed Bancroft for "hundreds of thousands of dollars for services that either were not performed or performed so poorly that it was as if the services had not been performed at all." Additionally, Bancroft was subject to increased scrutiny from the St. Lucia Ministry of Finance and the U.S. Internal Revenue Service due to Intercontinental's unreliable accounting services.

The St. Lucia Ministry of Finance required Bancroft, by law, to file an annual audited financial statement. BDO Seidman performed the annual audits of Bancroft's financial statements, and the Dernar Defendants failed to provide BDO Seidman with timely and accurate financial statements; the 2008 balance sheet alone had to be revised at least five times over a span of four months. Additionally, Intercontinental's successor, CBIZ, was unable to receive accurate information from Intercontinental and the Dernar Defendants so that it could complete the audit of Bancroft's 2008 financial statement. As of late fall 2009, CBIZ was unable to receive timely and accurate information from Intercontinental due to the errors of the Dernar Defendants, and Bancroft had to pay

CBIZ over $200,000 to correct the 2008 balance sheet so that it could complete the audit of its 2008 financial statement.

The Lawsuit

This time around, the Dernar Defendants sought dismissal due to Bancroft's lack of standing, because the Dernar Defendants had not actually been retained by Bancroft but by Bancroft's third-party administrator. The Court rejected this argument. It noted that the Dernar Defendants were hired specifically to prepare various financial statements for Bancroft and its ICs; were hired specifically to handle the Bancroft account; and that there were numerous revisions to the balance shees and other accounting records that necessitated constant communication between the Dernar Defendants and BDO Seidman, Bancroft's annual auditor. The Dernar Defendants also were found to have failed to notify Bancroft of suspicious circumstances, i.e., "red flags." which it had a duty to do even under a compilation level of service.

With respect to an accountant's duty to Bancroft as a non-client, the Court examined *Guy v. Liederbach,* 501 Pa. 47, 459 A.2d 744 (1983), and quoted Guy as follows:

> We find that the policy concerns expressed in *Ultramares Corp. v. Touche, supra,* and the History in California, following its abolition of the privity requirement in negligence suits arising out of agreements to furnish professional services, persuade us we should not eliminate the privity requirement in malpractice actions based on negligence. Thus we retain the requirement that plaintiff must show an attorney-client relationship **or a specific undertaking by the attorney furnishing professional services**, as in *Lawall*, as a necessary prerequisite for maintaining such suits in trespass on a theory of negligence (emphasis added). 501 Pa. at 57-58, 459 A.2d at 749-50.

The Court then noted that the Dernar Defendants breached their duty to Bancroft by failing to provide accurate balance sheets and reports, but also by failing to inform Bancroft of the errors that BDO Seidman had brought to the Dernar Defendants' attention and of the incomplete financial information it obtained from Intercontinental. The Court noted "…absence of this information should have put Dernar on notice of the fact that he was receiving incomplete information at best or inaccurate information at worst, thereby triggering an obligation to undertake greater due diligence rather than merely accepting the data supplied by [Intercontinental] at face value."

The history and decisions entered by the court in this matter provide clear warning that even with an engagement letter providing level of service limitations, the ultimate recipient of the services, even as a non-client, may still assert a viable claim should the services provided fail to meet the applicable standard of care.

Third Party Liability for Tax Opinions: Sixth Circuit Rules Opinion Letter Actionable Under RICO

By Daniel DeBlander

RECENTLY, IN *OUWINGA V. BENISTAR 410 PLAN SERVICES, INC.*, 694 F.3D 783 (6TH CIR. 2012), the United States Court of Appeals for the Sixth Circuit overturned a district court decision and reinstated claims for violations of the Racketeer Influenced and Corrupt Organization Act ("RICO") and for misrepresentation against a law firm, Edwards Wildman Palmer, and one of its partners, for allegedly providing incomplete and misleading opinion letters about the tax consequences of a welfare benefit plan ultimately found to be an abusive tax shelter. The district court had dismissed all of the claims against the insurance companies, attorneys and insurance agents who had marketed and sold the Benistar 419 Plan to the plaintiffs. Although the decision is on a motion to dismiss, before the matter can "be fleshed out in discovery" as the judge noted, it is a cautionary tale for lawyers who write opinion letters. The case indicates that, when there are allegations that a lawyer knew an opinion was incorrect and that non-clients may be relying on it, even with a written disclaimer stating the opinion is only for the attorney's client, a class action RICO case can proceed against the lawyer.

The factual background begins in the Fall of 2001, when a former high school classmate of one of the plaintiffs, by then an insurance agent, approached the plaintiffs about a potential tax-liability-reduction option, the Benistar 419 Plan, a John Hancock Life Insurance ("John Hancock") product. The plaintiffs, with their accountant and attorney, met with the insurance agent and his supervisor and were provided with a significant amount of paperwork on the Plan (referred to as "the Benistar Books"), including a legal opinion from the law firm defendants to its client John Hancock. The Benistar Books also included disclaimers signed by the plaintiffs. The plaintiffs agreed to participate in the Plan, based in part on the legal opinion in the Benistar Books, and contributed substantial sums.

A few years later, in 2003, the insurance agents told the plaintiffs the IRS had changed the rules and the plaintiffs would have to contribute additional money to keep the Plan compliant. In late 2003, the law firm issued three additional letters to John Hancock, all containing disclaimers stating no one other than the client could rely on them. The letters included assurances that the Benistar Plan was still viable against any challenge by the IRS. In 2006, the plaintiffs decided to terminate the Plan and were advised by their insurance agents that there would be no taxable consequences. In 2008, the IRS disallowed the deductions related to the Benistar Plan, asserted back taxes, interest and penalties and deemed the Benistar Plan an "abusive tax shelter." The plaintiffs filed this class action law suit in 2009.

The Complaint alleged RICO claims based on mail and wire fraud under 18 U.S.C. § 1962(c), which makes it unlawful to conduct or participate in the affairs of an "enterprise" through a pattern of racketeering activity, as well as a RICO conspiracy claim under 18 U.S.C. § 1962(d). State law claims included the tort of misrepresentation against the law firm defendants.

The plaintiffs alleged that their decision to buy into the Benistar Plan was based in part on four legal opinions issued by the law firm defendants to their client John Hancock. The first opinion letter, issued in 1998, was included in the marketing materials for the Plan. The other three, issued in 2003, were allegedly made available to plaintiffs by John Hancock and each contained disclaimers that no one other than the client could or should rely on them. Dismissing the

RICO claims for failure to sufficiently plead certain elements, the district court also found that the disclosures and disclaimers doomed plaintiffs' state law claims.

The Sixth Circuit reinstated the claims, however, finding that the Complaint sufficiently alleged that the lawyer defendants provided allegedly incomplete and misleading legal opinions, knowing full well that contributions to the plan were not likely to be allowed as deductions. On the RICO claims, the Court of Appeals found that it was enough to survive a motion to dismiss that the plaintiffs alleged that the lawyers knew the purpose of the plan was to falsely represent and promote the tax benefits of the plan and that they knew of the IRS warnings that these types of § 419 plans would not qualify for deductions. The Court also found that the four opinion letters prepared by the law firm defendants, in 1998 and over two months in 2003, were sufficient to show a pattern of racketeering over that period of time. While the district court had found the Complaint's allegations of conspiracy and "enterprise" insufficient and conclusory, the Sixth Circuit found the allegations enough to state a claim at the motion to dismiss stage of the case.

The Sixth Circuit also ruled that the state law misrepresentation claim should not be dismissed. The district court had dismissed the misrepresentation claim based on the explicit disclaimers in documents signed by the plaintiffs and because they were opinions only, not actionable as misrepresentations. The Sixth Circuit found the validity of the disclaimers was in question based on the full context of the presentations to the plaintiffs. The Court noted that the plaintiffs alleged the law firm defendants' tax advice was intended not just for the Plan but for the recipients of the Plan, taxpayers evaluating the Plan. The Sixth Circuit quoted from a Supreme Court case which states that "[w]hen an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." *United States v. Boyle,* 469 U.S. 241, 250 (1985). While the district court had relied upon a 1986 Michigan appellate case which stands for the proposition that opinions are not actionable as misrepresentations, the Sixth Circuit held that inferences should be drawn in the plaintiffs' favor at the motion to dismiss stage and the plaintiffs had alleged that the opinion letters added a "legal stamp of approval" to a fraudulent tax plan, which gave potential investors the peace of mind necessary to participate in the Plan. Thus, the letters could be held to be legal advice to the plaintiffs.

The law firm defendants' counsel has been quoted as saying the law firm looks forward to the opportunity to show that there is no basis for the claims against the firm. However, this federal court decision makes the issuance of tax opinions a more dangerous endeavor, with law firms subject to having to defend against possible RICO claims by unknown third-parties.

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