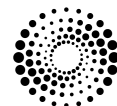


SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

Companion to PPC's Guide to

Write-Up Services



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Interactive Self-study CPE
Companion to PPC's Guide to
Write-Up Services

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INTRODUCTION

Companion to PPC's Guide to Write-Up Services consists of two interactive self-study CPE courses. These are companion courses to *PPC's Guide to Write-Up Services* designed by our editors to enhance your understanding of the latest issues in the field. To obtain credit, you must complete the learning process by logging on to our Online Grading System at cl.thomsonreuters.com or by mailing or faxing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2011**. Complete instructions are included below and in the Test Instructions preceding the Examination for CPE Credit Answer Sheet.

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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COMPANION TO PPC'S GUIDE TO WRITE-UP SERVICES

COURSE 1

PAYROLL AND PAYROLL TAX SERVICES (WUSTG101)

OVERVIEW

COURSE DESCRIPTION: This interactive self-study course discusses the payroll and payroll tax services that accountants may provide to their clients. Lesson 1 covers the design of a payroll system, the use of service providers, and how to obtain payroll information that is needed for processing. Lesson 2 looks at the processing of payroll information and making payroll tax deposits. Lesson 3 covers preparation and delivery of the various payroll tax returns.

PUBLICATION/REVISION DATE: November 2010

RECOMMENDED FOR: Users of *PPC's Guide to Write-Up Services*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of payroll.

CPE CREDIT: 5 QAS Hours, 5 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Accounting

EXPIRATION DATE: Postmark by **November 30, 2011**

KNOWLEDGE LEVEL: Basic

Learning Objectives:

Lesson 1—Payroll System Design and Obtaining Payroll Information

Completion of this lesson will enable you to:

- Recognize the appropriate determinations for designing a client's payroll system, including the information needed, the use of service providers, delegation of work, and maintaining records.
- Identify the payroll information needed for proper processing, including information related to employers, jobs, employees, and hours worked.

Lesson 2—Payroll Information Processing and Depositing Payroll Taxes

Completion of this lesson will enable you to:

- Recognize the information needed to process payroll and adhere to FLSA status for employees, and calculate gross pay and employment taxes.
- Identify requirements for depositing federal payroll taxes.

Lesson 3—Payroll Tax Return Preparation

Completion of this lesson will enable you to:

- Compare and contrast the required forms related to payroll tax returns.
- Identify the information needed for information returns, how to file them, and procedures for the delivery of all payroll tax returns.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
WUSTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: Payroll System Design and Obtaining Payroll Information

INTRODUCTION

Accountants often provide the following payroll services:

- Processing payrolls (i.e., computing payrolls and payroll withholdings, and preparing payroll checks).
- Posting payroll records (i.e., recording payrolls on the general ledger and maintaining employee payroll histories).
- Computing payroll tax deposits (i.e., determining the amount of employer and employee payroll tax and income tax withholdings that must be deposited with the IRS).
- Preparing payroll tax returns [such as Form 941 (Employer's Quarterly Federal Tax Return); Form 944 (Employer's Annual Federal Tax Return); Form 940 (Unemployment Tax Return); Schedule H (Form 1040) (Household Employment Taxes); Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees); Form 945 (Annual Return of Withheld Federal Income Tax); and annual information returns such as Forms W-2 and 1099].

Although accountants in industry may routinely provide all of those payroll services to their employers, accountants in public practice may or may not provide each service to each client. The extent of payroll services that they provide depends on the specific needs of their clients. In most cases, however, accountants in public practice will be involved in the preparation of payroll tax returns. Unless clients have well-trained staffs, it is unlikely that they can cope with the complexities of preparing quarterly and annual payroll tax returns. Generally, accountants in public practice will provide additional payroll services for clients in the following situations:

- *Payroll Confidentiality Is a Concern.* Maintaining payroll confidentiality can be difficult. That is particularly true if owners are on the payroll or wide variances in salaries exist. Even if clients implement procedures to restrict access to payroll information, the procedures may not be effective in all situations. Payroll confidentiality is increased when processing is performed by CPA firms.
- *Clients Have Large Numbers of Employees.* Preparing the payroll can be very time-consuming when there are large numbers of employees. When several people are employed, the client may be required to add the equivalent of at least a part-time employee to manage the payroll. In those situations, payroll can often be processed more economically by CPA firms.
- *Clients Lack Skill in Processing Payrolls.* Often, a client will lack the skill necessary to accurately compute payroll, payroll withholdings, and payroll tax deposits. In that situation, the CPA firm could train client employees to correctly process the payroll. However, the client may prefer the efficiency of allowing its employees to concentrate on other work while the CPA firm performs the processing.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the appropriate determinations for designing a client's payroll system, including the information needed, the use of service providers, delegation of work, and maintaining records.
- Identify the payroll information needed for proper processing, including information related to employers, jobs, employees, and hours worked.

Organization of the Course

The following subjects are covered in this course:

- Lesson 1 provides an overview of the issues that accountants should consider when designing a payroll system. It discusses not only what information the system should provide but how that information can be

provided accurately and efficiently. Lesson 1 also discusses procedures for collecting the raw payroll data from clients.

- Lesson 2 provides guidance on preparing payroll checks and recording payroll information. It also describes the payroll tax deposit calculation and reviews the federal payroll tax deposit requirements.
- Lesson 3 explains the federal payroll tax return reporting requirements. It provides specific guidance for preparing and filing Form 941 (Employer's Quarterly Federal Tax Return), Form 944 (Employer's Annual Federal Tax Return), Form 940 (Unemployment Tax Return), Schedule H (Form 1040) (Household Employment Taxes), Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees), Form 945 (Annual Return of Withheld Federal Income Tax), Form W-2 (Wage and Tax Statement), Form W-3 (Transmittal of Wage and Tax Statements), and annual information returns. It also discusses special compensation not processed by the normal payroll function.

This information is designed to benefit both the new and the experienced accountant. However, payroll processing and administration is a very complex area. For more comprehensive guidance, see *PPC's Payroll Tax Deskbook*. Other sources of information may be obtained at the following internet websites:

- Society for Human Resource Management: www.shrm.org.
- Internal Revenue Service: www.irs.gov.
- International Public Management Association for Human Resources: www.ipma-hr.org.
- International Association for Human Resource Information Management: www.ihrim.org.
- Social Security Administration: www.socialsecurity.gov/employer.

DESIGNING THE PAYROLL SYSTEM FOR A BUSINESS

What Information Should the System Provide?

One of the most important elements of a well-designed payroll system is that it provides the information that the employer needs. For many companies, the payroll system does not have to be elaborate. It can be designed to provide only the basic information necessary to:

- Calculate payrolls, including gross pay and withholdings for federal, state, and local income taxes, social security and Medicare (FICA) taxes, and other payroll deductions.
- Compute and make timely payroll tax deposits.
- Record payroll liabilities and expenses on the general ledger.
- Prepare quarterly and annual payroll tax returns.

Other employers may require more detailed information from the payroll system. For example, they may want to accumulate payroll expenses by department or project. Others may want to keep track of the hours worked by an employee or group of employees on a specific project.

Generally, the information necessary to calculate payrolls is provided by the employer. The remaining information is then generated by the payroll system. These areas are discussed in more detail throughout this course.

Using a Separate Payroll Bank Account

Rather than issue payroll checks from operating bank accounts, many companies establish separate payroll bank accounts. Using a separate payroll bank account requires additional administrative effort (for example, to set up the

account, record cash transfers, reconcile the account, and maintain internal controls). A separate payroll account may be warranted, however, when:

- The company has a large number of employees.
- Payroll is processed off-site by an outside service and that service has the authority to draft on the account.

Using Service Providers

Companies that have many employees or unusual compensation arrangements may find it most economical to use a service provider to process their payroll. Service providers are independent companies that provide payroll processing services. Service providers usually operate standard payroll systems, but many service providers also provide custom modifications. Since service providers perform payroll for many clients, they normally have strong technical staffs to stay abreast of legal and tax changes affecting payroll.

Companies purchase the services of the provider's hardware and software to perform their data processing functions. Often companies communicate with service providers by phone, fax, or internet.

Typically, service providers charge a fixed fee for each pay period, plus fees for processing each transaction and changing payroll information. If payroll data is transmitted to the service provider through a personal computer and an internet connection, additional costs may be charged for setup and software updates.

The payroll services offered by service providers can be classified as either (a) a basic preparation service, where the service provider simply prepares the payroll, generates the reports and paychecks, and returns the information to the client (i.e., no other services are performed); or (b) a payroll agency service, where the service provider not only processes the client's payroll but also prepares the withholding tax reports, remits payment to the taxing authorities on the client's behalf, and pays the client's employees and applicable tax agencies from its own bank account. (Some CPA firms also provide that service. However, providing such services could impair the firm's independence with respect to that client.)

The advantages and disadvantages of using a service provider (compared with using in-house prepackaged or custom-designed software) are summarized as follows:

Advantages

- Minimal processing downtime because service providers are trained to handle problems.
- Various reports have been developed from experience with similar customers, and in some (but not all) cases custom reports are also available.
- Fewer people from within the company can access payroll; therefore, earnings information will more likely remain confidential. Security identification and access codes are required.
- Because payroll processing may be the service provider's main business, these firms are motivated to employ the best technicians to stay abreast of the constant tax and nontax law revisions.
- The service provider's staff minimizes the need for on-site support personnel.

Disadvantages

- Special requests take longer to process, making a company's last-minute changes difficult.
- Because service providers serve more than one customer, keeping on schedule is vital. However, timesharing capabilities may alleviate this restriction.
- Besides the rate charged to have the payroll processed each month, service providers charge additional fees that a company would avoid by doing the payroll in-house. For example, service providers usually charge for all special reports generated and all additions, deletions, or changes to an employee pay record.

- The company's pay information must be communicated and entrusted to outside sources, thus increasing disclosure risks.
- Users do not have any control over the computer hardware or software modifications. The service provider could go out of business and no longer offer support to users.

Before choosing a payroll service provider, the company should:

- a. Require timely proof that the provider has actually performed the requested services.
- b. Determine if the company should perform some activities itself. For example, the company may ask the service provider to prepare the withholding reports and send them to the company for review. After reviewing the reports, the company can make the deposit directly.
- c. Investigate the service provider's financial condition and credit standing, both initially and on a periodic basis thereafter. How are the company's funds isolated from financial problems to which the provider or its other clients may suffer, and what coverage and conditions apply to fiduciary bonds of service provider employees? This is important because little protection or recourse is available to employers whose service provider misuses funds intended for payroll tax payments and then goes bankrupt.
- d. Document clearly in the contract the service provider's policy on indemnifying the client for interest and penalties that the service provider's errors cause.
- e. Regularly monitor tax accounts including a biannual review of tax transcripts looking for short, late, or missing payments and returns.
- f. Require the provider to use the Electronic Federal Tax Payment System (EFTPS).

Although accountants may not be extensively involved in processing the payroll of a company that uses a service provider, many clients may seek the accountant's advice regarding whether to use a service provider to process their payroll. In addition, accountants must still record the payroll liabilities and expenses on the company's general ledger. The information necessary to record payroll liabilities and expenses can be obtained by reviewing the payroll reports from the service provider for each pay period. Recording payroll information is discussed in Lesson 2.

Payroll Services on the Internet. Web-based payroll processing is steadily increasing in popularity. Several payroll processors have online services aimed at small businesses that want to reduce the time spent processing payroll but also want to maintain control of their payroll input. Some advantages to such a service are (a) it is easily accessible, 24 hours a day, to anyone with the appropriate hardware, software and security; (b) it is generally a lower cost alternative to the traditional payroll processor; and (c) it is more flexible, allowing users to choose between different set up and processing options and methods of payment (e.g., direct deposit).

When a traditional payroll processor receives payroll information via the telephone or fax, the data then has to be manually entered into the payroll processor's computer system. This method is both time-consuming and susceptible to data entry errors. In addition, clients can only access the payroll data during business hours. Using the internet, the client can access the file and input the information directly, from almost anywhere, anytime of the day or night. This reduces the processor's data entry time and completely automates the process. The web-based payroll service automatically calculates, deducts, pays, and files all federal, state, and local taxes. Employees can be paid then by direct deposit or, if preferred, a check and pay stub can be printed. Those employees opting for direct deposit will be given a password to view their pay stub online. Some services assume complete responsibility for federal and state payroll filings and payments directly from the employer's account(s) based on the data the employer supplies. As long as the information supplied is correct and timely and the employer has sufficient funds in its account(s), the service will file the forms and payments accurately and on time or pay the resulting payroll tax penalties. *myPay Solutions*, a business of Thomson Reuters, is an online payroll service provider that offers a dedicated specialist to answer clients' questions quickly and efficiently. For those clients of firms that use the *CS Professional Suite*, *myPay Solutions* creates detailed payroll journal entries that seamlessly import into *Write-Up CS™* and provides the type of add-on services discussed in this paragraph.

In addition to the online payroll services that are available, some accounting applications offer payroll services either as a part of the package or as an additional module that can be purchased separately.

Payroll Service Provider Software. As payroll service providers are developing online applications for their clients, software developers are creating software programs to help accountants become payroll service providers for their clients. With the purchased programs, practitioners are able to process their clients' payroll effectively and efficiently. The vendor typically installs the software and related tax tables and keeps the information current. Some vendors even sell consulting-type services to help practitioners streamline the payroll processing. Marketing advice and related links are included on many of the vendors' websites.

The right software and the correct client data make it is easy and fast to process payroll. The ideal software should offer:

- Adequate storage for each client's company and employee data.
- Enough income, earning, benefit, and deduction fields per employee to fit all clients.
- All pay period ranges that clients might use.
- Direct deposit capabilities.
- Password protection for salary data.
- Ability to print reports with a professional appearance.
- Easy data import from the accounting programs most used by clients.
- Easy data export of journal data to the accounting programs most used by clients.
- Import capabilities from time clock software if clients use it.
- Ability to print MICR-encoded checks with clients' digitized signatures and logos.

Delegating the Work

Accountants in public practice that provide payroll services should attempt to delegate as much of the work as possible to paraprofessionals. Payroll services are valuable professional services. However, just as attorneys use paralegals to perform recurring legal work, accountants can use paraprofessionals to perform payroll services. Well-trained and appropriately supervised paraprofessionals can generally perform all payroll services, including preparation of payroll tax returns.

Supervision. Clients will ultimately hold the CPA firm responsible for the services provided, not the paraprofessionals. Therefore, it is important to adequately supervise the work performed by paraprofessionals. Adequate supervision includes being available to answer technical questions as well as reviewing the paraprofessionals' work.

Maintaining Payroll Records

The types of payroll records maintained may vary with each employer. At a minimum, however, the Internal Revenue Service requires employers to maintain the payroll records listed in Exhibit 1-1. Ordinarily, accountants in public practice will only maintain records related to the information in Items 1–15 in their payroll workpapers. The remaining information will be kept by clients in their payroll and employee files.

Exhibit 1-1**Maintaining Payroll Records**

The Internal Revenue Service requires employers to maintain the following payroll records for at least four years after the later of (1) the due date of the related payroll tax returns or (2) the date the payroll taxes were paid:

1. Employer identification number.
2. Copies of payroll tax returns that have been filed, including E-file tax records and confirmation numbers.
3. Dates and amounts of payroll tax deposits made and acknowledgement numbers for deposits made by EFTPS.
4. Each employee's name, address, social security number, and occupation.
5. The total amount and date of each wage payment and the period of time the payment covers.
6. For each wage payment, the amount subject to income tax, social security tax, and Medicare tax withholdings.
7. The amounts of withholding taxes collected on each payment and the date it was collected.
8. The reasons for any differences between the taxable amounts and the total wage payment.
9. The total amount paid to employees during the calendar year.
10. The amount of compensation subject to federal unemployment tax.
11. The amount paid into state unemployment funds.
12. Any other information required to be shown on Form 940.
13. The fair market value and date of each payment of noncash compensation made to a retail commission salesperson, if no income tax was withheld.
14. For accident or health plans, information about the amount of each payment.
15. The dates in each calendar quarter on which any employee worked for the employer, but not in the course of the employer's trade or business, and the amount paid for that work.
16. Copies of any statements furnished by employees relating to nonresident alien status, residence in Puerto Rico or the Virgin Islands, or residence or physical presence in a foreign country.
17. Form W-4 (Employee's Withholding Allowance Certificate) for each employee.
18. Any agreement between the employer and employee for the voluntary withholding of additional amounts of tax.
19. Copies of statements given to the employer by employees reporting tips received in their work.
20. Requests by employees to have their withheld tax figured on the basis of their individual cumulative wages.
21. Form W-5 (Earned Income Credit Advance Payment Certificate) of employees who are eligible for the earned income credit and wish to receive their payment in advance, rather than when they file their income tax returns.
22. Record of fringe benefits provided, including substantiation.
23. Amounts and dates of pension and annuity payments.
24. Undeliverable employee copies of Forms W-2 and W-2c.
25. Dates of employment for each employee.
26. Periods for which employees and recipients were paid while absent due to sickness or injury, and the amount and weekly rate of payments the employer or third-party payers made to them.

* * *

How Long Should Payroll Records Be Kept? Some accountants retain payroll records and workpapers permanently while others have adopted retention periods ranging from four to 10 years. Obviously, the records should be kept so long as they serve a useful purpose or until all legal and regulatory requirements are met. The IRS requires the records listed in Exhibit 1-1 to be kept for at least four years after the later of (a) the due date of the related payroll tax returns or (b) the date the payroll taxes were paid. One school of thought is that, generally, employers should retain payroll ledgers and tax returns. Other payroll workpapers should be kept for seven years. Accountants in public practice should retain the payroll ledgers and tax returns of present clients permanently. They should retain other payroll workpapers of present clients (and all payroll records and payroll tax returns of former clients) for seven years.

The Need for Confidentiality. The importance of keeping payroll information confidential cannot be overemphasized. When an employer processes its own payroll, it normally takes the following steps to increase payroll confidentiality:

- a. *Emphasize and Require Confidentiality among All Employees.* Confidentiality requirements should apply not only to those processing payrolls but to all other employees as well. Employees should be instructed not to discuss salaries, wages, or other conditions of employment. Employers should make breach of confidentiality a condition for termination.
- b. *Place Payroll Responsibilities with a Trusted Employee.* Larger companies may have full-time employees on staff whose only responsibility is processing payroll. Smaller companies, however, may not have the resources to hire an employee to work only on payroll. Regardless, companies should place payroll responsibilities with one employee and structure that employee's duties so that he or she has sufficient time to concentrate on payroll.
- c. *Restrict Access to Payroll Records.* Only employees responsible for payroll (or owners or certain officers of the company) should have access to payroll records.

The concern over payroll confidentiality is one of the primary reasons that many companies ask CPA firms to provide payroll services. Thus, the preceding steps also should be taken by CPA firms that process client payrolls. In addition, a CPA firm's employees should be careful to only deliver payroll information to authorized client personnel.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Use of a payroll service provider would be advantageous for which of the following companies?
 - a. Company A is concerned about its earnings information remaining confidential.
 - b. Company B often has last-minute changes to its payroll.
 - c. Company C cannot meet the same payroll schedule every period.
 - d. Company D requires many ad-hoc reports to be generated to analyze payroll.
2. Carson Enterprises is considering hiring a service provider to process its payroll. Which of the following actions should the company take before making this decision?
 - a. Ask if the provider will regularly perform the services requested by the company.
 - b. Determine if the company meets the credit evaluation of the service provider.
 - c. Ensure that the service provider is indemnified from errors caused by the company.
 - d. Determine whether the company should perform some payroll activities itself.
3. The CPA firm of Blankenship & Dawes provides payroll services to its small business clients. The firm uses paraprofessionals to perform much of these services, such as payroll tax return preparation. Who will the client ultimately hold responsible for the payroll services under these circumstances?
 - a. The paraprofessionals.
 - b. The firm.
4. Blankenship & Dawes is made up of accountants in public practice. Which of the following payroll records would the firm keep in its records?
 - a. Employee names, addresses, social security numbers, and occupations.
 - b. Each employee's form W-4.
 - c. Records of fringe benefits that were provided.
 - d. Employees' employment dates.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Use of a payroll service provider would be advantageous for which of the following companies ? **(Page 5)**
 - a. **Company A is concerned about its earnings information remaining confidential. [This answer is correct. One advantage of using a service provider is that fewer people from within the company can access payroll. Therefore, earnings information will more likely remain confidential. Security identification and access codes are required with a service provider. Using a service provider, therefore, would help Company A alleviate this concern.]**
 - b. Company B often has last-minute changes to its payroll. [This answer is incorrect. One disadvantage to using a service provider is that special requests take longer to process, making a company's last-minute changes difficult. Company B's situation would not maximize the benefits of using a service provider.]
 - c. Company C cannot meet the same payroll schedule every period. [This answer is incorrect. One disadvantage of using a service provider is that, because they serve more than one customer, keeping on schedule is vital. Unless Company C can find a regular schedule it can stick to or workout some kind of timesharing capability, it should not use a service provider.]
 - d. Company D requires many ad-hoc reports to be generated to analyze payroll. [This answer is incorrect. One of the advantages of using a service provider is that the service has developed reports based on its experience with similar customers. Since Company D has so many ad-hoc reports, it would not be able to make full use of this time-saving advantage of using service provider. Also, though in some cases service providers will create custom reports, that is not always the case. Company D would not be able to use a service provider at all if the service provider did not provide custom reports. Based on those considerations, using a service provider may not be practical or advantageous for Company D.]
2. Carson Enterprises is considering hiring a service provider to process its payroll. Which of the following actions should the company take before making this decision? **(Page 6)**
 - a. Ask if the provider will regularly perform the services requested by the company. [This answer is incorrect. Before choosing a payroll service provider, the company should require that, if awarded the job, the service provider will supply the company timely proof that the provider has actually performed the requested services. Merely asking if the provider plans to provide the services is not enough proof. If the provider is unwilling to provide the requested proof, it may be in the company's best interest to choose a different payroll service provider.]
 - b. Determine if the company meets the credit evaluation of the service provider. [This answer is incorrect. Before choosing a payroll service provider, a company should investigate the service provider's financial condition and credit standing, both initially and on a periodic basis thereafter. This is important because little protection or recourse is available to employers whose service provider misuses funds intended for payroll tax payments and then goes bankrupt.]
 - c. Ensure that the service provider is indemnified from errors caused by the company. [This answer is incorrect. Before choosing a service provider, the company should document clearly in the contract the service provider's policy on indemnifying the client for interest and penalties that the service provider's errors cause, but not errors caused by the company.]
 - d. **Determine whether the company should perform some payroll activities itself. [This answer is correct. Before choosing a payroll service provider, the company should determine if the company should perform some activities itself. For example, the company may ask the service provider to prepare the withholding reports and send them to the company for review. After reviewing the reports, the company can make the deposit directly. The company should know what services it would like the service provider to perform before it enters into an arrangement with the service provider so that appropriate costs and deadlines can be negotiated.]**

3. The CPA firm of Blankenship & Dawes provides payroll services to its small business clients. The firm uses paraprofessionals to perform much of these services, such as payroll tax return preparation. Who will the client ultimately hold responsible for the payroll services under these circumstances? **(Page 7)**
- a. The paraprofessionals. [This answer is incorrect. Well-trained and appropriately supervised paraprofessionals can generally perform all payroll services, including preparation of payroll tax returns. However, ultimately, the clients will hold the CPA firm responsible, so the firm must ensure that supervision of the paraprofessionals is adequate.]
 - b. The firm. [This answer is correct. Clients will ultimately hold the CPA firm responsible for the services provided, not the paraprofessionals. Therefore, it is important to adequately supervise the work performed by paraprofessionals. Adequate supervision includes being available to answer technical questions as well as reviewing the paraprofessional's work.]**
4. Blankenship & Dawes is made up of accountants in public practice. Which of the following payroll records would the firm keep in its records? **(Page 7)**
- a. Employee names, addresses, social security numbers, and occupations. [This answer is correct. This information must be maintained, according to the Internal Revenue Service (IRS). Ordinarily, accountants in public practice will maintain records related to information including, among other things, (1) each employee's name, address, social security number, and occupation; (2) employer identification number, (3) the total amount paid to employees during the calendar year; and (4) the amount paid into state unemployment funds. Other information would ordinarily be kept by the client.]**
 - b. Each employee's form W-4. [This answer is incorrect. This information must be maintained according to the IRS; however, typically, W-4s would be kept by the clients, not the CPA firm.]
 - c. Records of fringe benefits that were provided. [This answer is incorrect. The client would ordinarily keep records related to fringe benefits, including substantiation, in their payroll and employee files. This is not information that the CPA firm would typically keep, but is information that should be maintained per the IRS.]
 - d. Employees' employment dates. [This answer is incorrect. This information is required to be maintained by the IRS; however, it would usually be maintained in the client's payroll and employee files, not in the CPA firm's records.]

OBTAINING PAYROLL INFORMATION NEEDED FOR PROCESSING

To accurately process payroll information, the accountant needs information about the employer, the job, the employee, and the time worked or leave taken during the pay period. This information is usually provided by the company and can be found in the company's procedural memos, employee information documents, or time sheets. The information concerning the employer, the job, and the employee changes infrequently, while information about the time worked or leave taken changes during each pay period. The following paragraphs provide a general discussion on obtaining (a) the employer information, (b) the job information, (c) the employee information, and (d) the time worked or leave taken during the pay period.

Employer Information

To accurately process payroll, the accountant needs the following information about the employer:

- a. Employer identification number (EIN).
- b. The workweek.
- c. The pay period.

Obtaining the Employer Identification Number. The federal employment tax system identifies employers by their federal employer identification number (EIN), a nine digit number in the form xx-xxxxxxx. [This identification number is also referred to as a taxpayer identification number (TIN)]. Before paying its first employee wages, a business should obtain an EIN by filing Form SS-4 (Application for Employer Identification Number) with the IRS. Certain states and municipalities also require a similar identification number. Requirements and filing procedures vary between jurisdictions and must be determined on an individual basis.

In some cases, the employer will ask the accountant to assist the business in applying for an EIN. An EIN may be applied for by mail, telephone, fax, or online.

- *Mail.* Form SS-4 should be completed at least four to five weeks before the EIN is needed. After the form has been signed by an authorized representative and dated, it should be mailed to the IRS center serving the state in which the business is located.
- *Telephone.* Taxpayers can receive their EIN and use it immediately to file a return or make a payment if they apply by telephone. Call the IRS at (800) 829-4933. Form SS-4 should still be completed in order to have all of the relevant information available. The IRS agent will ask for several details from the completed Form SS-4 and assign the EIN. The number assigned should be written in the upper right corner of the Form SS-4 and the taxpayer or taxpayer representative should sign and date the form. If requested by an IRS representative, the signed Form SS-4 should be mailed or faxed within 24 hours to the service center address provided by the IRS representative. The person making the call must be authorized to sign the form.
- *Fax.* Taxpayers can receive their EIN within four business days by applying by Fax-TIN. After Form SS-4 has been completed, signed by an authorized representative, and dated, it should be faxed to the IRS using the Fax-TIN number listed for the state in which the business is located. Taxpayers can provide their fax number and the IRS will fax the EIN to them.
- *Online.* Taxpayers can receive their EIN and use it immediately to file a return by mail or make a payment if they apply online at www.irs.gov and click on "Online EIN Application." An EIN will be issued after successful submission of the completed Form SS-4 online. Accountants may request EINs via the internet on behalf of their clients. However, they must retain on file a completed copy of the Form SS-4, signed by the client, and a signed statement authorizing them to file the online application. There are some business entity types that may not use this method.

Exhibit 1-2 provides the addresses and fax numbers of the appropriate IRS service centers (reproduced from Form SS-4 instructions).

Exhibit 1-2

IRS Service Center Units

This listing contains the IRS Service Centers’ addresses and fax numbers for requesting and submitting an application for an employee identification number (EIN). THE NUMBERS MAY CHANGE WITHOUT NOTICE. Call (800) 829-4933 to apply by telephone, verify a fax number, ask about an application by mail, or inquire about other Federal tax matters.

Form SS-4 should be completed prior to calling the IRS. This helps speed up the phone call, plus within 24 hours after the call the completed and signed form must be faxed or mailed to the IRS.

The Service Center phone numbers, fax numbers, and addresses are as follows:

If your principal business, office or agency, or legal residence in the case of an individual, is located in:	Call the Fax-TIN number shown or file with the “Internal Revenue Service Center” at:
One of the 50 states or the District of Columbia	Attn: EIN Operation Cincinnati, OH 45999 Fax-TIN (859) 669-5760
If you have no legal residence, principal place of business, or principal office or agency in any state:	Attn: EIN Operation Philadelphia, PA 19255 Fax-TIN (215) 516-1040

* * *

Accountants should be aware of requirements concerning who can apply for an EIN over the telephone and authorized signatories of the form itself. These requirements are included in the instructions to Form SS-4. When an EIN is applied for over the telephone, the individual making the call must be authorized to sign the form. Representatives who can sign Form SS-4 include—

- an individual (for individual applicants),
- the president, vice president, or other principal officer (for corporations),
- a duly authorized member or officer having knowledge of its affairs (for partnerships or other unincorporated organizations), and
- the fiduciary (for trusts or estates).

The accountant may obtain an EIN for his or her client if the client has completed the “Third Party Designee” portion of Form SS-4.

The Workweek. The federal law governing employee wages and work hours, the Fair Labor Standards Act (FLSA), requires the employer to designate and document the day and time when the workweek begins. The workweek consists of the seven consecutive 24-hour periods (168 consecutive hours) following the designated time. The FLSA requires application of the workweek definition when calculating overtime pay for employees who work in nonexempt positions.

In addition to the FLSA requirements, states may require that the business make a separate overtime calculation using the hours worked in the workday (rather than in the workweek). Some states require that notices be given or posted designating the workweek or workday. The business and the accountant should be familiar with the applicable state rules.

The Pay Period. The pay period is a grouping of workweeks or days, and the accountant must know the pay period in order to process payroll. The pay periods used most often by companies are as follows:

- Weekly (52 pay periods annually).
- Biweekly (26 pay periods annually).
- Semimonthly (24 pay periods annually).
- Monthly (12 pay periods annually).

Employers may set different pay periods for different groups of employees within the bounds set by state laws regulating when wages must be paid.

Job Information

Job positions can either be exempt or nonexempt from the FLSA's minimum wage and overtime requirements. A job's FLSA status as exempt or nonexempt has consequences for the payment amount, pay deductions, and time records used to calculate the employee's paycheck. Exhibit 1-3 summarizes these consequences. The definitions of *exempt* and *nonexempt* job positions are discussed further in Lesson 2.

Exhibit 1-3

Comparison of Exempt and Nonexempt Employees

Attribute	Exempt	Nonexempt
Payment amount	The employer pays an exempt employee a fixed salary for <i>any and all</i> work performed during a workweek. Pay does not vary with quality or quantity of work. Minimum wage and overtime pay requirements do not apply.	The employer may pay a nonexempt employee using an hourly, salary, piece, commission, or any other method. However, the total compensation must be at least the minimum wage for all hours worked, plus overtime pay for hours over the maximum.
Pay deductions	Generally, deductions may not be made from the weekly salary for time not worked; doing so will likely void the exemption. The FLSA does specify several exceptions to this policy.	The employer may pay a nonexempt employee only for the hours worked. Therefore, deductions may be made from wages for lateness, full or partial day absences, and any time the employee does not work.
Time records	Employers are not legally required to record the hours worked.	Employers must maintain accurate daily and weekly records of all hours worked.

* * *

Employee Information

The accountant needs the following information about the employee in order to accurately prepare or calculate a payroll:

- a. Name, address, and social security number.
- b. Work authorization status.
- c. Pay type (i.e., exempt or nonexempt).
- d. Salary or hourly rate.

- e. Pay frequency (e.g., weekly, biweekly, semimonthly, or monthly).
- f. Amount of federal income tax that should be withheld from each payroll check (i.e., the number of withholding allowances claimed on Form W-4 plus any additional withholding requested by the employee).
- g. Advanced earned income credit (EIC) status. That is, whether the employee has filed Form W-5 to receive advance payments of the earned income credit.
- h. Amount of other authorized payroll deductions (e.g., for retirement plans, savings plans, or insurance) and whether those deductions should be made before or after federal income taxes.
- i. Number of normal and overtime hours worked (if employee is nonexempt).

The information in items a.–g. above is usually provided once—before the initial payroll is processed. Thereafter, the information should be provided only as employees are added or as changes in the information about existing employees occur. Generally, the information in items a.–g. can be obtained by reviewing employee files containing employment contracts or letters, completed Forms W-4 and W-5, benefit enrollment forms, etc. To facilitate payroll processing, however, the information should be summarized in one place using a form such as the Employee Payroll Information Sheet illustrated in Exhibit 1-4. The following paragraphs provide additional discussions on gathering the employee information.

Name, Address, and Social Security Number. Because the employee's name is used by the Social Security Administration and IRS, the accountant should not change an employee's name (such as through marriage or divorce) in the payroll records until the employer has verified that the employee has a revised social security card. In addition, the address data should be kept current to allow the business to fulfill its legal obligations to deliver Forms W-2, benefit plan information, and insurance notices. (A business may notify the accountant of any employee data changes by completing and submitting a revised Employee Payroll Information Sheet.)

Federal agencies may impose fines on employers who report wage information with inaccurate or missing social security numbers (SSNs). Therefore, the business (or accountant) should gather the SSN when the employee completes Form W-4, (Employee's Withholding Allowance Certificate).

Employers can verify the SSNs of new employees directly with the SSA. SSA will verify employee names and numbers for Form W-4 purposes. The SSA has two internet options for verifying SSNs using the SSN Verification Service (SSNVS). The first option allows registered users to verify up to 10 names and SSNs online at one time and receive immediate results. After verifying 10 names and SSNs, the user can select the "Verify more SSNs" link to verify up to 10 additional SSNs. This process can be repeated as many times as the user desires. Alternatively, a user may upload batch files of up to 250,000 names and SSNs and usually receive results the next government business day. A user may verify up to 250,000 names and SSNs using a spreadsheet software program to create an SSNVS File, as long as the file is in the correct format. The specifications for the file layout can be found at www.ssa.gov/employer/ssnvs_handbk.htm (click on "Submission File Format" in the table of contents). Registration for SSNVS is on the SSA's website at www.socialsecurity.gov/bsowelcome.htm.

**Exhibit 1-4
Employee Payroll Information Sheet**

Company: Acme Industries

Completed by: Mark James Date: 6-4-X3

Instructions: This form should be completed for each employee. A new form should be completed as changes in an employee's general information, pay rate, or payroll deductions occur.

GENERAL INFORMATION

Employee number: 155 Social security number: 458-00-1296

Name: Darla Mae Jones
(First, middle, last)

Address: 555 Maple Street

City: Fort Worth State: JX Zip: 76171

Phone number (home): 817-555-1234 Cell: 817-555-6789 Email: djones@aol.com

Department: Sales Title: Telemarketer

Date employed: 6-1-X3 Date terminated: _____

PAYMENT INFORMATION

Pay frequency Weekly Biweekly Semimonthly Monthly

Pay type Salaried Hourly

Pay rate (annual salary if salaried or hourly rate if hourly) \$8.50/hour

Overtime rate (hourly only) \$12.75/hour

DEDUCTION INFORMATION

	Federal	State	Local
Income taxes			
Number of allowances claimed	<u>2</u>	<u>n/a</u>	<u>n/a</u>
Additional withholding requested	_____	_____	_____
Exempt status claimed	_____	_____	_____
Marital status	<input checked="" type="checkbox"/> Married <input type="checkbox"/> Single <input type="checkbox"/> Married, but withhold at higher single rate		

Earned income credit

Has the employee filed Form W-5 for this year with the employer? Yes No

Has the employee's spouse filed Form W-5 for this year with any employer? Yes No

Other deductions (Enter the deduction amount or percentage of gross wages that should be deducted before and after income taxes in each pay period.)

	Before tax	After tax
Health Insurance	_____	<u>\$25</u>
Dental Insurance	_____	<u>\$10</u>
Retirement plan	<u>10%</u>	_____
Savings plan	_____	_____
Disability Insurance	_____	<u>\$4</u>
Life Insurance	_____	<u>\$5</u>
_____	_____	_____
_____	_____	_____

* * *

In addition to the Internet options, up to 10 names and numbers can be verified by using an automated telephone service, Telephone Number Employer Verification (TNEV), that is very similar to the SSNVS. Registration for TNEV and SSNVS are completed in the same process. When registration is complete and the activation code is entered online, the employer will be able to access TNEV and/or SSNVS to verify SSNs. The employer can access TNEV by calling either (800) 772-1213 and when prompted say "Employer SSN Verification" or (800) 772-6270 and when prompted say or press "1" to verify a SSN. Requests may also be submitted on paper. To verify 1–50 names and numbers, submit a paper listing to the employer's local Social Security office containing each employee's SSN, last name, first name, middle initial (if applicable), date of birth, and gender. The local office will provide format and submission instructions. To locate local Social Security offices, visit the SSA's website at www.socialsecurity.gov/locator/. Employers may also verify 50 to 300 names on paper but must first register for the Employee Verification Service (EVS) using the registration form found in the EVS instruction book, available on the SSA's website at www.ssa.gov/employer/EVSregistration.pdf. Paper listings with 50 to 300 SSNs are not sent to the employer's local social security office. Instead, they must be sent to the SSA's Wilkes-Barre, PA address. For 300 or more verification requests one of the two SSNVS internet options discussed previously should be used.

Employees needing to obtain or revise a social security card should complete Form SS-5 (Application for a Social Security Card) [available at local Social Security offices, downloaded at www.ssa.gov, or by calling (800) 772-1213]. It usually takes two weeks to obtain a new or revised card.

Work Authorization Status. Employers must also be aware of the requirements imposed by the Immigration Reform and Control Act of 1986 (IRCA). This law prohibits employers from knowingly hiring (or having in their employ) illegal aliens, and applies to the government, household and farm employers, and other business employers. Under IRCA, no employer can lawfully hire *anyone* (U.S. citizens or aliens) without checking the person's identity and authorization for employment. Verification that an employee's identity and eligibility were checked is made by completing Form I-9 (Employment Eligibility Verification).

All employees must complete Section 1, "Employee Information and Verification," of the I-9 at the time of hire, which is the date the employee actually begins working. Employers may have employees complete the form earlier, as long as the form is completed at the same point in the employment process for all employees. The employer is responsible for ensuring that Section 1 of the I-9 is timely and properly completed.

An employee's identity and eligibility must be reviewed and verified by the employer, or state employment agency if the applicant was referred by such agency. Within three business days of when employment begins, employers must inspect certain documents (chosen by the employee) proving the employee's identity and authorization to work in the United States. Verification that an employee's identity and eligibility were checked is made by completing Section 2, "Employer Review and Verification," of the I-9. Three lists of documents that meet the IRCA identity and employment authorization requirements are listed on the back of Form I-9.

If an employee's work authorization has an expiration date, the employer must reverify the employee's work authorization no later than the date the original authorization expires. If at that time the employee presents a document that shows either continuing employment eligibility or a grant of work authorization, the employer must check the document and note the number and expiration date in Section 3 of the I-9 form. If neither of these is provided, the employer must terminate the individual's employment as of the work authorization expiration date. The employer should monitor expiring documents by establishing a "tickler file" to notify the employee at least 60 days before a document expires.

The Illegal Immigration Reform and Immigrant Responsibility Act of 1996 (IIRIRA '96) reduced the number of documents that can legally establish worker eligibility. In response to the changes made by IIRIRA '96, the Immigration and Naturalization Service (INS) released interim rules and proposed regulations reducing the number of documents that may be used to establish identity and eligibility to work in the United States. The Form I-9 was revised to reflect the many changes that had been made to the 1991 edition of the Form I-9. In April 2009, the Form I-9 was revised to no longer allow expired documents as acceptable forms of identification or employment authorization. The current Form I-9 lists six acceptable "A" list documents as proof of both identity and of work eligibility. Employers who fail to use the revised form will be subject to applicable penalties. In August 2009, the Form I-9 expiration date was set to August 31, 2012. Practitioners should be sure the most recent form is used;

however, employers may also use a Form I-9 with a revision date of 02/02/09 since the only change to the current form was to reflect the new expiration date.

Employers should retain all Form I-9 for the longer of three years or one year after employment termination. They should not file Form I-9 in each employee's personnel file. Doing so may allow the immigration agency access to the entire personnel file. Instead:

- File alphabetically, in one file, all Forms I-9 of current employees, except those whose documents are subject to expiration (such as work visas).
- File separately all Forms I-9 that are subject to expiration, in expiration date order.
- File separately all Form I-9 of terminated employees, by termination date. Mark the top of the form with the termination date for easy reference and filing.

Employers should periodically conduct an internal audit to ensure they have Forms I-9 on file for all employees. If the audit reveals missing forms the employer should immediately ask the employees without forms to complete a Form I-9. The completed forms should not be backdated and the employer should consider making a notation of the situation and placing it in the file with the recently completed Form I-9. If the employee does not provide acceptable documentation, he or she should be terminated.

The Department of Homeland Security (DHS) allows employers to utilize electronic signatures and store Forms I-9 electronically. These rules closely follow the widely accepted electronic storage standards and requirements in previously published IRS guidance for electronic document retention.

Form I-9 and further information about IRCA are in the Immigration and Naturalization Service Publication, *Handbook for Employers*. The handbook is available on the U.S. Citizenship and Immigration Services (USCIS) website at www.uscis.gov/files/nativedocuments/m-274.pdf. The USCIS hotline is (800) 375-5283. Exhibit 1-5 presents tips to help successfully complete and process the Form I-9.

Employee's Withholding Status. To properly withhold federal income taxes and calculate an employee's net wages, the employer must ask each new employee to complete a Form W-4 before or on employment commencement. Form W-4 informs the accountant of the number of withholding allowances claimed by the employee. Such claims then determine the amount of federal income tax that should be withheld from the employee's gross pay. If the employee has not submitted a valid Form W-4 in time to calculate his or her first payroll, the employer must withhold FIT as if the employee is single with no exemptions. In addition, some states require that employees complete a separate state withholding allowance certificate.

A Form W-4 can be in either paper or electronic form. Employers can establish electronic Form W-4 filing systems that enable employees to file and make changes to their Forms W-4 by means of a computer network or interactive voice response system. While employers can adopt an electronic Form W-4 system for use by all its employees, a paper Form W-4 option must be "reasonably available upon request to any employee who has a serious objection to using the electronic system or whose access to, or ability to use, the system may be limited (for example, as a result of a disability). The paper option would be satisfied, for example, if the employer informs employees how they can obtain a paper Form W-4 and where they should submit the completed paper Form W-4."

The employer should retain the signed original Forms W-4 (no copies) for four years after the company files the related annual employment tax returns. Forms W-4 in electronic form should also be retained for four years.

Because claims for excessive allowances and exemptions may result in civil and criminal penalties, neither the employer nor the accountant should suggest or recommend to the employee a number of withholding allowances. Accountants and employers, however, can refer employees to Form W-4 and its instructions; IRS Pub. 919, "How Do I Adjust My Tax Withholding?"; and Pub. 505, "Tax Withholding and Estimated Tax." These publications can be ordered by calling 1-800-TAX-FORM or can be downloaded from the IRS website, www.irs.gov. Accountants and employers also can refer employees to the IRS online W-4 Withholding Allowance Calculator, which can be found on the IRS website at www.irs.gov by clicking on "Individuals" and then clicking on "IRS Withholding Calculator."

Exhibit 1-5

Tips for Completing Form I-9

Complete Form I-9 only *after* making the employment offer. To do otherwise will seriously weaken the company’s defenses against claims of hiring discrimination.

Request documentation for all persons hired, even if the employer knows that an applicant is a U.S. citizen.

Apply the laws to temporary workers.

Ensure that the employee checks the proper box under the attestation section of Part 1. If the employee is an alien, the employee also must provide the alien identification number and expiration date (if applicable).

Inspect either one document from List A or one document from both Lists B and C of Form I-9.^a The inspection must be made within three business days of when the employee begins employment.

Do not specify which documents the employee must show. This is illegal.

Accept only authentic-looking, original documents. The document’s front and the back, pictures, and names should appear original and consistent. The INS’s Handbook for Employers includes copies of acceptable authentic documents.

Complete the employer’s portion of Form I-9 (section 2), attesting that the documents have been inspected and appear valid. If applicable, the employer should complete the document identification number section and expiration date.

Require individuals who cannot show proof of identity and authorization to work in the United States to at least produce a receipt showing that they have applied for the documents. The employee then must produce the original document(s) within 90 days of hire.

Ask the company’s attorney whether the company should copy the authorization documents. Attorneys differ on the advisability of this practice.

Monitor expiring documents. Establish a *tickler file* to notify the employee at least 60 days before a document expires.

Note:

^a The U.S. Citizenship and Immigration Services (USCIS) released a revised version of Form I-9 in August 2009. The current Form I-9 includes six acceptable “A” list documents as proof of both identity and of work eligibility. The revised Form I-9 was effective as of August 7, 2009. The current Form I-9 expires on August 31, 2012. Practitioners should be sure that the most recent form is used.

* * *

Some employees may claim a total exemption (exempt status) from federal income tax withholding. (However, withholding social security and Medicare taxes may still be required). To qualify for exempt status, the employee must meet *both* of the following conditions:

- The employee must expect to have no federal income tax liability for the current taxable year. If circumstances change and a liability is expected in the current year, the employee must file a new Form W-4 within 10 days (for liabilities expected in the following year, by the later of 10 days or December 1).
- The employee must not have had a tax liability in the prior year.

Student employee and others who claim to be exempt from withholding must update their W-4 forms each year. Forms W-4 can be obtained by calling 1-800-TAX-FORM or at www.irs.gov.

The IRS requires that employees file an amended Form W-4 within 10 days of an event that decreases their number of withholding allowances. For example, such decreases may occur:

- Upon marriage to an employed spouse.
- Upon a divorce or legal separation.
- When a spouse claims himself or herself as an exemption, as when the spouse begins a new job.
- When someone else will claim a claimed dependent.
- When a claimed dependent's level of income will invalidate the allowed exemption.
- When income is more, or exemption or deductions are less than previously planned.

An employee may amend the Form W-4 for an increased number of withholding allowances at any time.

When an employer receives an amended Form W-4, the employer must comply with its withholding instructions no later than the start of the first payroll period ending on or after 30 days from the receipt of the amended Form W-4. Generally, the withholding instructions continue to apply until the employee amends the Form W-4. However, an employee claiming fully exempt status annually must renew the Form W-4 by February 15; otherwise, the employer must resume withholding as though the employee is single with zero withholding allowances.

The employer is not under any affirmative obligation to evaluate the number of exemptions for which the employee is entitled. However, the employer should ignore invalid Forms W-4. A Form W-4 is rendered invalid if the employee changes or adds language to the form, such as rescinding the certification that the form is correct. The form is also considered invalid if the employee indicates verbally that the form is not correct. When a form is invalid, the employer should request a valid one; until a valid form is received, the employer should withhold based on an earlier valid form or as if no form had been returned (i.e., at a single, no allowances level). Employers are no longer required to submit copies of Forms W-4 with Form 941. Instead, employers must send Forms W-4 to the IRS only if (a) the employer receives a written notice from the IRS directing it to do so, or (b) published guidance (i.e., a revenue ruling or IRS notice) directs the employer to do so.

Hints for Processing Form W-4. In accepting and processing Forms W-4, employers should keep the following general rules in mind:

- a. *The Employer Should Withhold Based Only Upon an Original Form W-4.* The employer should not withhold based on a photocopy or facsimile of Form W-4, a letter from the employee, or verbal instructions from the employee. Furthermore, the employer should not override the Form W-4 based on personal knowledge of the employee's current marital or financial situation.
- b. *The Employer Is Not Required to Send Copies of Forms W-4 to the IRS Unless Notified in Writing to Do So.* However, if it appears that the employee is claiming an incorrect withholding amount, the employer should advise the employee that the IRS may review the employee's withholding to make sure it is adequate.
- c. *Base Withholding on Form W-4 Unless Notified by the IRS to Do Otherwise.* If the IRS notifies an employer about a particular employee, the employer should base withholding on the number of withholding allowances shown in the IRS notice. If the employer later receives a new Form W-4 from the employee, the employer should follow it only if (1) exempt status is not claimed and (2) the number of withholding allowances is equal to or fewer than the number in the IRS notice.
- d. *The Employer Is Not Responsible for Verifying, on the IRS's Behalf, the Withholding Exemptions and Allowances Claimed by the Employee.* Unless otherwise instructed by the IRS, the employer is entitled to withhold based on the most recent Form W-4 on file. However, the employer must reject certain Forms W-4

(e.g., where the employee indicates that information on the form is false), in which case the employer should continue to withhold as if the rejected Form W-4 was never received.

- e. *Similarly, the Employer Is Not Required to Verify That the Employee Has Claimed All Exemptions and Allowances to Which He or She Is Entitled.* While the employer can assist the employee in understanding how to complete Form W-4, the employer should not complete the form and should not provide advice concerning the number of allowances that can be claimed. Instead, the employer should encourage the employee to obtain and read IRS Pub. 919, "How Do I Adjust My Tax Withholding?" to determine the employee's permissible allowances and exemptions or to access the IRS's online Withholding Calculator which can be found on the IRS website at (How Do I Adjust My Tax Withholding?) to determine the employee's permissible allowances and exemptions or to access the IRS's online Withholding Calculator which can be found on the IRS website at **www.irs.gov/individuals**.
- f. *As with Other Tax Return Information, the Contents of Each Employee's Form W-4 Are Confidential.* In short, the employer should not disclose Form W-4 information to third parties.
- g. *IRS Information Reporting Call Site.* The IRS has a toll-free information reporting call site [(866) 455-7438] that answers tax law and paper filing questions about Form W-4.

EIC Status. Employees with income less than an annually designated amount (\$40,545 for taxpayers that are married filing jointly in 2010 with one qualifying child; \$35,535 for all other taxpayers in 2010 with one qualifying child) may qualify for an advance earned income credit (EIC) that will increase the paycheck amount. [The annual amount can be found in IRS Publication 15, "Circular E, Employer's Tax Guide," which can be obtained by calling 1-800-TAX-FORM. All references in this course to Publication 15 include both Publication 15 and 15-A, "Employer's Supplemental Tax Guide (Supplement to Circular E, Employer's Tax Guide, Publication 15)."] Employees wanting to receive the advance EIC must file Form W-5 (Earned Income Credit Advance Payment Certificate).

Employers are legally required to personally notify certain employees that they may be eligible for the earned income tax credit (EIC) and may receive the credit in advance as part of their wages. The easiest way for employers to comply is to either have IRS Notice 797, "Possible Federal Tax Refund Due to the Earned Income Credit (EIC)," printed on the back of the Form W-2 or sent to all employees with their copy of the Form W-2. Employers should not change the language of the notice. Accountants can learn more about the EIC and employers' duties in IRS Pub. 15. IRS forms and publications related to the EIC can be obtained by calling 1-800-TAX-FORM. The IRS has an electronic tool kit that helps tax preparers understand and assist their clients in claiming the earned income credit at **www.eitc.irs.gov/rptoolkit/main/**.

Other Authorized Deductions. To accurately compute an employee's net pay, the accountant must know the nature and amount of other payroll deductions (for example, for retirement plans, insurance, or loan repayments). The Fair Labor Standards Act (FLSA) requires the payroll records to clearly show the date, amount, and description of deductions from wages; many computerized payroll accounting systems produce a deductions register that lists such information.

Reporting New Employees. All states and U.S. possessions have a State Directory of New Hires where employers are required to send information about newly hired employees that is checked against the state's records of individuals with outstanding child support obligations, and is then forwarded to Washington, D.C. where it is checked against the national database. When a match is found at the state level, the state Office of Child Support Enforcement sends a withholding notice to the employer of the new hire, directing the employer to withhold the required child support from the employee's pay. When a match is found at the national level evidencing an outstanding child support obligation in a different state, the federal Office of Child Support Enforcement sends an interstate withholding notice to the employer of the new hire, directing the employer to withhold the required child support from the employee's pay. Additional information on new hire reporting is available on the Administration for Children and Families (within the Department of Health and Human Services) website at **www.acf.hhs.gov/programs/cse/newhire/employer/private/newhire.htm**.

Federal law mandates that new hires be reported within 20 days of the date of hire. However, states are given the option of establishing reporting timeframes that may be shorter than 20 days. Employers must adhere to the

reporting timeframe of the state to which they report. Employers should check with their state contact to learn the state's requirements.

The information required to be reported is the name, address, and social security number of each new employee. A copy of the employee's Form W-4 can be used to provide the required information, or the employer can develop its own equivalent form. The report must also contain the employer's name, address, and employer identification number.

Although most states plan to require only the basic information noted previously, some states may require additional data. The state should notify employers of its required data elements.

Multistate employers have two reporting options. They may report newly hired employees to the state in which they are working, or alternatively, they may submit all new hires to a single state. If employers choose to report all new employees to only one state, they should notify the Department of Health and Human Services (DHHS) with written notification of their choice. The DHHS has developed a form that employers may (but are not required to) use for that purpose. Notification should be mailed to the following address:

Department of Health and Human Services
Administration for Children and Families
Office of Child Support Enforcement
Multistate Employer Registration
P.O. Box 509
Randallstown, MD 21133

Employers may also register online at www.acf.hhs.gov/programs/cse/newhire/employer/private/newhire.htm.

If the company is a multistate employer and reports to a single state, it should include the following information in the notification to DHHS:

- The company's name and address.
- The company's federal employer identification number.
- A contact person within the company and a telephone number.
- The state to which new hires will be reported.
- The states in which the employer has employees.

Hours Worked

The number of normal and overtime hours worked (if an employee is nonexempt) should be provided as soon as possible after the end of the pay period. Generally, the number of normal and overtime hours worked can be determined by reviewing time cards or approved time sheets. An indication of whether the normal withholdings reflected on each employee's Employee Payroll Information Sheet are to apply can also be provided.

Determining What Type of Time Was Used. Not all time is compensated at the same rate; some time worked is paid at the regular rate, some at an overtime rate, and some leave time is unpaid. To properly process a payroll, the accountant must first determine what type of time has been used.

Generally, the employee includes a description of how the time was spent (work, vacation, sick leave, and so forth) on the time card or time sheet. Based on that description, the employer then indicates what type of time was used. While the business usually categorizes leave into detailed subcategories (such as holiday, vacation, sick leave, jury leave, and family and medical leave) in order to administer leave benefits, the primary distinction for wage calculations is whether the time was worked time, paid leave, or unpaid leave. In categorizing the time used, the accountant should be aware that under the FLSA:

- *Paid or Unpaid Leave Does Not Count Towards Overtime.* For example, no overtime is incurred when an employee takes a paid holiday and works 40 hours during the remainder of the workweek. The paid holiday

is considered paid leave, not time worked, and the employee did not exceed 40 hours worked. Vacations, holidays, sick leave, and other paid or unpaid leave should not be considered in determining if more than 40 hours were worked during the workweek.

- *Only the Excess of 40 Hours Worked during the Workweek Is Considered Overtime Hours.* Under the FLSA, the employer should accumulate the first 40 hours worked during the workweek as regular hours, and then consider any excess to be overtime. For example, if a part-time employee works 30 hours in the workweek instead of the usual 20, the employer incurs no overtime liability, because the hours worked did not exceed 40.
- *Each Workweek Stands Alone.* Time worked during one workweek cannot be averaged with the time worked in a second workweek, even if the two weeks are in the same pay period. For example, if a nonexempt employee that is paid biweekly works 45 hours during the first workweek and 35 hours the second, the employer must pay overtime for the extra five hours worked during the first week.

Some states, however, may have different wage and hour rules (that may be more advantageous to the employee), such as requirements that overtime pay be based on the number of hours worked in a day, the number of days worked in a week, or working a specific day of the week.

Avoiding Delays in Receiving Information

To provide payroll services efficiently, it is critical that payroll information be received on time. Delays in receiving information can often be avoided if accountants:

- Educate the employer about why the requested information is needed and provide assurances that confidentiality will be maintained.
- Obtain an understanding with the employer about the information that is needed and the consequences of providing that information late (i.e., that payroll checks or payroll tax returns will not be delivered on time).
- Clearly state when the information is needed. (For most small to medium-sized companies, establishing due dates two days prior to the pay date will allow sufficient time to process the employer's payroll.)

When a CPA firm processes a client's payroll, receiving and transmitting payroll information quickly is an important consideration. Thus, it may be tempting to receive (or send) payroll information via fax. Due to the confidential nature of the information, that practice should be avoided. If a fax is used, however, particular care should be taken to ensure that only authorized personnel will receive it.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. Corgi Inc. engages its accountant, Harry, to help it prepare to process payroll. One of Harry's tasks is to assist the company in applying for its employer identification number (EIN). The company's first payroll checks are ready to go out to employees, so the company would like to get its EIN as quickly as possible and use it immediately. Which of the following methods would be the best choice for Harry to use to apply for the EIN under these circumstances?
 - a. Mail.
 - b. Fax.
 - c. Telephone or online.
6. Breakwater Inc. decides to apply for an EIN over the telephone. Under these circumstances, is Sally, the company's accountant, allowed to place the call?
 - a. Yes, as accountants are allowed to sign Form SS-4.
 - b. Yes, if additional steps are taken.
 - c. No, as she is not allowed to sign the form.
 - d. It is up to the discretion of Sally's employer.
7. Stacy, a CPA, is engaged to prepare payroll for Applecart Enterprises. One of her tasks is to make sure she has all the necessary employee information. Greta, one of the employees of Applecart, recently got married and took her husband's name. Greta informs Stacy of the change via email. Should Stacy make this change in the payroll records?
 - a. Yes.
 - b. No.
8. Stacy gathers employee information for her payroll preparation engagement. How should she verify the social security numbers (SSNs) of new employees?
 - a. Using Form W-2.
 - b. Using Form W-4.
 - c. Using Form SS-5.
 - d. Directly with the Social Security Administration (SSA).
9. In which of the following circumstances has LittleCo correctly dealt with an issue related to an employee's withholding status and the Form W-4?
 - a. Alison does not fill out Form W-4 before her first paycheck is issued, so LittleCo withholds as if she is single with no exemptions.
 - b. LittleCo retains all signed, paper Forms W-4 for four years and retains all electronic Forms W-4 for two years and then destroys them.
 - c. LittleCo has its accountant recommend the appropriate number of withholding allowances to all of its employees.
 - d. Gregory gets a divorce. He files an amended Form W-4 with LittleCo within 30 days of the event to decrease his withholding allowances.

10. Megan is a single mother with one qualifying child. She earns \$33,500 annually. Does Megan qualify for the earned income credit (EIC)?
- a. Yes.
 - b. No.
11. Lewis, a CPA, is engaged to prepare payroll for a small business client. When categorizing time worked for nonexempt employees, which of the following Fair Labor Standards Act (FLSA) rules should Lewis keep in mind?
- a. Paid leave counts toward overtime.
 - b. Overtime occurs when over 40 hours are worked in one workweek.
 - c. Workweeks in the same pay period can be combined.
 - d. All time is compensated at the same rate of pay.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

5. Corgi Inc. engages its accountant, Harry, to help it prepare to process payroll. One of Harry's tasks is to assist the company in applying for its employer identification number (EIN). The company's first payroll checks are ready to go out to employees, so the company would like to get its EIN as quickly as possible and use it immediately. Which of the following methods would be the best choice for Harry to use to apply for the EIN under these circumstances? **(Page 14)**
 - a. Mail. [This answer is incorrect. When applying by mail, Form SS-4 should be completed at least four to five weeks before the EIN is needed. Of all the possible methods, applying by mail takes the longest amount of time; therefore, this method would not be the best one for Harry to use in this scenario.]
 - b. Fax. [This answer is incorrect. Taxpayers can receive their EIN within four business days by applying by Fax-TIN. Though this method has a faster response than some of the available application methods, there is another choice Harry can make that will allow him to deliver the EIN to his client more quickly than if he used the fax method.]
 - c. **Telephone or online. [This answer is correct. Before paying its first employee wages, a business should obtain an EIN by filing Form SS-4 with the IRS. In some cases, the employer will ask the accountant to assist the business in applying for an EIN. If the application is made via the telephone or online, taxpayers can receive their EIN and use it immediately to file a return or make a payment. Therefore, Harry should use one of these two methods to assist Corgi Inc. with obtaining its EIN.]**
6. Breakwater Inc. decides to apply for an EIN over the telephone. Under these circumstances, is Sally, the company's accountant, allowed to place the call? **(Page 15)**
 - a. Yes, as accountants are allowed to sign Form SS-4. [This answer is incorrect. According to the instructions of Form SS-4, representatives who are allowed to sign the form include (1) an individual (for individual applicants); (2) the president, vice president, or other principal officer (for corporations); (3) a duly authorized member or officer having knowledge of its affairs (for partnerships or other unincorporated organizations); and (4) the fiduciary (for trusts and estates). This list provided in the instructions of the form does not allow accountants to sign Form SS-4.]
 - b. **Yes, if additional steps are taken. [This answer is correct. When an EIN is applied for over the telephone, the individual making the call must be authorized to sign the form. An accountant may obtain an EIN for his or her client if the client has completed the "Third Party Designee" portion of Form SS-4.]**
 - c. No, as she is not allowed to sign the form. [This answer is incorrect. According to the instructions of Form SS-4, it is possible for Sally to obtain an EIN for her client if she has the proper documentation.]
 - d. It is up to the discretion of Sally's employer. [This answer is incorrect. There are requirements concerning who can apply for an EIN over the telephone and authorized signatories of the form itself. These requirements are included in the instructions to Form SS-4. Therefore, Breakwater Inc. must follow these instructions when deciding whether to have Harry make the phone call to apply for the company's EIN.]
7. Stacy, a CPA, is engaged to prepare payroll for Applecart Enterprises. One of her tasks is to make sure she has all the necessary employee information. Greta, one of the employees of Applecart, recently got married and took her husband's name. Greta informs Stacy of the change via email. Should Stacy make this change in the payroll records? **(Page 17)**
 - a. Yes. [This answer is incorrect. Stacy has not received all of the information necessary to change Greta's name in the payroll records, so based on the Social Security Administration and the IRS's guidelines, the change should not be made.]

- b. **No. [This answer is correct. Because the employee's name is used by the Social Security Administration and IRS, the accountant should not change an employee's name (such as through marriage or divorce) in the payroll records until the employer has verified that the employee has a revised social security card. Because Stacy does not have verification of a revised social security card in this scenario, she should inform Greta that the payroll records will not be changed until that verification is received.]**
8. Stacy gathers employee information for her payroll preparation engagement. How should she verify the social security numbers (SSNs) of new employees? **(Page 17)**
- a. Using Form W-2. [This answer is incorrect. Form W-2 is not part of the SSN verification process; therefore, Stacy would not use it under these circumstances. Businesses need to keep their employees' address data current so they can fulfill their legal obligations to deliver Forms W-2, benefit plan information, and insurance notices.]
- b. Using Form W-4. [This answer is incorrect. The business (or the accountant) should gather employees' SSNs when the employees complete Form W-4 (Employee's Withholding Allowance Certificate). However, though Form W-4 is used to gather the SSN information from employees, to verify SSNs, Stacy will need to perform additional processes separate from Form W-4.]
- c. Using Form SS-5. [This answer is incorrect. Employees needing to obtain or revise a social security card should complete Form SS-5 (Application for a Social Security Card). Verification of SSNs by the business (or the accountant) requires a different procedure that does not include the use of Form SS-5.]
- d. **Directly with the Social Security Administration (SSA). [This answer is correct. Federal agencies may impose fines on employers who report wage information with inaccurate or missing SSNs. Employers can verify the SSNs of new employees directly with the SSA. SSA will verify employee names and numbers for Form W-4 purposes. The SSA has two internet options for verifying SSNs using the SSN Verification Service (SSNVS). In addition to the internet options, up to 10 names and numbers can be verified by using an automated telephone service, Telephone Number Employer Verification (TNEV), that is very similar to the SSNVS.]**
9. In which of the following circumstances has LittleCo correctly dealt with an issue related to an employee's withholding status and the Form W-4? **(Page 20)**
- a. **Alison does not fill out Form W-4 before her first paycheck is issued, so LittleCo withholds as if she is single with no exemptions. [This answer is correct. To properly withhold federal income taxes and calculate an employee's net wages, the employer must ask each new employee to complete a Form W-4 before or on employment commencement. Form W-4 informs the accountant of the number of withholding allowances claimed by the employee. Such claims then determine the amount of federal income tax that should be withheld from the employee's gross pay. If the employee has not submitted a valid Form W-4 in time to calculate his or her first payroll, the employer must withhold federal income taxes as if the employee is single with no exemptions. Therefore, LittleCo has properly withheld federal income taxes for Alison in this scenario.]**
- b. LittleCo retains all signed, paper Forms W-4 for four years and retains all electronic Forms W-4 for two years and then destroys them. [This answer is incorrect. The employer should retain the signed original Forms W-4 (no copies) for four years after the company files the related annual employment tax returns. Forms W-4 in electronic form should also be retained for four years. Therefore, in this scenario, LittleCo has not retained its electronic Forms W-4 for a long enough time period.]
- c. LittleCo has its accountant recommend the appropriate number of withholding allowances to all of its employees. [This answer is incorrect. Because claims for excessive allowances and exemptions may result in civil and criminal penalties, neither the employer nor the accountant should suggest or recommend to the employee a number of withholding allowances. Accountants and employers, however, can refer employees to Form W-4 and its instructions, IRS Pub. 919, and Pub. 505. Accountants and

- employers also can refer employees to the IRS online W-4 Withholding Allowance Calculator. Any of these options would be preferable for LittleCo and the company's accountant in this scenario.]
- d. Gregory gets a divorce. He files an amended Form W-4 with LittleCo within 30 days of the event to decrease his withholding allowances. [This answer is incorrect. The IRS requires that employees file an amended Form W-4 within 10 days of an event that decreases their number of withholding allowances. Therefore, Gregory did not file his amended Form W-4 by the appropriate deadline in this scenario.]
10. Megan is a single mother with one qualifying child. She earns \$33,500 annually. Does Megan qualify for the earned income credit (EIC)? **(Page 23)**
- a. **Yes. [This answer is correct. Employees with income less than an annually designated amount (\$40,545 for taxpayers that are married filing jointly in 2010 with one qualifying child; \$35,535 for all other taxpayers in 2010 with one qualifying child) may qualify for an advance EIC that will increase the paycheck amount. The annual amount can be found in IRS Publication 15. Based on the facts in this scenario, Megan qualifies for the EIC because her annual income is under the applicable amount for 2010.]**
- b. No. [This answer is incorrect. According to the annually designated amount available in IRS Publication 15, Megan qualifies for the EIC. If she wants to receive the EIC, she must file Form W-5.]
11. Lewis, a CPA, is engaged to prepare payroll for a small business client. When categorizing time worked for nonexempt employees, which of the following Fair Labor Standards Act (FLSA) rules should Lewis keep in mind? **(Page 24)**
- a. Paid leave counts toward overtime. [This answer is incorrect. Under FLSA, vacations, holidays, sick leave, and other paid or unpaid leave should not be considered in determining if a nonexempt employee worked overtime during the work week.]
- b. **Overtime occurs when over 40 hours are worked in one workweek. [This answer is correct. Under the FLSA, the employer should accumulate the first 40 hours worked during the workweek as regular hours, and then consider any excess to be overtime. Some states, however, may have different wage and hour rules, so Lewis will need to understand those rules, as well as the FLSA rules.]**
- c. Workweeks in the same pay period can be combined. [This answer is incorrect. According to FLSA, each workweek stands alone. Time worked during one workweek cannot be averaged with the time worked in a second workweek, even if the two weeks are in the same pay period.]
- d. All time is compensated at the same rate of pay. [This answer is incorrect. Not all time is compensated at the same rate; some time worked is paid at the regular rate, some at an overtime rate, and some leave time is unpaid. To properly process payroll, the accountant must first determine what type of time has been used. FLSA includes guidance that accountants should be aware of when they categorize time used.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (WUSTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. Grady, a CPA, is engaged to design a payroll system for his small business client. What is the most important thing that the payroll system must do?
 - a. Correspond with state agencies about employee levies and child support.
 - b. Provide the information that the business needs to complete its payroll.
 - c. Verify supporting personnel documentation for new hires.
 - d. Determine medical deductions for each employee.

2. Whammy Inc. needs payroll services that will be accessible 24-hours a day, have a low cost, and offer maximum flexibility; however, due to independence issues, the company would prefer not to have its accountant involved with payroll. What type of payroll services would be the best match for this company?
 - a. Payroll service provider software.
 - b. Traditional payroll service providers.
 - c. Internet payroll services.
 - d. Do not select this answer choice.

3. Betty is a public accountant who provides payroll services. According to the Internal Revenue Service (IRS), what is the minimum amount of time she should keep payroll records after the later of the payroll tax return's due date or the date the taxes were paid?
 - a. Four years.
 - b. Seven years.
 - c. Ten years.
 - d. The records must be maintained permanently.

4. The Bluebonnet Company is concerned with keeping its payroll information confidential. Which of the following steps would help the company meet that goal?
 - a. Giving employees a warning if they breach confidentiality.
 - b. Spreading payroll duties over as many employees as possible.
 - c. Allowing employees access to payroll records only upon request.
 - d. Requiring all employees to sign confidentiality agreements.

5. Sarah, a CPA, is engaged to process the payroll information of Baker's Dozen. List all of the information she will need related to the employer in order to complete this engagement accurately.
- i. Name, address, and social security number.
 - ii. Employer identification number (EIN).
 - iii. Advanced earned income (EIC) status.
 - iv. Number of normal and overtime hours worked.
 - v. Work authorization status.
 - vi. Pay frequency.
 - vii. Information about the workweek.
 - viii. Information about the pay period.
- a. i., ii., and iii.
 - b. ii., vii., and viii.
 - c. ii., iii., vi., and vii.
 - d. i., iii., iv., v., and vi.
6. As defined by the Fair Labor Standards Act (FLSA), what period of time must consist of seven 24-hour periods that fall consecutively?
- a. The workweek.
 - b. The pay period.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.
7. Which of the following employees would be classified as *exempt* under FLSA?
- a. Moe is paid a base salary and also earns commissions. He is paid for the hours he works, plus any overtime.
 - b. Cleo maintains lengthy and accurate daily and weekly records of her hours worked.
 - c. Jan is paid a fixed salary for all her work during the workweek. Her salary does not vary based on the quantity or quality of her work.
 - d. Tom arrives late to work three different times during the workweek, and the missing hours are deducted from his salary.
8. Which of the following employers has correctly dealt with an issue related to their employees' work authorization status?
- a. Alpha Company allows employees to use expired documents as proof of identification.
 - b. Beta Company retains Form I-9 for all employees for a maximum of one year after employment commences.
 - c. Gamma Company has all employees complete Section 1 of Form I-9 prior to beginning work.
 - d. Delta Company only verifies the identity and employment authorization of those who match a profile.

9. GoldenCo establishes an electronic filing system that allows its employees to file and make changes to their Forms W-4. Which of the following best describes how GoldenCo must address the issue of requests to use paper Forms W-4?
- a. The company can require that all employees use the electronic system; therefore, the company does not have to maintain a paper Form W-4 option.
 - b. The company should have a paper option reasonably available for employees who object to the electronic system or whose access to/ability to use the electronic system is limited.
 - c. The company can allow employees to file paper Forms W-4 if the employees so choose, but the company does not have to make any special provisions or share any information on the subject.
 - d. The company's system for filing paper Forms W-4 must be as extensive and detailed as its electronic filing system.
10. GoldenCo should do which of the following when accepting and processing Forms W-4?
- a. Withhold federal income taxes based on the employee's original Form W-4.
 - b. Send copies of all employees' Forms W-4 to the IRS.
 - c. Verify all employees' withholding exemptions on the IRS's behalf.
 - d. Verify that employees' have claimed all exemptions to which they are entitled.
11. GoldenCo reports all new hires to the State Directory of New Hires, as well as the national database, within 20 days of the hire date. If a match is found in one of these databases, what must GoldenCo withhold from the new hires' pay?
- a. Retirement plan contributions.
 - b. Insurance payments.
 - c. Loan repayments.
 - d. Child support.

Lesson 2: Payroll Information Processing and Depositing Payroll Taxes

INTRODUCTION

The first section of this lesson discusses processing payroll information, including topics such as computing gross pay and employment taxes, making other payroll deductions, recording payroll information, reconciling the payroll bank account, and reconciling employee payroll deductions. The lesson concludes with a discussion of the requirements for depositing federal payroll taxes, which includes a look at the coupon and electronic deposit methods, when deposits are due, and applicable penalties for late deposits.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the information needed to process payroll and adhere to FLSA status for employees, and calculate gross pay and employment taxes.
- Identify requirements for depositing federal payroll taxes.

PROCESSING PAYROLL INFORMATION

After all the necessary payroll information has been obtained, payrolls can be processed—that is, payroll checks can be prepared and payrolls can be recorded on the general ledger. When computerized payroll systems are used, payroll processing is almost automatic. Once employee data, pay rates, and withholding information have been entered into the payroll software, the accountants need only enter the number of hours worked during the period by nonexempt employees and, if normal withholdings are not to apply, adjust the withholding information stored in the payroll system. The payroll software then calculates gross pay and all withholdings. Payroll records are automatically posted and relevant tax return data are stored. When payroll information is processed manually, more effort is normally involved. The procedures and calculations are relatively straightforward, however, and generally require nothing more than the accountants' time, a knowledge of how to use withholding tables, and some calculator skills.

Regardless of whether manual or computerized payroll systems are used, it is important that accountants understand the steps needed to process payroll information. The following paragraphs provide guidance for (a) computing gross pay, employment taxes, and other payroll deductions and (b) recording payroll information.

Computing Gross Pay

In most instances, the calculation of gross pay is fairly simple and depends largely on whether the employee is considered exempt or nonexempt from the Fair Labor Standards Act's (FLSA's) minimum wage and overtime requirements. Two areas of interest to investigators in the U.S. Department of Labor's (DOL) Wage and Hour Division are violations of minimum wage laws and improperly classifying hourly employees as exempt from overtime pay. The DOL has a website at www.dol.gov/elaws that walks employers through questions regarding complying with the FLSA. The DOL's Fair Pay Overtime Initiative defines exemptions from the FLSA for "white-collar" employees. Among other things, the initiative sets the salary threshold (below which workers would automatically qualify for overtime) as \$455 a week. The rule also includes the definitions of *executive*, *administrative*, *professional*, *outside sales reps*, and *computer professional*. (See Exhibit 2-1.) The rule also exempts from overtime pay employees earning \$100,000 or more annually and performing nonmanual work if they met even just one, but not all, of the elements of the duties test for an exempt employee. Exhibit 2-1 lists job positions that are considered exempt from FLSA. Exhibit 2-2 presents the federal definition of the more common exempt groups. (Generally, the employer, not the accountant, should determine whether an employee's position is exempt or nonexempt from FLSA. Consequently, a detailed discussion of exempt and nonexempt job positions is beyond the scope of this course.) The following paragraphs discuss the calculation of gross pay for both exempt and nonexempt employees.

Exempt Employees. The gross pay of exempt employees is computed by dividing the annual salary by the number of pay periods during the year. For example, if a company pays its employees twice each month (i.e., 24 times each year) the gross pay each pay period of an employee earning \$36,000 annually would be \$1,500 ($\$36,000 \div 24$). Exempt employees generally receive the same gross pay each pay period regardless of the number of hours worked. Therefore, for those employees, accountants can calculate the first payroll of the year and simply duplicate that payroll until employee salaries or deductions change.

In some cases, however, companies may enter into unusual compensation arrangements with their employees. For example, an employee may be paid a commission, a bonus based on company or department performance, or a combination of salary and bonus. In those cases, the calculation of gross pay can become complex. Accountants should carefully review any such arrangements and compute gross pay in accordance with compensation agreements. (In some instances, income tax withholdings on such compensation may be based on a flat rate of 25%.)

Prevent the Loss of Exempt Status. As discussed above, exempt employees should generally receive the same gross pay each pay period regardless of the number of hours worked or the quality of the work performed. If a company varies the pay of an exempt worker, wage and hour auditors may reclassify employees from exempt to nonexempt and award backpay.

The FLSA only permits reductions in these specific circumstances:

- Absence for personal business, but only in whole day units.
- Absence for sickness or disability, but only in whole day units. Additionally, the business must have insurance covering such incidents or have a practice of traditionally providing compensation benefits for such incidents.
- Absence for family or medical leave.
- Penalties for violating safety rules if assessed in good faith and for major safety infractions.
- Prorations of salary during initial and terminal weeks.

The three common practices that may forfeit the exempt status are—

- deductions in units of less than a day (except for family and medical leave),
- deductions for lateness, and
- partial week suspensions without pay.

The employer should place a very high priority on protecting its FLSA exemptions and especially on preventing unallowed deductions from exempt employee salary or accrued leave.

**Exhibit 2-1
FLSA Exemptions**

Fully Exempt from Minimum Wage and Overtime Pay	Fully Exempt from Overtime Pay	Partially Exempt from Overtime Pay	Partially Exempt from Minimum Wage
Executive employees	Employees of a railroad	Hospital and nursing home employees	Learners and student learners
Administrative employees	Employees of a motor carrier	Employees of certain wholesale petroleum distributors	Apprentices
Professional employees	Employees of an airline	Employees working under certain union contracts	Handicapped workers
Computer professionals	Seamen on American vessels		Messengers
Outside salespeople	Announcers, news editors, and engineers of small radio and TV stations	Employees processing tobacco	Full-time students
Employees of certain seasonal amusement or recreational establishments	Drivers and their helpers paid under an approved trip plan	Employees who gin cotton	Teenage trainees
Employees engaged in fishing and fish processing of products at sea	Agricultural employees	Employees who process sugar	
Babysitters and companions to the sick and aged	Employees of nonprofit irrigation systems		
Certain agricultural employees	Maple sap processing employees		
Employees of certain small newspapers	Transporters of farm products		
Seamen on foreign vessels	Taxicab drivers		
Newspaper deliverers	Live-in domestic servants		
Homeworkers making evergreen wreaths	Certain employees of small loggers		
Elementary and secondary school students	Motion picture theater employees		
	Certain livestock auctioneers		
	Retail commission salespersons		
	*	*	*

Exhibit 2-2

FLSA White-collar Exemptions

Pay and Nonexempt Work

Other Qualifications

Executive—A bona fide executive employee meets *all* the following tests:

- | | |
|---|---|
| <ol style="list-style-type: none"> 1. Is compensated for services on a salary basis at a rate of not less than \$455 per week, exclusive of board, lodging, and other facilities. 2. Does not devote more than 20% of working time to activities that are not directly and closely related to the work described in column 2. | <ol style="list-style-type: none"> 1. Primary duty must be managing the enterprise, or a recognized department or subdivision of the enterprise; 2. Must customarily and regularly direct the work of at least two or more other full-time employees or their equivalent; and 3. Has the authority to hire or fire other employees, or whose suggestions and recommendations about hiring or firing, advancement and promotion, or any other change of status are given particular weight. |
|---|---|

Administrative employee—A bona fide administrative employee meets *all* the following requirements:

- | | |
|--|--|
| <ol style="list-style-type: none"> 1. Is compensated for services on a salary basis at a rate of not less than \$455 per week, exclusive of board, lodging, and other facilities. 2. Does not devote more than 20% of working time to activities that are not directly related to the exempt duties described in column 2. | <ol style="list-style-type: none"> 1. Primary duty must be the performance of office or nonmanual work directly related to management policies or general business operations of the employer or the employer's customers; and 2. Must customarily and regularly exercise discretion and independent judgment with respect to matters of significance. |
|--|--|

Professional—A bona fide professional employee meets *all* the following requirements:

- | | |
|--|---|
| <ol style="list-style-type: none"> 1. Is compensated for services on a salary basis at a rate of not less than \$455 per week, exclusive of board, lodging, and other facilities. 2. Does not devote more than 20% of working time to activities that are not directly related to the exempt duties described in column 2. | <p>For the learned professional</p> <ol style="list-style-type: none"> 1. Primary duty must consist of work requiring knowledge of an advanced type, defined as work which is predominantly intellectual and varied in character (as opposed to routine mental, manual, mechanical, or physical work) and which includes work that requires the consistent exercise of discretion and judgment in its performance; 2. The advanced knowledge must be in a field of science or learning; and 3. The advanced knowledge must be customarily acquired by a prolonged course of specialized intellectual instruction. |
|--|---|

For the **creative** professional

1. Primary duty must be the performance of work that is original and creative in character, requiring invention, imagination, originality, or talent in a recognized field of artistic or creative endeavor (as opposed to work that can be produced by a person endowed with general manual or intellectual ability and training).

Pay and Nonexempt Work

Other Qualifications

Outside Salesperson—A bona fide outside salesperson meets *all* the following requirements:

- 1. No salary requirement.
- 2. Does not devote more than 20% of the work hours of a nonexempt employee involved in nonexempt duties. Work performed incidental to and in conjunction with the employee’s own outside sales or solicitations, including incidental deliveries and collections, is considered exempt work.

- 1. Is employed for the purpose of, and is customarily and regularly engaged away *from the employer’s place of business* in, making sales or obtaining orders or contracts for services or for the use of facilities for which the client or customer will pay a consideration.

Computer Professional—A bona fide computer professional meets *all* the following requirements:

- 1. Is compensated for services on a salary basis at a rate of not less than \$455 per week, exclusive of board, lodging, and other facilities; or
- 2. Paid at an hourly rate of not less than \$27.63 per hour.

Must be employed as a systems analyst, programmer, software engineer, or other similarly skilled worker in the computer field; and primary duty must consist of one or more of the following:

- 1. The application of systems analysis techniques and procedures, including consulting with users, to determine hardware, software, or system functional specifications;
- 2. The design, development, documentation, analysis, creation, testing, or modification of computer systems or programs, including prototypes, based on and related to user or system design specifications;
- 3. The design, documentation, testing, creation, or modification of computer programs related to machine operating systems; or
- 4. A combination of the aforementioned duties, the performance of which requires the same level of skills.

Highly Compensated Employee—A highly compensated employee meets *all* the following requirements:

- 1. Is compensated at least \$100,000 annually which must include at least \$455 per week, exclusive of board, lodging, and other facilities.

- 1. Must perform office or nonmanual work;
- 2. Must perform at least one of the duties of an exempt executive, administrative, or professional employee identified in the standard tests for exemptions.

* * *

Nonexempt Employees. For nonexempt employees, gross pay usually is computed by multiplying the hourly pay rate by the number of hours worked (or to be compensated for as paid leave) during the pay period. For example, the gross pay of an employee receiving \$8.50 per hour and working 40 hours during the pay period would be \$340 (\$8.50 × 40 hours).

Overtime. If overtime hours are worked, the calculation of gross pay becomes more complex. Under the FLSA, employers are required to pay overtime to workers in nonexempt positions who work more than 40 hours during the workweek. (A handful of states require overtime pay based on the number of hours worked during a day or the number of days worked during the week). The FLSA requires no overtime pay for employees in exempt positions regardless of the hours worked.

The FLSA requires employers to keep records of pay for overtime hours. Overtime pay represents 1.5 times regular rate multiplied by hours worked in excess of 40. For example, assume the employee has a regular wage rate of \$8.50. The straight time (nonovertime) pay for the employee working 56 hours during the workweek would be \$340

$(\$8.50 \times 40 \text{ hours})$, overtime premium pay would be $\$204 [(\$8.50 \times 1.5) \times (56 - 40 \text{ hours})]$, and total wages would be $\$544$.

To calculate the overtime pay, the accountant first determines the amount of regular and overtime hours. The accountant then determines the overtime rate and calculates the overtime pay. The following paragraphs briefly discuss these two activities.

The employee's overtime rate equals 1.5 times the *regular rate*. The FLSA defines the regular rate as the workweek's total *includable compensation* before any overtime pay divided by the workweek's total hours worked.

Includable compensation consists of the employee's basic hourly wages for the workweek plus commissions; incentive, on-call, attendance, quality, production, and hazard bonuses; suggestion awards; and noncash compensation. In practice, most businesses consider the employee's basic hourly rate to be the regular rate. While this is often true, it is not always true, and the accountant and employer need to understand that differences exist.

The regular rate may change weekly as the employee earns different amounts of includable compensation (such as production bonuses, commissions, standby pay) and works different numbers of hours. Significant expense and penalties could be assessed for miscalculation of employee overtime.

For example, an employee has a base hourly rate of $\$9.00$. During the workweek, the employee worked 45 hours. In addition, the business paid the employee a production bonus of $\$50$ for the week. The regular rate for the week is calculated as follows:

$$(45 \text{ hours} \times \$9.00) + \$50 \text{ (bonus)} = \$455 \div 45 \text{ hours} = \$10.11 \text{ hourly regular rate}$$

The additional $\$1.11$ per hour ($\$10.11 - \9.00) results entirely from the $\$50$ bonus.

The employee's pay is then calculated using the regular rate, rather than the $\$9.00$ base hourly rate, as follows:

$$(40 \text{ hours} \times \$10.11) + [(45 - 40) \times \$10.11 \times 1.5] = \$480.23 \text{ total pay}$$

Once the accountant has determined the overtime hours and overtime rate, the accountant simply multiplies the two to determine the overtime pay. Ideally, the accountant can use a computerized payroll system to record overtime pay separately from regular pay. Management often can use the separate overtime pay number to gauge the effectiveness of staffing and scheduling. In addition, the business usually needs to know nonovertime wages in order to calculate accurately workers' compensation and various benefit plan premiums.

Classifying Time between Work and Not Work. Federal statutes and regulations outline in detail what constitutes time worked for nonexempt employees. Exhibit 2-3 describes those regulatory distinctions. In some cases, state law, contract, or employer's practice may alter the treatment of time not considered worked. In addition, the transportation industry has special regulations.

Exhibit 2-3

Classifying Time Worked for Nonexempt Employees

Work Time	Not Work Time
<ul style="list-style-type: none"> • Overtime hours about which the employer has knowledge or reason to believe is occurring. • Work at home about which the employer has knowledge or reason to believe is occurring. • Meal periods during which employee is not completely relieved of duties or lasting less than 30 minutes. • Changing clothes or washing when required by the nature of the work or for the employer’s convenience. Putting on protective equipment worn by employees that is required by law, by the employer, or due to the nature of the job. • Charitable work, if requested or controlled by the employer. • Maintaining machinery or preparing tools. • Necessary activities to change shifts. • Medical care, received at the work site during work hours, or medical care received at the employer’s order. • Rest periods lasting 20 minutes or less (even if employees request that breaks be unpaid). • Time spent waiting to learn that work is available (show-up time) or to receive work instructions. • Time spent waiting during the workday while on duty. • Time spent traveling from the employer’s office to a customer’s office or between worksites to perform work. • Time spent in emergency travel from employee’s home to customer’s site <i>after</i> the ordinary workday. (Regulations do not address the emergency travel from the employee’s home to the employer’s office.) • During a “within the day” business trip, the time spent traveling between the airport and the trip destination, except for meal times. • During an overnight business trip, time spent traveling during the normal business hours (even if travel is on weekends).^a • Time spent “on call” when the employee’s movement and use of time is restricted. • Time spent in training programs, unless attendance is voluntary, outside regular work hours, if the program does not involve productive work and is not directly related to employee’s current job. 	<ul style="list-style-type: none"> • Overtime hours worked against the employer’s authorization and about which the employer has no knowledge or reason to know. • Work at home about which the employer has no knowledge or reason to know. • Lunch periods lasting at least 30 minutes, where employee is free to leave the workstation and is completely relieved of all duties. (Note: Some courts use a relief standard of substantial, rather than all, duties.) • Changing clothes or washing, if only for the employee’s convenience. • Charitable work, if performed outside normal work hours and the employee volunteers. • Time not worked because the entire plant is shut down for machinery maintenance. • Time spent by showing up early for a shift change, when neither the employer nor the nature of the work require it. • Medical care, when employee visits company doctors outside working hours or chooses to have work injury treated by own doctor. • Rest periods (including coffee breaks) lasting more than 20 minutes. • Time spent waiting for work to start. • Time spent traveling between the employee’s home to the employer’s office or work site for regular work hours. However, if the employee drives a company car from home to the worksite (or the reverse), the commute time is work time, unless the vehicle is used within the normal commuting area for the employer’s business and is subject to an agreement between the employer and employee. • During a “within the day” business trip, the time spent traveling between the employee’s home and the airport, train station, or bus depot. • During an overnight business trip, time spent as a passenger traveling outside normal business hours or spent in meal periods. However, if work is required during the travel, then the time worked is work time. • Time spent “on call” when the employee’s use of time is unrestricted. (Courts are divided regarding what constitutes a restriction. Requiring a maximum response time may be a restriction.) • Time spent in an independent school program, even though job related.

Work Time	Not Work Time
<ul style="list-style-type: none"> • Time spent sleeping, when tour of duty lasts less than 24 hours. (Special rules apply when tour of duty is longer than 24 hours.) • Time during the workday spent performing incidental activities that are not an integral part of the employee's duties if the employer benefits, controls the time, and "suffers or permits" the work. Such activities may also be compensable under a contract, employer practice, or custom. • Time spent before, during, or after the workday performing incidental activities that are an integral part of the employee's principal duties. Examples are filing time and expense reports, cleaning out company fleet vehicles, requesting supplies, and making bank deposits. 	<ul style="list-style-type: none"> • Time spent during the workday performing incidental activities that are not an integral part of the employee's duties, if the employee is completely free of work duties for at least 30 minutes. • Time spent before or after the workday performing incidental activities that are not an integral part of the employee's duties, unless required by contract, policy, or custom.

Note:

- ^a When the employee drives instead of taking public transportation (such as planes) for an out-of-town trip, the employer can base payment upon the time the public transportation would have taken.

* * *

Rounding Payroll Calculations. Overtime calculations frequently produce fractional cents (for instance, \$8.75 for time-and-one-half is \$13.125). Some companies round at this point and calculate overtime based on a rounded overtime rate of \$13.13. Other companies use fractional cents throughout the calculation and round the calculated result. For instance, five hours of overtime could be paid as overtime wages of \$65.65 (\$13.13—the rounded overtime rate—for five hours) or it could be paid as overtime wages of \$65.63 (the rounded wages resulting from calculating \$13.125 for five hours, or \$65.625). Either method is acceptable. However, it is important that calculations be made consistently for all employees.

Employer's Payment of Employee's Taxes (Grossed-up Wages). Employers can pay the employee's income tax and FICA taxes on wages and benefits given. For example, the employer may prefer not to deduct cash from the employee's paycheck for a noncash benefit, such as excess group-term life insurance, or the employer may want the employee to receive a specific amount as the net bonus or pay the employee's portion of employment taxes or moving expenses.

However, the employer's payment of the employee's taxes is in itself taxable compensation. To calculate the amount needed to pay for the employee's tax and all the resulting compounding of taxes, the employer can use the following formula:

$$\text{Final Payment} = \frac{\text{Net Amount to Employee}}{1 - \text{Cumulative Tax Rate}}$$

For example, assume the employer wishes to pay the tax on \$122.80 of excess group-term life insurance value an employee realizes. The employer assumes Miss Scarlett has a FIT rate of 15% and a FICA rate of 7.65%. The employer calculates that the "grossed up" fringe benefit value is \$158.76 $\{ \$122.80 \div [1 - (15\% + 7.65\%)] \}$, and the company must pay Miss Scarlett \$35.96 $(\$158.76 - \$122.80)$ in additional wages to cover her portion of the employment taxes (but not the employer's portion) on the benefit.

Computing Employment Taxes

Current federal tax law provides for the following types of employment taxes:

- *Federal Income Tax Withholding.* Employers must withhold personal income taxes from employees' wages and remit the withholdings directly to the federal government or its depository bank.
- *Social Security and Medicare Taxes (FICA).* Employers and employees are subject to FICA taxes. Employers must withhold the taxes from employee wages and pay a matching amount. Employers then

must remit their payments, along with employee withholdings, directly to the federal government or its depository bank.

- *Unemployment Taxes.* Only employers are subject to federal and state unemployment taxes; no amounts are withheld from employees.

Employers also may be required to withhold federal income taxes (backup withholding) on payments to certain independent contractors. In addition, employers must withhold and pay employment taxes imposed by state laws. (State employment taxes vary depending on the laws of each state. Accordingly, a detailed discussion of state employment tax requirements is beyond the scope of this course.)

Who Is Subject to Federal Employment Tax Laws? Individual workers generally fall into one of two classes: employees of the business or independent contractors (i.e., self-employed individuals who have contracted to perform work for the business). The process of determining whether a worker is an employee or an independent contractor is called *worker classification*. A business must withhold and pay employment taxes on employee wages, provide employee benefits, and observe certain employee rights during employment. A business does not need to give independent contractors the same treatment and some benefits, such as qualified retirement plan benefits, can only be offered to employees. The definition of employee under each of the federal employment tax laws is as follows:

- *Federal Income Tax Withholding.* For federal income tax withholding purposes, individuals are generally classified by the common-law concept of employee. That is, they are employees if the payor has the right to control how the work is performed. Certain individuals are classified as employees and non-employees by law, however. For example, federal income tax withholding regulations consider compensated corporate officers employees and licensed real estate agents and direct sellers as nonemployees. Federal income tax regulations and related court decisions should be referred to for guidance in determining the status of individuals.

Years ago, the IRS developed a list of 20 factors it considered indicative of the employer-employee relationship. Responding to voters, however, Congress halted further IRS implementation of detailed regulations defining the employee and independent contractor relationships. In response to changes implemented in the Small Business Job Protection Act, the IRS in 1996 instructed its agents to modify their application of the 20 factors. The IRS has since codified a methodology called the *categories-of-evidence*, which includes the categories of behavioral control, financial control, and the type of relationship. This guidance is generally broader and less specific than the 20-factor test. Even though the IRS stresses the new methodology, a business is advised to consider all the factors that might indicate its control of how the work is performed. Exhibit 2-4 lists the 20 common-law factors (as modified by the categories-of-evidence methodology). IRS Pub. 15-A, "Employer's Supplemental Tax Guide," includes industry-specific examples. The classification of individuals should be documented.

The IRS estimates millions of workers are misclassified as independent contractors, depriving the federal government of huge sums of tax revenue because of underreported income and related unpaid employment taxes. To combat this, worker classification is a primary issue in most payroll audits and continues to be a major area of emphasis for the IRS. IRS auditors are expected to take a tougher stance if businesses have too much control over workers to justify independent contractor status. The IRS will use leads from workers, who can file a special form [Form 8919 (Uncollected Social Security and Medicare Tax on Wages)] if the workers think they have been misclassified. In addition, the IRS has entered into data-sharing agreements with several state workforce agencies to refer employment tax cases for audit.

- *Federal Unemployment Taxes.* Generally, individuals are classified the same for FUTA taxes as they are for federal income tax withholding. An exception, however, is that FUTA regulations consider certain agent (or commission) drivers and traveling salespersons as employees.
- *Social Security and Medicare Taxes.* FICA regulations add full-time life insurance agents and certain homeworkers to FUTA's list of employees.

Exhibit 2-4

IRS Factors for Evaluating Independent Contractors

CATEGORY ONE: DEGREE OF BEHAVIORAL CONTROL^a

1. **Instructions.** If the payor has the legal right (whether used or not) to mandate when, where, or with what tools, personnel, and methods the work is done, the payor has an employer's right to control how the work is performed.
2. **Training.** Through training, the payor controls how the work should be performed, which is more common to an employer-employee relationship.
3. **Specifying the Worker.** Payors can exercise control by selecting only workers who use approved methods, which is more common to an employer-employee relationship.
4. **Available to the Public.** A separate economic entity will present itself as such to the public, which is more common to an independent contractor relationship.
5. **Employing Assistants.** If the worker hires, supervises, and pays assistants, these activities imply an economic entity that is separate from the payor, which is more common to an independent contractor relationship.
6. **Hours of Work.^b** Specifying precisely when the work can be performed is an integral part of how the work should be performed, which is more common to an employer-employee relationship.
7. **Full-time Effort.^b** Full-time workers usually are economically dependent upon the payor. Workers who are economically dependent upon the payor are generally employees.
8. **Job Location.^b** Specifying where the work can be performed is an integral part of how the work should be performed, which is more common to an employer-employee relationship.
9. **Sequence of Work.** Specifying the sequence of the work is an integral part of how work is to be performed, which is more common to an employer-employee relationship.
10. **Reporting.** Required reporting by the worker implies that the payor has the right to exercise control over how the work is performed, which is more common to an employer-employee relationship.

CATEGORY TWO: DEGREE OF FINANCIAL CONTROL

11. **Fixed Pay.** Employees sell labor (measured by time), while independent contractors sell a product or service (measured by results).
12. **Reimbursements.** To control reimbursed expenses, payors will exercise control over methods used, which is more common to an employer-employee relationship.
13. **Tools and Supplies.** An independent business will possess the necessary tools and equipment. Payors can exercise control over workers (employees) methods used through the selection of the tools and supplies and the supervision of their use.
14. **Risk of Loss.** The opportunity for financial loss or gain implies a separate economic entity controlled by an active management, which is more common to an independent contractor relationship.
15. **Substantial Investment.** A substantial investment by the worker implies a separate economic entity, which is more common to an independent contractor relationship.
16. **Outside Work.** A separate economic entity can give equal priority to work for other parties, which is more common to an independent contractor relationship.

CATEGORY THREE: RELATIONSHIP OF THE PARTIES

17. **Integration.** A business will control how its ordinary and necessary activities are performed, which is more common to an employer-employee relationship.
18. **Termination.** Payor-IC relations are contractual; employer-employee relations are under common law.
19. **Quit.** Payor-IC relations are contractual; employer-employee relations are under common law.
20. **Continuing Relationship.** Long-standing and continuous workers are more likely to be economically dependent upon the payor. Workers who are economically dependent upon the payor are generally employees.
21. **Employee Benefits.^c** If worker receives benefits given to employees, worker may be an employee.
22. **Intent of Parties.^c** Demonstration of the parties' mutual intent for the worker to be IC weighs toward IC treatment.

Notes:

- a IRS training materials indicate these factors will be given less weight when the worker is in a professional occupation when instructions result from a government mandate.
- b IRS 1996 training materials indicate that it no longer considers this factor very relevant, although it relied on it in the past.
- c Not one of the original 20 factors, but the 1996 IRS Training Manual indicates that it will be considered a factor in the future.

* * *

Many types of businesses and employees receive special treatment under the employment tax laws. Accountants should refer to IRS Publication 15, "Employer's Tax Guide," to determine whether any of their clients' employees should receive special treatment. IRS Publication 15 can be obtained by calling 1-800-TAX-FORM or at www.irs.gov.

What Compensation Is Taxed? Generally, wages paid to employees for services performed are subject to federal employment taxes. (For that purpose, wages generally include cash or the cash value of any remuneration paid in another medium.) The taxation of fringe benefits such as employee discounts, low-cost lunches, free use of employer-owned automobiles, club memberships, and low-cost loans is less clear, however. As a general rule, fringe benefits are subject to employment taxes unless they are excluded by a specific section of the Internal Revenue Code. The amount of fringe benefit subject to tax is the fair value of the benefit less the amount paid for it by the employee and less any amount the law excludes from taxation.

Classes of fringe benefits that are specifically excluded from taxation include the following:

- *No-additional-cost Fringe Benefits.* When employers incur substantially no additional costs to provide a benefit, its value is not taxable. Industries that traditionally provide such benefits include airlines, hotels, railroads, and health clubs. The benefit must be provided within the line of business that the employee works, however. For example, if the employer operates a hotel chain and an airline, a hotel employee cannot receive a tax-free airline ticket. In addition, the employee cannot displace a paying customer.
- *Qualified Employee Discounts.* Employee discounts that do not exceed the product's gross profit or 20% of the service's price are nontaxable so long as the discounts are available to all employees. The exemption does not apply to real estate or personal property held for investment, however. In addition, similar to no-additional-cost fringe benefits, the discounts must be offered within the line of business that the employee works.
- *Working Condition Fringe Benefits.* The fair value of any property or services provided to employees is nontaxable if (a) employees would have been entitled to a tax deduction if they had personally incurred the costs, (b) the employees' use of the property or service is related to the employer's trade or business, and (c) the employees' use of the property is substantiated by adequate records or sufficient evidence corroborating the employees' own statements. Examples include business-related magazine subscriptions, professional dues, and use of a company car for business purposes.
- *De Minimis Fringe Benefits.* Such benefits are those that would otherwise be taxable, but because the goods or services are nominally valuable, accounting for the income is impractical. Examples include the occasional typing and mailing of personal letters by a company administrative assistant, occasional personal use of a company copier, and company picnics. In addition, the value of subsidized meals provided at employer-owned facilities on or near the employer's premises is nontaxable so long as revenue from the facility equals or exceeds the operating costs of the facility.
- *On-Premises Athletic Facility.* An on-premises athletic facility (for example, a tennis court, gym, or exercise center) will qualify for exclusion if the facility is not open to the public.
- *Qualified Transportation Fringe Benefits.* These refer to transit passes, qualified parking, and certain transportation in commuter highway vehicles.

- *Qualified Moving Expense Reimbursement.* These refer to employer reimbursements of an employee's qualified moving expenses (including payments made directly to a third party and services furnished in kind).
- *Qualified Retirement Planning Services.* Qualified retirement planning services include information about the employer's plan, advice and information regarding retirement income planning for an individual, and how the employer's plan fits into the individual's overall retirement plan. However, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal, or brokerage services.
- *Qualified Military Base Realignment and Closure Fringe Benefits.* These refer to one or more payments made under the Homeowners Assistance Program (HAP) to offset the adverse effects on housing values as a result of a military base realignment or closure.

The following discusses the taxability of specific fringe benefits commonly provided by employers:

- *Meals and Lodging.* In certain limited circumstances, employer-provided meals and lodging are nontaxable. The value of meals generally is nontaxable if they are furnished (a) for the employer's convenience and (b) on the employer's premises. The value of lodging is nontaxable if the employer requires the employee to accept such lodging on the employer's premises as a condition of employment and if the lodging is provided for the employer's convenience.
- *Moving Expenses.* Moving expenses are nontaxable if the employer reasonably expects the employee to deduct the expense. Otherwise, the expenses are considered taxable wages.
- *Business Expense Reimbursements.* Business expense reimbursements are generally nontaxable so long as (a) the expense was incurred while performing services as an employee, (b) the employer adequately accounts for and documents the expenses within 60 days of paying them, and (c) the employee returns any reimbursements that exceed the actual or deemed business-related expenses within 120 days after the expense was paid.
- *Automobiles.* The use of employer-provided vehicles is considered a working condition fringe benefit (and thus nontaxable) if it is (a) a substantiated business use of a company vehicle, (b) an employer-provided "qualified nonpersonal use vehicle" (e.g., a bus, delivery truck, or flat-bed truck), (c) an employer-provided security vehicle, or (d) a *de minimis* usage (i.e., very occasional usage). Other employer-provided auto usage is considered personal usage and generally is taxable.

The IRS has established specific requirements for supporting deductions for travel expenses, entertainment expenses, business gifts, and expenses in connection with the business use of automobiles. Taxpayers must be able to substantiate the amount, time, place, and business purpose of those expenses. (The business relationship of the person entertained or receiving business gifts must also be substantiated.) Although a written expense log is not required, the IRS states that an adequate accounting generally requires the submission of an account book, expense diary or log, or similar record maintained by the employee and recorded at or near the time the expense is incurred. In addition, receipts or paid bills generally are required to support lodging and other expenses that exceed \$75. Exhibit 2-5 describes the elements that should be documented for each expense.

**Exhibit 2-5
Documentation Requirements for Certain Business Expenses**

	Amount	Time	Place	Description	Business Purpose	Business Relationship
Travel expenses	Amount of each separate expense for travel, lodging, and meals. (Incidental expenses may be totaled in reasonable categories, such as taxis, daily meals, etc.)	Date employee left and returned for each trip, and number of days for business	Name of city or other designation	Not applicable	Business reason for travel or the business benefit gained or expected to be gained	Not applicable
Entertainment expenses	Amount of each separate expense. (Incidental expenses, such as taxis, telephones, etc., may be totaled daily.)	Date of entertainment or use of a facility for entertainment For meals or entertainment directly before or after a business discussion, the date and duration of the business discussion	Name and address or location of place where entertainment occurred, or the location of any facility used for entertainment Type of entertainment (if not otherwise apparent) Place where business discussion was held if entertainment is directly before or after a business discussion	Not applicable	Business reason or the business benefit gained or expected to be gained Nature of business discussion or activity	Occupations or other information, such as names or other designations, about the persons entertained that shows their business relationship to employer. (If all people entertained did not take part in the business discussion, identify those that did. Employers must also prove that they or one of their employees were present if the entertainment was a business meal.)
Business gifts	Cost of gift	Date of gift	Not applicable	Description of gift	Business reason for giving the gift or the business benefit gained or expected to be gained	Occupation or other information (such as name or other designation) that shows the recipient's business relationship to the employer
Automobile expenses	Amount of each separate expense including the cost of the car Mileage for each business use of the car, and Total miles for the tax year	Date of the expense or use	Name of city or other designation if applicable	Not applicable	Business reason for the expense or use of the car	Not applicable

* * *

Federal Income Tax Withholdings. Generally, federal income taxes should be withheld on all salaries, fees, bonuses, commissions on sales or on insurance premiums, taxable fringe benefits, pensions and retirement pay (unless taxed as an annuity) paid as compensation for services.

The amount of withholding will vary depending on each employee's wage, marital status, and withholding allowances claimed on Form W-4. (As previously discussed, the withholding information may be summarized on the Employee Payroll Information Sheet to facilitate payroll processing.) Federal income tax withholding may be computed using any of the methods listed in Exhibit 2-6. The most common methods used, however, are the wage bracket method and the percentage method.

- *Wage Bracket Method.* Accountants can avoid the detailed work of computing withholding amounts by using the wage-bracket tables in IRS Pub. 15-T, "New Wage Withholding and Advance Earned Income Credit Payment Tables." (The examples in this section were prepared using 2010 wages, as the tables for 2011 wages were not available at the time this course went to press.) Different withholding tables are available for each payroll period (for example, weekly, biweekly, semimonthly, etc.) and for single and married employees. To determine withholding amounts, accountants should (a) locate the table applicable to the appropriate marital status and payroll period, (b) locate the wage bracket (first column of the table) in which the wage payment falls, (c) locate the withholding amount on the line for that wage bracket that is listed in the column for the number of allowances claimed by the employee, and (d) add any additional amount of voluntary withholding that was requested by the employee to the amount determined in (c).

To illustrate, the withholding amount for a married employee that is paid semimonthly is found on the Married Persons—Semimonthly Payroll Period withholding table. If, during 2010, the employee is paid \$2,000 semimonthly and claims four allowances, the withholding amount is \$102. If the employee is paid \$1,500 and claims two allowances, the withholding amount is \$73.

- *Percentage Method.* Income tax withholdings are determined using IRS rate tables. Different rate tables are available for each payroll period and for single and married employees. To determine the amount of income tax withholdings, accountants should (a) multiply the amount allowed for one withholding allowance for the particular pay period by the number of allowances claimed by the employee, (b) subtract the amount in (a) from the employee's wages, and (c) compute the amount to withhold based on the amount determined in (b) and the appropriate rate table. IRS rate tables can be found in IRS Pub. 15-T, "New Wage Withholding and Advance Earned Income Credit Payment Tables." (The examples in this section were prepared using 2010 wages, as the tables for 2011 wages were not available at the time this course went to press.)

To illustrate, assume that, during 2010, an unmarried employee claiming two allowances is paid \$500 weekly. The income tax withholding of \$30.14 would be computed as follows:

Total wage payment		\$ 500.00
Adjustment for one allowance for weekly pay periods	70.19	
Allowances claimed	<u>× 2</u>	\$ (140.38)
Wages subject to withholding		<u>\$ 359.62</u>
Withholding per Table 1—Weekly Payroll Period, Single Person {\$8.40 + [(\$359.62 - \$200) × 15%]}		<u>\$ 32.34</u>

Exhibit 2-6**Federal Income Tax Withholding Methods**

Method	Comments^a
Percentage method	See IRS Pub. 15-T, "New Wage Withholding and Advance Earned Income Credit Payment Tables."
Wage bracket tables	See IRS Pub. 15-T.
Alternative formula for percentage withholding	Useful for computerized payroll systems. See IRS Pub. 15-T.
Wage bracket percentage method withholding table	Useful for computerized payroll systems. See IRS Pub. 15-T.
Combined income, employee social security, and employee Medicare tax table	See IRS Pub. 15-T.
Annualized wage method	See IRS Pub. 15-T.
Average estimated wage method	See IRS Pub. 15-T.
Cumulative wage method	Useful for commission salespersons. See IRS Pub. 15-T. Employee must make a written request, and employer must consent.
Part-year employment method	Useful for temporary or seasonal employees working less than 245 days a year. See IRS Pub. 15-T. Employee must make a written request, and employer must consent.
Additional voluntary withholding	Employee must indicate additional amounts on Form W-4.
Other alternative methods	See IRS Pub. 15-T.
Nonresident aliens	Withholding is subject to treaty obligations. See IRS Pub. 515, "Withholding of Tax on Nonresident Aliens and Foreign Entities."
Third-party sick pay	See IRS Pub. 15-A, "Employer's Supplemental Tax Guide."
Withholding on pensions and annuities	See IRS Pub. 15-A.

Note:

^a IRS publications can be ordered by calling 1-800-TAX FORM or at www.irs.gov.

* * *

Generally, federal income tax withholdings are reported to the Internal Revenue Service on Form 941 (Employer's Quarterly Federal Tax Return), Form 944 (Employer's Annual Federal Tax Return), Schedule H (Form 1040) (Household Employment Taxes), or Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees). Federal income tax withholdings are reported annually to the employee on Form W-2 (Wage and Tax Statement).

Federal Income Tax Withholdings on Supplemental Wages. Supplemental wages are compensation paid to employees in addition to their regular wages. Examples include (but are not limited to) bonuses, commissions, tips, overtime pay, awards, prizes, backpay, retroactive pay increases, accumulated sick leave, severance pay, vacation pay, reimbursed employee business expenses (under a nonaccountable plan), taxable fringe benefits, and payment of reimbursed nondeductible moving expenses. The IRS allows employers to withhold a flat 25% for wages paid in 2010 on supplemental wages. (Withholdings on supplemental wages in excess of \$1 million should be at 35%.) Alternatively, if income tax was previously withheld during the year on the employee's regular wages, the employer may calculate withholding on the combined total of supplemental and regular wages for the most recent payroll period and withhold the difference between the calculated combined withholding and the amount already withheld on the regular wages. If income tax was not previously withheld on the employee's regular wages (for example, due to low pay and a large number of allowances), the combined calculation should be used.

Generally, federal income tax withholdings on supplemental wages are reported quarterly to the IRS on Form 941 (Employer's Quarterly Federal Tax Return) or annually on Form 944 (Employer's Annual Federal Tax Return). Federal income tax withholdings on supplemental wages are reported annually to the employee on Form W-2 (Wage and Tax Statement).

Federal Income Tax Withholdings on Taxable Noncash Fringe Benefits. Four considerations are important when calculating the withholding for taxable noncash fringe benefits. (Noncash fringe benefits were discussed earlier in this lesson.):

- Taxable noncash fringe benefits are supplemental wages. Thus, withholding amounts should be computed at a flat 25% rate or in accordance with the supplemental wage rules described above.
- Employers may choose to treat taxable noncash benefits as paid on a pay period, quarterly, semiannually, annually, or on another basis (but at least annually). Different periods may be chosen for different employees, and the period may be changed (so long as all benefits paid are included in the tax year). Employers may also treat a single benefit payment as paid throughout the year.
- Employers may elect to not withhold income tax on the personal use of company-owned vehicles. (Social security and Medicare taxes must be withheld, however.) The election need not apply uniformly to all employees.
- Taxable noncash fringe benefits given in November or December may be treated as paid in the following year. The election need not be made for all noncash fringe benefits paid in November or December, but it must be made for all employees receiving the particular benefit.

Generally, federal income tax withholdings on taxable noncash fringe benefits are reported quarterly to the Internal Revenue Service on Form 941 (Employer's Quarterly Federal Tax Return) or annually on Form 944 (Employer's Annual Federal Tax Return). Federal income tax withholdings on taxable noncash fringe benefits are reported annually to the employee on Form W-2 (Wage and Tax Statement).

Backup Withholding. The IRS requires companies to withhold income taxes at 28% on payments to nonemployees made in 2010 if either of the following conditions exist:

- The independent contractor did not furnish a taxpayer identification number (TIN). (For individuals, the TIN is the social security number; for corporations and partnerships, the TIN is the federal employer identification number.)
- The IRS informs the company that the TIN furnished by the nonemployee is invalid.

Backup withholdings are reported annually to the Internal Revenue Service on Form 945 (Annual Return of Withheld Federal Income Tax). Backup withholdings are reported annually to nonemployees on payroll information returns such as Form 1099-MISC (Miscellaneous Income).

Social Security and Medicare Withholding. The Federal Insurance Contributions Act (FICA) provides for a system of old-age, survivors, disability, and hospital insurance. The insurance is financed through the assessment of social security taxes (for old-age, survivors, and disability insurance) and Medicare taxes (for hospital insurance). The taxes are levied equally on both employers and employees. Employers collect the employees’ portions of the taxes through payroll deductions. Those deductions, along with the employers’ matching amounts, are then paid to the federal government and reported on employment tax returns by the employers.

For 2010, the amounts that should be withheld from employee wages are as follows:

- Social security tax—6.2% of the first \$106,800 of each employee’s wages.
- Medicare tax—1.45% of each employee’s wages (no annual ceiling).

To illustrate computing withholdings for social security and Medicare taxes, assume that an employee’s gross pay for the current pay period is \$5,000, and the employee’s 2010 year-to-date gross pay (prior to the current pay period) is \$104,000.

Calculation of social security withholding

Current period gross pay		\$ 5,000
Gross pay in excess of wage limit:		
Year-to-date gross pay (including the current pay period) (\$5,000 + \$104,000)	\$ 109,000	
Social security wage limit	106,800	<u>(2,200)</u>
Current period gross pay subject to social security withholding		2,800
Social security withholding rate		× <u>6.20%</u>
Current period social security withholding		<u>\$ 174</u>

Calculation of Medicare withholding

Current period gross pay		\$ 5,000
Medicare withholding rate		× <u>1.45%</u>
Current period Medicare withholding		<u>\$ 73</u>

Social security and Medicare withholdings are reported to the Internal Revenue Service on Form 941 (Employer’s Quarterly Federal Tax Return), Form 944 (Employer’s Annual Federal Tax Return), Schedule H (Form 1040) (Household Employment Taxes), or Form 943 (Employer’s Annual Federal Tax Return for Agricultural Employees). Social security and Medicare withholdings are reported annually to the employee on Form W-2 (Wage and Tax Statement).

Unemployment Taxes. The Federal Unemployment Tax Act (FUTA) together with state unemployment systems provides for payments of unemployment compensation to workers that have lost their jobs. Most employers pay federal and state unemployment taxes to fund the following two-tier system:

- *State Level.* Each state sets its state unemployment insurance (SUI) tax rate and wage base so that sufficient funds are raised to pay anticipated benefit claims (and provide a surplus for solvency). State rates currently vary from 0% to 12.27%, and the wage base levels range from \$7,000 to \$36,800.
- *Federal Level.* The federal government sets a federal unemployment tax rate and wage base sufficient to establish a pool from which states may borrow if their benefit funds become depleted. The federal tax rate currently is 6.2% (6% basic rate and a .2% temporary surtax that is scheduled to expire after June 30, 2011) and the wage base is \$7,000.

Special FUTA coverage tests apply to agricultural and household employers. Also, services performed for Section 501(c)(3) tax-exempt organizations are not subject to FUTA.

State and federal unemployment taxes are interrelated. The federal government generally allows employers a credit against FUTA taxes of up to 5.4% (90% of the 6% basic FUTA tax rate) for fully paying state unemployment taxes. (The credit generally is allowed even if the employer's state unemployment tax rate is less than 5.4%.) Thus, an employer that fully pays its state unemployment taxes would actually be assessed federal unemployment taxes of 0.8% (6.2% – 5.4%).

The employer should contact its state employment authority for copies of the state's definition of employee, definition of wages, tax rate tables, and other information.

Employers must calculate and deposit FUTA taxes quarterly. To illustrate calculating the FUTA tax liability, assume that a company has three employees whose wages during the year were as follows:

	<u>YTD wages as of the end of the</u>			
	<u>1st Qtr</u>	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>
M. Jones	\$ 5,500	\$ 11,000	\$ 16,500	\$ 22,000
B. Dugan	6,000	12,000	18,000	24,000
A. Roberts	<u>8,000</u>	<u>16,000</u>	<u>24,000</u>	<u>38,500</u>
	<u>\$ 19,500</u>	<u>\$ 39,000</u>	<u>\$ 58,500</u>	<u>\$ 84,500</u>

Calculation of 1st quarter FUTA tax liability

Total year-to-date wages	\$ 19,500
Less wages in excess of FUTA limit:	
A. Roberts (\$8,000 – \$7,000)	<u>(1,000)</u>
Wages subject to FUTA	18,500
FUTA tax rate (assuming that state unemployment taxes were fully paid)	<u>× 0.8 %</u>
FUTA tax liability	<u>\$ 148</u>

Calculation of 2nd quarter FUTA tax liability

Total year-to-date wages	\$ 39,000
Less wages in excess of FUTA limit:	
M. Jones (\$11,000 – \$7,000)	\$ 4,000
B. Dugan (\$12,000 – \$7,000)	5,000
A. Roberts (\$16,000 – \$7,000)	<u>9,000</u>
Year-to-date wages subject to FUTA	21,000
Less wages subject to FUTA in 1st quarter	<u>18,500</u>
	2,500
FUTA tax rate (assuming that state unemployment taxes were fully paid)	<u>× 0.8 %</u>
FUTA tax liability	<u>\$ 20</u>

Calculation of 3rd and 4th quarter FUTA liability

No FUTA tax is due since all of the wages paid in the 3rd and 4th quarters were in excess of the FUTA wage limit for each employee.

Federal unemployment taxes are reported annually to the Internal Revenue Service on Form 940 (Employer's Annual Federal Unemployment FUTA Tax Return).

Correcting Withholding Errors. Errors in withholding are treated differently depending on whether taxes are overwithheld or underwithheld and on whether the error is corrected before or after filing quarterly tax returns (Form 941) or annual tax return (Form 944).

- *If Payroll Taxes Are Overwithheld and the Error Is Discovered before Filing Form 941 or Form 944*, the employer should return the overwithholding to the employee before the Form 941 or Form 944 is filed and obtain a signed receipt showing the date and amount repaid.
- *If Payroll Taxes Are Underwithheld and the Error Is Discovered before Filing Form 941 or Form 944*, the employer should report the correct amount of withholdings on Form 941 or Form 944, pay the employee's portion of taxes that were underwithheld, and deduct the needed withholdings from the employee's next payroll check. However, any underwithheld income tax generally must be recovered by December 31.
- *If Payroll Taxes Are Overwithheld and the Error Is Discovered after Filing the Employment Tax Return*, the employer filing Form 941 must (a) settle with the affected employees by either repaying the employees or obtaining written consent from the affected employees to file a claim on their behalf, and (b) file a claim for refund or credit. Overcollected federal income taxes (for a prior calendar quarter in the same year) are reported on Form 941-X. Overcollected FICA taxes are reported on Form 941-X. Since Form 944 is filed annually, any overwithheld federal income taxes cannot be reported as an adjustment. Corrections for income tax withholding may be made only for administrative errors. Adjustments for overwithheld social security and Medicare taxes are reported on Form 944-X.
- *If Payroll Taxes Are Underwithheld and the Error Is Discovered after Filing the Employment Tax Return*, the employer must report the adjustment on a timely filed Form 941 for the calendar quarter in which the error is ascertained. Undercollected federal income tax (for a prior calendar quarter in the same year) and undercollected FICA taxes plus the employer's share of FICA taxes are reported on Form 941-X. Since Form 944 is filed annually, any underwithheld federal income taxes cannot be reported as an adjustment. Corrections for income tax withholding may be made only for administrative errors. Adjustments for underwithheld social security and Medicare taxes are reported on Form 944-X. The underwithheld FICA taxes do not have to be collected from the employee within any specific time period. Underwithheld federal income taxes generally must be recovered by December 31.

It should be noted that employers are liable for withholding errors caused by payroll software. Therefore, an employer or accountant using payroll software (or a payroll service) to calculate tax withholdings should routinely review the withholding calculations for reasonableness. The payroll register's totals should be reviewed to determine if withholdings are as expected (consistent with other similar pay periods) and if any individual employee amounts appear unusually high or low. The total Medicare withholdings should always be 1.45% of the total Medicare wages. For employees with 2010 year-to-date earnings equal to or less than \$106,800, the social security withholdings should be 6.20% of the social security wages. If the software lists the employer portions of FICA taxes, the amounts should match the employee withholdings. When implementing new payroll software, the employer or accountant should run selected past payrolls (especially the year-end close) and compare the withholding results from the new software to past results for accuracy.

Other Payroll Deductions

Accountants may be required to compute a number of payroll deductions in addition to federal, state, and local employment taxes. Many of the deductions benefit the employees by funding insurance or retirement plans. Such deductions often may be subtracted from gross wages before computing income tax and FICA withholdings. Other deductions, such as those for creditor garnishments, tax levies, and mandatory child support, may be less popular with employees. Accountants should be familiar with the requirements, tax treatments, and limitations of all payroll deductions offered by their clients to ensure that the deductions are computed accurately.

Recording Payroll Information

Recording payroll information is an automatic function of most computerized payroll and general ledger systems. The software posts the information on the general ledger and prints (or produces the information necessary to prepare) quarterly and annual payroll tax returns and employee W-2s. When payroll is prepared manually, however, accountants must summarize the information for each pay period and record it on the general ledger through

journal entries. They must also summarize the information by employee to provide the quarterly and year-to-date information necessary to prepare payroll tax returns and employee W-2s.

Recording Payrolls on the General Ledger. In most cases, wages, payroll taxes, and withholdings for each pay period are summarized (in total or by department) and recorded on the general ledger through two journal entries—one to record wages and employee withholdings and another to record the employer portion of payroll taxes. For example, assume that a company's payroll checks totaled \$12,935 and consisted of the following:

Gross wages		\$ 18,500
Withholdings:		
Federal income taxes	\$ 3,450	
Social security	1,147	
Medicare	268	
Insurance	700	<u>5,565</u>
Net pay		<u>\$ 12,935</u>

Assume further that the wages paid are subject to federal unemployment taxes of 0.8% and state unemployment taxes of 2.8%. The company's payroll would be recorded on the general ledger through the following entries:

Salaries	\$ 18,500	
Federal income tax withheld		\$ 3,450
FICA taxes payable (\$1,147 + \$268)		1,415
Insurance payable		700
Cash		12,935

To record salaries and employee withholdings.

Payroll taxes	\$ 2,081	
FICA taxes payable		\$ 1,415
FUTA taxes payable (\$18,500 × .8%)		148
State unemployment taxes payable (\$18,500 × 2.8%)		518

To record the company's portion of payroll taxes.

(While it is preferable to record the FUTA and SUTA taxes as part of the payroll journal entry, many businesses with small FUTA and SUTA taxes expense the taxes quarterly.)

Maintaining a Payroll History for Each Employee. Accountants must post payrolls to provide quarterly and year-to-date payroll information by employee so that payroll tax returns and employee W-2s can be prepared. As previously discussed, recording payroll information is an automatic function of most computerized payroll and general ledger systems. However, it also can be accomplished by completing an "Employee Earnings History Form" (or something similar) for each employee. The form accumulates an employee's gross wages; wages subject to social security, Medicare, and unemployment taxes; withholdings; and net pay for each pay period. In addition, the form provides for quarter and year-to-date totals of those amounts. As a result, accountants can obtain the information needed to prepare quarterly and annual tax returns by totaling quarterly and year-to-date amounts for all employees.

Reconciling the Payroll Bank Account

As discussed in Lesson 1, it is possible for a business to use a separate bank account for payroll. However, due to the extra effort involved, using a separate account might be preferred only under certain circumstances. If the business chooses to use a separate bank account, the account should be reconciled monthly. The procedures and forms for reconciling the account are the same as those used for the business's regular cash account.

The accountant should follow the applicable state laws when dealing with outstanding (uncashed) payroll checks. These laws are called escheat laws, and the accountant can obtain information about them from the state (usually the secretary of state or state controller) or an attorney.

Reconciling Employee Payroll Deductions

Accountants should reconcile the deductions made from employees to the deductions remitted to benefit plan providers, insurers, the IRS, courts, and other payees. A reconciliation should be made because a business has a legal duty to forward such funds and not use them for general business purposes. Sometimes the timetable for making the remittances is set by state law; in other cases, it is part of a contractual agreement between the business and the employees. Although it is the business’s responsibility to make timely remittances, accountants should periodically confirm that the business is aware of the appropriate deadline and provide assistance when it is requested.

Accountants may perform the reconciliation by analyzing monthly the general ledger accounts used to record the employer’s liability. For example, the accountants may perform the following analysis of the health insurance withholdings account (used to record amounts withheld from employees to pay for health insurance).

<u>Description</u>	<u>Amount</u> <u>Dr. (Cr.)</u>
Components of March’s beginning balance:	
February withholdings	\$ (1,250)
February liability for B. Brown on COBRA	(50)
Beginning balance	<u>(1,300)</u>
Added withholdings:	
March 1 payroll	\$ 300
March 8 payroll	300
March 15 payroll	325
March 22 payroll	325
March 29 payroll	325
Total added withholdings	<u>1,575</u>
Remittances:	
AAAA Insurance 3/15/X4 check #123	1,300
Other:	
Coverage for B. Brown during COBRA election period	<u>(50)</u>
March’s ending G/L balance	<u>\$ (1,625)</u>

This analysis shows that (a) the \$1,300 remittance of the February deductions was timely and (b) the amounts paid match those withheld.

Accountants should perform a similar monthly analysis on each deduction’s general ledger account.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Carlos is an employee of SmallCo. He makes \$47,000 annually and is classified as an exempt employee. SmallCo pays its employees semimonthly. Assuming no unusual compensation arrangements or bonuses apply, calculate his gross pay.
 - a. \$903.85.
 - b. \$1807.69.
 - c. \$1958.33.
 - d. \$3916.67.

13. The following individuals are all employed by SmallCo and are classified as exempt employees. Which one is in danger of having his exempt status revoked?
 - a. Morgan is absent from work for one full day for personal reasons.
 - b. Collin's salary is prorated by SmallCo during his first week of employment.
 - c. Gene misses work for the duration of her medical leave.
 - d. Benjamin is suspended by SmallCo for three days without pay.

14. Donna is a nonexempt employee of SmallCo. She is paid \$9 per hour. During the previous workweek, Donna worked 46 hours. Calculate her gross pay for this workweek.
 - a. \$360.
 - b. \$414.
 - c. \$441.
 - d. \$621.

15. Which of the following nonexempt employees of SmallCo can classify their time spent as work time? (List all that qualify.)

Linda works overtime hours at her company's request.

Mark takes a 30-minute lunch break away from his desk, free from his duties.

Sheila volunteers for charitable work outside of working hours.

Kevin takes a 15-minute rest break.

Rebecca spends two evenings a week on-call, and her ability to leave home and to use her time is restricted.

 - a. Linda only.
 - b. Linda and Sheila.
 - c. Linda, Mark, and Kevin.
 - d. Linda, Kevin, and Rebecca.

16. What type of employment taxes would SmallCo, but not SmallCo's employees, be subject to?
- Federal income tax withholding.
 - Social security and Medicare taxes (FICA).
 - Unemployment taxes.
17. Which of the following fringe benefits would be excluded from income taxes?
- The Dress Shack offers all employees a 15% discount on store merchandise. The store's merchandise generally makes 20% gross profit.
 - Harmon Enterprises sends their top executives and their spouses to Italy for a week. Two days of the trip will consist of meetings, and the rest of the trip will be planned entertainment.
 - Citywide Motors provides a company sedan to all of its upper-level employees for both work and personal use.
 - Tip Top Finances provides its employees tax preparation, accounting, legal, or brokerage services related to retirement planning.
18. Baker Publishing must withhold taxes on taxable noncash fringe benefits. Which of the following considerations would apply?
- The withholding amount should be a flat 30%.
 - Employers can elect the pay basis when the taxable noncash benefits are paid.
 - Employers do not have to withhold income, social security, or Medicare taxes on personal use of company-owned vehicles.
 - All taxable noncash fringe benefits must be treated as paid in the year given.
19. Louise, an employee of Baker Publishing, earns an annual salary of \$150,000. Calculate the total amount of social security and Medicare taxes that should be withheld from her wages.
- \$2,175.
 - \$6,662.
 - \$8,797.
 - \$11,475.
20. Baker Publishing discovers a withholding error in the payroll taxes that must be corrected. Under what circumstances would Baker Publishing either need to settle with the employee or get permission to file a claim on the employee's behalf?
- Taxes were overwithheld and the error discovered before the return was filed.
 - Taxes were underwithheld and the error discovered before the return was filed.
 - Taxes were overwithheld and the error discovered after the return was filed.
 - Taxes were underwithheld and the error discovered after the return was filed.

21. In which of the following instances has the accountant correctly dealt with an issue related to a payroll engagement?
- a. Roy deducts employees' retirement contributions from gross wages after taxes are computed.
 - b. Deb treats her client's uncashed payroll checks according to the state escheat laws.
 - c. Joe accepts the benefit department reports on deductions and assumes that the employee deductions have been remitted appropriately.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

12. Carlos is an employee of SmallCo. He makes \$47,000 annually and is classified as an exempt employee. SmallCo pays its employees semimonthly. Assuming no unusual compensation arrangements or bonuses apply, calculate his gross pay. **(Page 36)**
- a. \$903.85. [This answer is incorrect. Carlos would earn this much per paycheck if SmallCo paid its employees weekly instead of semimonthly.]
 - b. \$1807.69. [This answer is incorrect. Carlos would earn this much per paycheck if SmallCo paid its employees every other week instead of semimonthly.]
 - c. **\$1958.33. [This answer is correct. Because SmallCo pays its employees semimonthly, Carlos will be paid 24 times per year. The gross pay of exempt employees is computed by dividing the annual salary by the number of pay periods during the year. In this case, the calculation would be $\$47,000 \div 24 = \1958.33 . Exempt employees generally receive the same gross pay each pay period regardless of the number of hours worked. Therefore, for those employees, accountants can calculate the first payroll of the year and simply duplicate that payroll until employee salaries or deductions change.]**
 - d. \$3916.67. [This answer is incorrect. Carlos would earn this much per paycheck if SmallCo paid its employees once per month instead of semimonthly.]
13. The following individuals are all employed by SmallCo and are classified as exempt employees. Which one is in danger of having his exempt status revoked? **(Page 36)**
- a. Morgan is absent from work for one full day for personal reasons. [This answer is incorrect. FLSA permits the reduction of an exempt employee's pay when the absence is for personal reasons, but the absence must take place in whole day units. Therefore, SmallCo is allowed to reduce Morgan's pay under these circumstances.]
 - b. Collin's salary is prorated by SmallCo during his first week of employment. [This answer is incorrect. FLSA permits exempt employees' salaries to be prorated during initial and terminal weeks. Therefore, SmallCo is allowed to reduce Collin's salary under these circumstances.]
 - c. Gene misses work for the duration of her medical leave. [This answer is incorrect. FLSA permits the reduction of an exempt employee's pay when they are absent on family or medical leave. Therefore, SmallCo is allowed to reduce Gene's pay under these circumstances.]
 - d. **Benjamin is suspended by SmallCo for three days without pay. [This answer is correct. FLSA only allows the salary of an exempt employee to be reduced under certain specific circumstances. Three common practices that may cause an employer to forfeit the exempt status are (1) deductions in units of less than a day (except for family and medical leave), (2) deductions for lateness, and (3) partial week suspensions without pay. Because Benjamin's suspension is not one of the circumstances allowed by FLSA, SmallCo is in danger of Benjamin being reclassified to nonexempt status, which might then mean SmallCo would owe Benjamin back pay.]**
14. Donna is a nonexempt employee of SmallCo. She is paid \$9 per hour. During the previous workweek, Donna worked 46 hours. Calculate her gross pay for this workweek. **(Page 39)**
- a. \$360. [This answer is incorrect. If Donna worked 40 hours during the workweek, her gross pay would be \$360 ($\9×40).]
 - b. \$414. [This answer is incorrect. This gross pay was calculated by multiplying Donna's hourly rate (\$9) by the number of hours she worked (46); however, it does not take into account overtime pay.]

- c. **\$441. [This answer is correct. Donna's gross pay is made up of 40 hours at regular pay ($\$9 \times 40 = \360) and 6 hours at overtime pay at time and a half ($\$13.5 \times 6 = \81). Donna's total gross pay is $\$81 + \$360 = \$441$.]**
- d. \$621. [This answer is incorrect. Overtime pay is 1.5 times the employee's hourly rate of pay (for Donna, $\$9 \times 1.5 = \13.5). The calculation used for this amount was $\$13.5 \times 46$. Using this calculation does not correctly take into account the number of hours Donna worked that would be eligible for overtime pay.]
15. Which of the following nonexempt employees of SmallCo can classify their time spent as work time? (List all that qualify.) **(Page 41)**
- Linda works overtime hours at her company's request.
- Mark takes a 30-minute lunch break away from his desk, free from his duties.
- Sheila volunteers for charitable work outside of working hours.
- Kevin takes a 15-minute rest break.
- Rebecca spends two evenings a week on-call, and her ability to leave home and to use her time is restricted.
- a. Linda only. [This answer is incorrect. Because Linda's employer has knowledge about her overtime, Linda can classify her time as time worked. However, Linda is not the only employee on this list whose work is classified as time worked, so this answer is insufficient.]
- b. Linda and Sheila. [This answer is incorrect. If the charity work were requested or controlled by her employer, Sheila would be able to count it as time worked; however, as she volunteered for the work and it occurred outside of normal working hours, Sheila's time is not considered time worked.]
- c. Linda, Mark, and Kevin. [This answer is incorrect. Because Mark is free to leave his workstation and is relieved of his duties, he cannot classify his time as time worked.]
- d. **Linda, Kevin, and Rebecca. [This answer is correct. Federal statutes and regulations outline in detail what constitutes time worked for nonexempt employees. Based on the scenarios listed above, all three of these nonexempt employees can classify their time spent as working hours. Even if Kevin requests that his break be unpaid, his time would be classified as time worked.]**
16. What type of employment taxes would SmallCo, but not SmallCo's employees, be subject to? **(Page 42)**
- a. Federal income tax withholding. [This answer is incorrect. According to federal tax law, employers must withhold personal income taxes from employee's wages and remit the withholdings directly to the federal government or its depository bank. Therefore, the employees are subject to this type of tax.]
- b. Social security and Medicare taxes (FICA). [This answer is incorrect. Employers and employees are subject to FICA taxes under current federal tax law. Employers must withhold the taxes from employee wages and pay a matching amount.]
- c. **Unemployment taxes. [This answer is correct. Under the applicable laws, only employers are subject to federal and state employment taxes; no amounts are withheld from employees.]**
17. Which of the following fringe benefits would be excluded from income taxes? **(Page 45)**
- a. **The Dress Shack offers all employees a 15% discount on store merchandise. The store's merchandise generally makes 20% gross profit. [This answer is correct. Employee discounts are specifically excluded from taxation under the Internal Revenue Code, if they do not exceed the product's gross profit or 20% of the service's price so long as the discount is available to all employees.]**

- b. Harmon Enterprises sends their top executives and their spouses to Italy for a week. Two days of the trip will consist of meetings, and the rest of the trip will be planned entertainment. [This answer is incorrect. Travel expenses related to the business would be excludable, but the portion of the trip not related to work and related to the spouses' travel would be considered a fringe benefit and taxable to the employee.]
- c. Citywide Motors provides a company sedan to all of its upper-level employees for both work and personal use. [This answer is incorrect. According to the Code, the use of employer-provided vehicles is considered a working condition fringe benefit (and, thus, nontaxable) if it is (1) a substantiated business use of a company vehicle, (2) an employer-provided "qualified nonpersonal use vehicle" (e.g., a bus, delivery truck, or flat-bed truck), (3) an employer-provided security vehicle, or (4) a *de minimis* usage (i.e., very occasional usage). Other employer-provided auto usage is considered personal usage and generally is taxable.]
- d. Tip Top Finances provides its employees tax preparation, accounting, legal, or brokerage services related to retirement planning. [This answer is incorrect. Under the Code, retirement planning services qualified for the tax exemption include information about the employer's plan, advice and information regarding retirement income planning for an individual, and how the employer's plan fits into the individual's overall retirement plan. However, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal, or brokerage services.]
18. Baker Publishing must withhold taxes on taxable noncash fringe benefits. Which of the following considerations would apply? **(Page 50)**
- a. The withholding amount should be a flat 30%. [This answer is incorrect. Taxable noncash fringe benefits are supplemental wages. Thus, withholding amounts should be computed at the flat rate mentioned in the supplemental wage rules, which is a rate other than 30%.]
- b. Employers can elect the pay basis when the taxable noncash benefits are paid. [This answer is correct. Employers may choose to treat taxable noncash benefits as paid on a pay period, quarterly, semiannually, annually, or on another basis (but at least annually). Different periods may be chosen for different employees, and the period may be changed. Employers may also treat a single benefit payment as paid throughout the year. The rules for noncash fringe benefits are discussed in the Internal Revenue Code.]**
- c. Employers do not have to withhold income, social security, or Medicare taxes on personal use of company-owned vehicles. [This answer is incorrect. Employers may elect not to withhold income tax on the personal use of company-owned vehicles. Social security and Medicare taxes must be withheld, however.]
- d. All taxable noncash fringe benefits must be treated as paid in the year given. [This answer is incorrect. Taxable noncash fringe benefits given in November or December may be treated as paid in the following year.]
19. Louise, an employee of Baker Publishing, earns an annual salary of \$150,000. Calculate the total amount of social security and Medicare taxes that should be withheld from her wages in 2010. **(Page 51)**
- a. \$2,175. [This answer is incorrect. This answer choice correctly reflects the calculation for the amount of Medicare taxes Baker Publishing would withhold from Louise's wages, but it does not correctly account for the applicable social security taxes.]
- b. \$6,662. [This answer is incorrect. This answer choice correctly reflects the calculation for the amount of social security taxes Baker Publishing would withhold from Louise's wages, but it does not correctly account for the applicable Medicare taxes.]
- c. \$8,797. [This answer is correct. Baker Publishing should withhold \$2,175 in Medicare taxes ($\$150,000 \times 1.45\%$) and \$6,622 ($106,800 \times 6.2\%$) in social security taxes from Louise's wages. There is no annual ceiling for Medicare taxes, but social security taxes are only withheld from the first \$106,800 of an employee's wages.]**

- d. \$11,475. [This answer is incorrect. This answer choice correctly reflects the calculation for the amount of Medicare taxes Baker Publishing would withhold from Louise's wages, but too much was withheld from Louise's wages for the social security taxes based on maximum limits.]
20. Baker Publishing discovers a withholding error in the payroll taxes that must be corrected. Under what circumstances would Baker Publishing either need to settle with the employee or get permission to file a claim on the employee's behalf? **(Page 53)**
- a. Taxes were overwithheld and the error discovered before the return was filed. [This answer is incorrect. Under these circumstances, the employer should return the overwithholding to the employee before the Form 941 or Form 944 is filed and obtain a signed receipt showing the date and amount repaid.]
- b. Taxes were underwithheld and the error discovered before the return was filed. [This answer is incorrect. Under these circumstances, the employer should report the correct amount of withholdings on Form 941 for Form 944, pay the employee's portion of taxes that were underwithheld, and deduct the needed withholdings from the employee's next payroll check.]
- c. **Taxes were overwithheld and the error discovered after the return was filed. [This answer is correct. Under these circumstances, the employer must (1) settle with the affected employees by either repaying the employees or obtaining written consent from the affected employees to file a claim on their behalf and (2) file a claim for refund or credit. Overcollected federal income taxes are reported on Form 941-X. Overcollected FICA taxes are reported on Form 941-X.]**
- d. Taxes were underwithheld and the error discovered after the return was filed. [This answer is incorrect. Under these circumstances, the employer must report the adjustment on a timely filed Form 941 for the calendar quarter in which the error is ascertained.]
21. In which of the following instances has the accountant correctly dealt with an issue related to a payroll engagement? **(Page 54)**
- a. Roy deducts employees' retirement contributions from gross wages after taxes are computed. [This answer is incorrect. Payroll deductions that benefit employees by funding retirement plans often may be subtracted from gross wages before computing income tax and FICA withholdings. Roy's action would be correct only for different types of deductions, such as creditor garnishments or tax levies.]
- b. **Deb treats her client's uncashed payroll checks according to the state escheat laws. [This answer is correct. The accountant should follow the applicable state laws when dealing with outstanding (uncashed) payroll checks. These laws are called escheat laws, and the accountant can obtain information about them from the state (usually the secretary of state or the state controller) or an attorney.]**
- c. Joe accepts the benefit department reports on deductions and assumes that the employee deductions have been remitted appropriately. [This answer is incorrect. Accountants should reconcile the deductions made from employees to the deductions remitted to benefit plan providers, insurers, the IRS, courts, and other payees. A reconciliation should be made because a business has a legal duty to forward such funds and not use them for general business purposes. Although it is the business's responsibility to make timely remittances, accountants should periodically confirm that the business is aware of the appropriate deadline and provide assistance when it is requested.]

DEPOSITING AN EMPLOYERS PAYROLL TAXES

Federal Payroll Tax Deposit Requirements

Generally, employers must deposit federal unemployment taxes, backup withholding, income tax withheld, and both the employer's and employees' social security and Medicare taxes (less any advance payments of the earned income credit) in an authorized financial institution. [Household employers are an exception to that general rule, however. They report federal payroll taxes on Schedule H (Form 1040) (Household Employment Taxes), and pay the taxes directly to the IRS when they file their individual tax returns.]

Many troubled businesses, unaware of the stiff penalties faced by both the business and the responsible individuals, fail to make timely employment tax deposits. If a business fails to withhold employment taxes or to remit the taxes, the IRS can levy a 100% penalty for the taxes due on either (a) the business or (b) the business's individual officers and employees. IRS Pub. 594, "The IRS Collection Process," contains the IRS's explanation of its powers to assess and collect the 100% penalty.

Because banks typically would not knowingly loan a business money to be used for payroll or payroll taxes, the best strategy is for accountants to advise their business clients to never get behind on payroll tax deposits.

This section describes (a) how to determine the amount of payroll taxes to be deposited, (b) the process for depositing the taxes, (c) the required schedule for depositing employment taxes, and (d) the penalties for late deposits.

Determining the Deposit Amount. If taxes are voluntarily deposited when every payroll is run, the amount of FIT and FICA taxes to be deposited can be calculated using the Payroll Tax Deposit Calculation Worksheet as illustrated at Exhibit 2-7. However, since most computerized payroll systems automatically calculate employee and employer payroll taxes, the amounts withheld from the employees and the employer's matching amounts can easily be determined. The payments of advance earned income credit (if any) are obtained from the payroll register. The total deposit should be the amount of the withheld FIT and FICA taxes, plus the employer's matching FICA taxes, less any advance earned income credit payments.

Exhibit 2-7

Payroll Tax Deposit Calculation Worksheet

Company: Blue Creek Industries Pay period: 7-31-X4
 Prepared by: Tom Jackson Date: 8-1-X4

Instructions: This form should be completed immediately upon writing the payroll checks and a deposit made the same day. Enter amounts from the period's payroll.

1. Social security taxes withheld	\$ <u>868.00</u>
2. Medicare taxes withheld	<u>203.00</u>
3. Total FICA taxes withheld (Line 1 + Line 2)	<u>1,071.00</u>
4. Multiply by 2	× <u>2</u>
5. Total employer and employee FICA taxes	<u>2,142.00</u>
6. Add—federal income taxes withheld	+ <u>2,674.25</u>
7. Subtract—advance payments of the earned income credit	—
8. Required payroll tax deposit (Line 5 + Line 6 – Line 7)	<u>\$ 4,816.25</u>

* * *

Making the Deposit. As previously stated, employers generally must deposit federal unemployment taxes, backup withholding, income tax withheld, and both the employer's and employees' social security and Medicare taxes in an authorized financial institution. Through 2010, some businesses were allowed to pay their taxes by depositing a check along with Form 8109 (Federal Tax Deposit Coupon) at their local bank. The U.S. Department of Treasury announced that employers using paper federal deposit coupons must make payroll deposits electronically beginning in 2011. An exception exists for businesses that have \$2,500 or less in quarterly tax liabilities that pay their payroll taxes when filing their quarterly payroll tax return. In August 2010, the IRS issued proposed regulations to implement the U.S. Department of Treasury electronic deposit requirement by requiring employers to remit all employment taxes electronically using the Electronic Federal Tax Payment System (EFTPS) and not allowing deposits to be made on paper deposit coupons. The proposed regulations are expected to be finalized by December 31, 2010, and effective as of January 1, 2011.

Electronic Tax Deposits. Most businesses must make electronic deposits of all depository taxes (for example, employment taxes, corporate income tax, and back-up withholding) using the EFTPS. In order to deposit taxes using EFTPS, taxpayers must enroll either online at www.eftps.gov or by completing Form 9779 (EFTPS—Business Enrollment Form) and mailing it to the EFTPS enrollment center at least 10 weeks prior to the first federal tax deposit or federal tax payment due date. (New employers may be automatically pre-enrolled in EFTPS.) If an employer deposits payroll taxes from one account and corporate tax from another, the employer must complete two Forms 9779. Only the original of the form should be submitted because the form is read by optical scanner (i.e., copies of the form are not acceptable). The form can be obtained by calling the IRS at (800) 555-4477. The IRS also has a centralized number [(866) 255-0654] for its e-help desk, which provides assistance with various IRS electronic filing and payment programs, including EFTPS.

Applicants for employer identification numbers (EINs) that expect to have federal tax obligations will be automatically pre-enrolled in the EFTPS system. Applicants will receive instructions through the mail explaining how to activate their EFTPS enrollment.

When the enrollment process is completed, the employer will receive two separate mailings. One will have a confirmation/update form and a step-by-step instruction booklet. The other mailing will be a letter that includes an enrollment trace number, a personal identification number (PIN), and instructions on how to obtain an internet password. Upon receiving the PIN, an employer may begin making payments by phone. Employers wanting to make payments online must first follow the instructions and obtain an internet password.

The EFTPS website includes several features such as allowing taxpayers to access their payment histories for the past 16 months and to search, print, or download payment history by date, tax type, amount, tax form, and other factors. The site also allows taxpayers to change bank accounts by phone without completing a new enrollment and access links directly from the EFTPS website to states with electronic tax payment systems.

Tax practitioners, accountants, and payroll companies that make payments on behalf of their clients can use EFTPS without having to register. However, their clients must be registered. There are batch provider options for payroll processors and others who wish to enroll their clients and submit batches of payment. There are also bulk provider options for payroll processors who initiate frequent payments from and desire automated enrollment through an Electronic Data Interchange (EDI)-compatible system. For more information see Publication 3425, "4 Easy Ways to Use EFTPS." Under the EFTPS system, the employer may choose to make the transfer using:

- *EFTPS-Direct.* With the EFTPS-Direct option, tax payments are made by the employer accessing EFTPS by internet or by phone at least one calendar day before the deposit due date (no later than 8 p.m. EST) and, by following the prompts, entering the necessary information to complete the tax payment. The employer's PIN must be used in combination with its Taxpayer Identification Number (TIN) to gain access to EFTPS.

The system processes the information reported and, when accepted, sends the employer an Electronic Funds Transfer (EFT) acknowledgement number. This acknowledgement number verifies the timely initiation of payment and, therefore, should be kept by the employer in case of any questions at a later date.

Once the employer's tax payment instructions are accepted, EFTPS originates an Automated Clearing House (ACH) debit transaction against the employer's designated account on the date indicated by the

employer. The funds are then transferred to the Treasury's account, and the tax data is reported to the IRS to update the employer's tax records. No government agency has access to the employer's account.

Once the EFTPS issues an acknowledgement number to the employer, the EFTPS is responsible for processing the payment. Thus, any failure to deposit the tax at that point will not be subject to a late payment penalty provided the employer initiated the transaction on time, requested the correct amount to be withdrawn, recorded the EFT acknowledgement number, and had sufficient funds in the bank account for the withdrawal.

Receipt of an acknowledgement number for an EFTPS-Direct transaction verifies when the necessary payment information was received by the financial agent, but does not constitute proof of payment. The procedure for establishing proof of payment is the same for EFTPS-Direct and EFTPS-Through a Financial Institution payments. The employer must obtain a statement from its bank that (1) shows the amount and the date of the payment and (2) identifies the U.S. government as the payee.

When using the EFTPS-Direct system, employers can initiate the transaction between one and 120 days prior to the tax due date, thus allowing users the option to schedule, or warehouse, their tax payments up to 120 days in advance of payment due dates. With EFTPS warehousing, the payments work the same as other EFTPS payments, except they are stored for future use. However, regardless of when the transaction is initiated, the tax payment is not subtracted from the taxpayer's account until the actual due date. If a transaction is initiated early, the employer has the ability to cancel it anytime up to the business day prior to the due date.

- *EFTPS-Through a Financial Institution.* With the EFTPS-Through a Financial Institution option, which is less convenient than EFTPS-Direct, employers initiate a tax payment at least one day prior to the tax due date by instructing their financial institution to send a payment directly to the Treasury's account at the Federal Reserve Bank. The financial institution will originate an ACH credit transaction to EFTPS, transferring the funds to the Treasury's account and the tax data to the IRS for updating the employer's tax records. In order for the payment to be timely, employers must make the tax payment prior to the financial institution's ACH processing deadline. Not all financial institutions offer this service; therefore, employers should check with their financial institution to learn if they offer this service, how much it costs, and if they are eligible to use it.

Employers using the EFTPS-Through a Financial Institution method remain liable for the timeliness of the deposit until it is credited to the Treasury's account at the Federal Reserve. In other words, merely providing the proper instructions to the bank to make a tax deposit transfer is not enough to avoid a late penalty if the bank makes a mistake. However, the IRS will abate the penalty if the taxpayer establishes that the instructions it provided to its financial institution were timely and correct, and that it had sufficient funds to make the tax payment. Banks, however, can be held liable for late payments and assessed interest in cases where they cause EFTPS payments to be untimely. See previous discussions for how to establish proof of payment.

Employers using the EFTPS-Through a Financial Institution option will receive a PIN that can be used for payment inquiries only. The PIN cannot be used to make or cancel payments online.

All employers participating in EFTPS may use Electronic Tax Application (ETA) as a backup to the EFTPS-Direct and EFTPS-Through a Financial Institution payment methods. ETA is a subsystem of EFTPS that receives, processes, and transmits a federal tax deposit or a federal tax payment and the related tax payment information for taxpayers that make same day payments through Fedwire value transfers, Fedwire non-value transactions, and Direct Access transactions. Taxpayers should contact their financial institutions to determine if the financial institution is capable of making an ETA payment and the fees involved. The EFTPS payment instruction booklet that the taxpayer receives upon enrollment in the EFTPS program includes information on the ETA system. The IRS generally will deem an ETA payment to have been made on the date the payment is received by the Federal Reserve Bank (FRB). The financial institution will require some amount of time prior to 5 p.m. to complete processing. ETA payments received by the FRB after 5:00 p.m. EST will not be accepted. Payments that are not accepted must be reoriginated using an ETA transaction or any other permissible remittance method. The taxpayer

should contact the financial institution through which the ETA payment will be made to determine the deadline for initiating ETA payments for a particular day.

The IRS website at www.irs.gov has detailed information on the EFTPS program. The IRS also offers Publication 966, "Electronic Choices to Pay All Your Federal Taxes" and Publication 3425, "4 Easy Ways to Use EFTPS" for additional information on EFTPS.

When Are Deposits Due? Employers must deposit federal payroll taxes (excluding FUTA taxes) when the accumulated amounts owed exceed certain levels prescribed by the IRS for specified periods. Employers are classified as either monthly or semiweekly depositors, depending on the amount of employment taxes that they reported on their employment tax returns. For employers who file Form 941, the lookback period for each calendar year is the 12 months ending the previous June 30 (the lookback period). For employers who file Form 944 (Employers' Annual Federal Tax Return), the lookback period is the second calendar year preceding the current calendar year. For example, the lookback period for calendar year 2009 is calendar year 2007. Classifications are determined at the beginning of each calendar year and generally remain in effect during the entire calendar year.

- a. *Monthly Depositor.* Employers reporting employment taxes of \$50,000 or less during the lookback period are classified as monthly depositors. Monthly depositors must pay each month's employment taxes by the 15th of the following month. If depositories are closed on the 15th, employers may deposit their taxes on the next business day. (New employers are also classified as monthly depositors.)
- b. *Semiweekly Depositor.* Employers reporting employment taxes of over \$50,000 during the lookback period are classified as semiweekly depositors. Semiweekly depositors must deposit employment taxes after each payday, and deposits are due based on the day of the week that the payday falls. If the payday falls on Wednesday, Thursday, or Friday, employment taxes must be deposited by the following Wednesday. If the payday falls on any other day of the week, employment taxes must be deposited by the following Friday.

The following are exceptions to the monthly and semiweekly depositor rules:

- a. An employer that owes less than \$2,500 in employment taxes may pay its liability when it files its quarterly or annual employment tax return.
- b. An employer must deposit its employment taxes by the next banking day if its accumulated liability reaches \$100,000. In addition, the employer becomes classified as a semiweekly depositor for the remainder of the calendar year and for the next calendar year.

An employer must calculate its FUTA tax liability at the end of each quarter and, if the cumulative unpaid liability is \$500 or more, deposit the tax by the end of the following month. If the employer is not required to make any deposits during the calendar year and the ending tax liability is less than \$500 the employer may pay the tax when it files Form 940. If the liability at the end of the calendar year is over \$500, however, the employer must deposit the taxes by January 31st of the following year.

As discussed below, the penalties for failing to pay employment taxes are severe. Depositing payroll taxes when payroll checks are released, even though the deposits may legally be made at a later date, assures the employer that its deposit requirements are met. For most small to medium-sized businesses, that assurance usually outweighs whatever float they surrender.

Penalties. Late deposit penalties vary depending on how long the deposit is overdue. Other deposit penalties are based on specified percentages unrelated to time. The IRS currently assesses the following penalties for late or improper payment of employment taxes:

Infraction	Penalty (as a percentage of the deposit due)
<i>Late deposit penalties:</i>	
1–5 days	2%
6–15 days	5%
Over 15 days	10%
Within 10 days after demand is made by IRS	10%
More than 10 days after demand is made by the IRS	15%
<i>Other deposit penalties:</i>	
Deposit made to an unauthorized financial institution, paid directly to the IRS, or paid with the tax return	10%
Amounts subject to electronic deposit requirements but not deposited using the Electronic Federal Tax Payment System (EFTPS)	10%

The IRS can also assess a penalty equal to 100% of the taxes due if an employer does not withhold or remit employment taxes. The penalty can be assessed on any person that the IRS determines (a) is responsible for collecting, accounting for, and paying the taxes and (b) acted willfully in not doing so. Thus, the penalty can be levied against the company or an officer or employee of the company.

Should the Accountants Make the Payroll Tax Deposit?

It generally would not be a best practice for a CPA firm to make payroll tax deposits for clients. As discussed above, the penalties for failing to make the deposits timely are severe. In addition, interest is charged on the underpaid taxes. As a result, more than one accountant/client relationship has soured because of payroll tax penalties. Accountants should make it clear to their clients that making timely payroll tax deposits is the clients' responsibility—not the accountants'. The accountants should be available to explain the rules and answer any questions, however.

Accountants that make payroll tax deposits for clients should insist on receiving payroll information *prior* to the issuance of payroll checks. Therefore, payday should be set after the end of the pay period—not on the last day of the pay period. That allows time for the accountants to receive the information, process it, and make the deposit calculation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Calculate the amount of an employer's total payroll tax deposit using the following information.

Social security taxes withheld:	\$434
Medicare taxes withheld:	\$102
Federal income taxes withheld:	\$1,337
Advance payments of the earned income credit:	\$0

- a. \$536.
 - b. \$1,072.
 - c. \$1,873.
 - d. \$2,409.
23. The Rubber Duckie House (RDH) will deposit payroll taxes using the Electronic Federal Tax Payment System (EFTPS). Which of the following statements accurately describes this process?
- a. RDH must enroll online.
 - b. Once RDH has a personal identification number (PIN), it can make payments online.
 - c. RDH must be registered to make payments using EFTPS.
24. The Sleep Firm deposits \$10,000 of federal payroll taxes seven days late. Calculate the penalty that the company will have to pay in this scenario.
- a. \$200.
 - b. \$500.
 - c. \$1,000.
 - d. \$1,500.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. Calculate the amount of an employer's total payroll tax deposit using the following information. **(Page 64)**

Social security taxes withheld:	\$434
Medicare taxes withheld:	\$102
Federal income taxes withheld:	\$1,337
Advance payments of the earned income credit:	\$0

- a. \$536. [This answer is incorrect. This is the total of the social security taxes and the Medicare taxes, but other amounts are included in the calculation of the total payroll tax deposit.]
- b. \$1,072. [This answer is incorrect. This is the total amount of the employer and the employee's FICA taxes, but other amounts are included in the calculation of the total payroll tax deposit.]
- c. \$1,873. [This answer is incorrect. The correct amount of FICA taxes has not been withheld to get this amount.]
- d. \$2,409. [This answer is correct. The calculation for the total payroll tax deposit is as follows: $\{(\$434 + \$102) \times 2\} + \$1,337 - 0 = \$2,409$.]**
23. The Rubber Duckie House (RDH) will deposit payroll taxes using the Electronic Federal Tax Payment System (EFTPS). Which of the following statements accurately describes this process? **(Page 65)**
- a. RDH must enroll online. [This answer is incorrect. In order to deposit taxes using EFTPS, taxpayers must enroll either online or by completing Form 9779 and mailing it to the EFTPS enrollment center at least 10 weeks prior to the first federal tax deposit or federal tax payment due date.]
- b. Once RDH has a personal identification number (PIN), it can make payments online. [This answer is incorrect. When the enrollment process is completed, the employer will receive two separate mailings. One will have a confirmation/update form and a step-by-step instruction booklet. The other mailing will be a letter that includes an enrollment trace number, a PIN, and instructions on how to obtain an internet password. Upon receiving the PIN, an employer may begin making payments by phone. Employers wanting to make payments online must first follow the instructions and obtain an internet password.]
- c. RDH must be registered to make payments using EFTPS. [This answer is correct. Tax practitioners, accountants, and payroll companies that make payments on behalf of their clients can use EFTPS without having to register. However, their clients must be registered. Since RDH is not a tax practitioner, accountant, or payroll company, it will have to register.]**
24. The Sleep Firm deposits \$10,000 of federal payroll taxes seven days late. Calculate the penalty that the company will have to pay in this scenario. **(Page 67)**
- a. \$200. [This answer is incorrect. The IRS currently assesses a penalty of 2% of the deposit due for deposits that are one to five days late.]
- b. \$500. [This answer is correct. The IRS currently assesses a penalty of 5% of the deposit due for deposits that are six to fifteen days late. The deposit date in this scenario falls into that range.]**
- c. \$1,000. [This answer is incorrect. The IRS currently assesses a penalty of 10% of the deposit due for deposits that are over fifteen days late or within ten days after demand is made by the IRS.]
- d. \$1,500. [This answer is incorrect. The IRS currently assesses a penalty of 15% of the deposit due for deposits made more than ten days after the demand is made by the IRS.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (WUSTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

12. Lisa is an employee of the Caramel Corporation (CC). She is classified as an exempt employee. Lisa's annual salary is \$67,000. CC pays its employees biweekly, and no unusual compensation arrangements or bonuses apply. Calculate Lisa's gross pay.
- \$1288.46.
 - \$2576.92.
 - \$2791.67.
 - \$5583.33.
13. According to FLSA, which of the following employees would be fully exempt from overtime pay, but not exempt from minimum wage requirements?
- Agnes is a computer professional.
 - Bob is a seaman on an American ship.
 - Carol is a full-time student.
 - Doug processes tobacco.
14. Assuming that the salary and percentage of time tests are met, match the following white-collar employees with the applicable qualifications for their exemptions.

Employees

- Executive
- Administrative employee
- Learned professional

Exemption Qualifications

- He must be employed as a programmer, systems analyst, or similar skilled worker in this field. His primary duty must be one or more of the following: applying systems analysis techniques; designing, developing, documenting, analyzing, creating, or modifying computer systems or programs in relation to user or system design specifications; designing, documenting, testing, creating, or modifying computer programs in relation to machine operating systems; or a combination of these tasks requiring the same level of skills.
- Her primary duty is managing the enterprise (or a department or subdivision, thereof). She customarily and regularly directs the work of two or more full-time employees (or their equivalent). She has the authority to fire or hire other employees, or his suggestions about such status changes are given particular weight.
- His primary duty is performing office or nonmanual work related to management policies or the general business operations of the employer or its customers. He customarily and regularly exercises independent judgment and discretion regarding matters of significance.

4. Computer professional
- iv. She must perform either office or nonmanual work, including at least one of the duties of an exempt executive, administrative, or professional employee.
5. Highly compensated employee
- v. His primary duty consists of work that requires knowledge of an advanced type, including work requiring the consistent exercise of discretion and judgment in its performance. The advanced knowledge is in the field of science or learning and is usually acquired by a prolonged course of specialized intellectual instruction.

- a. 1., ii.; 2., iii.; 3., v.; 4., i.; 5., iv.
- b. 1., iii.; 2., iv.; 3., i.; 4., v.; 5., ii.
- c. 1., iv.; 2., v.; 3., ii.; 4., iii.; 5., i.
- d. 1., v.; 2., i.; 3., iv.; 4., ii.; 5., iii.

15. Calculate the gross pay for a nonexempt employee based on the following information:

Hours worked:	50
Regular rate of pay:	\$12
Bonus:	\$100

- a. \$700.
- b. \$760.
- c. \$770.
- d. \$1,000.
16. Based on the following information, would an employee be considered a common law employee or an independent contractor?

The employee presents himself as available to the public.

The employee chooses where to perform the work.

The employee sells his service for a fixed price.

The employee is not economically dependent on the employer.

- a. Common law employee.
- b. Independent contractor.
- c. Do not select this answer choice.
- d. Do not select this answer choice.

17. Sage, a CPA, is engaged to prepare her client's payroll. To calculate employees' federal income tax withholdings, she multiplies the amount for one withholding allowance for the pay period by the number of allowances the employee claimed, subtracts that amount from the employee's wages, and computes the amount to withhold based on the resulting amount and the appropriate rate table provided by the IRS. What method did Sage use?
- The wage bracket method.
 - The annualized wage method.
 - The percentage method.
 - The cumulative wage method.
18. Wedded Bliss Ltd. (WBL) pays supplemental wages to most of its employees during 2010. The total of the supplemental wages varies by employee, but none of them are paid more than \$500,000. How much should WBL withhold for these supplemental wages?
- 15%.
 - 25%.
 - 28%.
 - 35%.
19. WBL must pay unemployment taxes on both the state and federal level. Which of the following statements best describes this process?
- Federal unemployment insurance rates vary from 0 to 12.27%.
 - All states use an unemployment wage base of \$7,000.
 - State and federal unemployment taxes are interrelated.
 - Employers must calculate and deposit federal unemployment taxes annually.
20. Diet Plans 'R Us uses electronic payroll software. The company's accountant discovers withholding errors made by the payroll software. Who is liable for these errors?
- Diet Plans 'R Us.
 - The employees whose accounts were affected by the errors.
 - The accountant.
 - The payroll software company.
21. Jeb, a CPA, prepares his client's payroll manually. How should he record the information about payroll taxes and withholdings for each pay period in the general ledger?
- Using two journal entries—one for wages and employee withholdings and one for the employer portion of the payroll taxes.
 - Using two journal entries—one for quarterly information and one for year-to-date information needed to prepare payroll tax returns and the employees' W-2s.
 - By summarizing all information about wages, employee withholdings, and the employer portion of the payroll taxes into one journal entry.
 - Recording payroll information is an automatic part of the manual process, so Jeb will not need to perform any additional steps for the general ledger.

22. Carbon Copy has had a downturn in profit this year. Because of this downturn, Carbon Copy is behind on depositing its federal unemployment taxes, backup withholding, income tax withheld, and social security and Medicare taxes. What is the highest penalty the IRS can levy on the business or its officers and employees?
- a. 25%.
 - b. 50%.
 - c. 75%.
 - d. 100%.
23. June Bug, Inc. has always made its federal payroll tax deposit in its local bank, accompanied by Form 8109. When must June Bug start using the Electronic Federal Tax Payment System (EFTPS)?
- a. August 1, 2010.
 - b. January 1, 2011.
 - c. January 1, 2012.
 - d. January 1, 2013.
24. Harvest Inc. reports \$75,000 in employment taxes during its lookback period. When will its federal payroll tax deposits be due?
- a. Monthly.
 - b. Semiweekly.
 - c. At the end of each quarter.
 - d. When its quarterly or annual employment tax return is due.

Lesson 3: Payroll Tax Return Preparation

INTRODUCTION

Payroll tax returns can be complex. As a result, payroll tax return preparation is a valuable service that accountants can provide their clients or employer. This section discusses special compensation not processed by the normal payroll function and the federal payroll tax returns. (A discussion of state and local payroll tax requirements is beyond the scope of this course.) Federal payroll tax returns can be obtained by calling 1-800-TAX-FORM or by downloading the document at www.irs.gov.

Learning Objectives:

Completion of this lesson will enable you to:

- Compare and contrast the required forms related to payroll tax returns.
- Identify the information needed for information returns, how to file them, and procedures for the delivery of all payroll tax returns.

FEDERAL PAYROLL FORMS

Recording Other Special Compensation

In order to have complete, accurate, and consistent returns and tax deposits, the accountant must properly record other special compensation, as many items of taxable compensation do not flow through the payroll system or are not paid in cash. Taxable fringe benefits and other special compensation include such items as the value of personal use of company autos, country club dues paid for employees, and employer provided group life insurance coverage over \$50,000. The company is required to withhold taxes relating to many types of special compensation.

To properly withhold and report payroll taxes and accurately prepare the annual payroll tax returns, combine the special compensation with other payroll information. The method used to combine the special compensation with regular payroll will vary depending on the flexibility of the company's payroll system. Whatever the method, the result should be that special compensation is added to compensation in the payroll register to reflect total wages. Adding special compensation to payroll register wages also requires the company to recalculate payroll taxes. It is important to leave clear documentation as to what adjustments are made to payroll register amounts for special compensation and their effect on payroll taxes.

Which Reporting Forms Should Be Used? It can be very confusing trying to determine whether to include certain income on a 1099 or a W-2. Exhibit 3-1, Payment Reporting Forms Table, identifies the proper forms to be filed for different types of income. As a general rule, withholding taxes on nonpayroll items such as those reported on Forms 1099 and W-2G (see Exhibit 3-1 and examples provided in the "Form 945" paragraph later in this lesson) should be reported on Form 945. As indicated above, taxable fringe and other special compensation should normally be considered part of W-2 wages, and the corresponding taxes should be reported on Form 941 or Form 944, if applicable.

Form 941 (Employer's Quarterly Federal Tax Return)

Most employers report wages, tips, and payroll related federal income tax withholding and FICA taxes to the IRS quarterly using Form 941 (Employer's Quarterly Federal Tax Return). Seasonal employers, however, are not required to file Form 941 for quarters in which they regularly do not have payroll. If at least one quarterly return is filed each year, seasonal employers should mark the appropriate box on Line 19 of Form 941 to indicate seasonal status.

If a business is sold or transferred during a quarter, the prior owner and the new owner must both file Form 941 for that quarter. Each party should only report the wages it paid during the quarter, however. Businesses that cease operations or cease to be employers should mark the box on Line 18 and enter the date final wages were paid.

Exhibit 3-1**Payment Reporting Forms Table**

Type of Payment	Form	Type of Payment	Form
Advance Earned Income Credit	W-2	Death benefits	1099-R
Agriculture payments	1099-G	Dependent care payments	W-2
Allocated tips	W-2	Directors fees	1099-MISC
Annuities	1099-R	Dividends	1099-DIV
Auto reimbursements:		401(k) contributions	W-2
Employee	W-2	Health Savings Accounts, Medicare Advantage MSAs, and Archer MSAs:	
Nonemployee	1099-MISC	Contributions	5498-SA
Awards:		Distributions	1099-SA
Employee	W-2	Interest income	1099-INT
Nonemployee	1099-MISC	IRA and Roth IRA contributions	5498
Bingo, slot machines, keno	W-2G	IRA and Roth IRA distributions	1099-R
Bond tax credit	1097-BTC	Liquidation distributions	1099-DIV
Bonuses:		Moving expense	W-2
Employee	W-2	Pension plan distributions	1099-R
Nonemployee	1099-MISC	Prizes—employee	W-2
Broker transactions	1099-B	Rents	1099-MISC
Car expenses:		Royalties	1099-MISC
Employee	W-2	SEP or SIMPLE contributions	W-2, 5498
Nonemployee	1099-MISC	SEP or SIMPLE distributions	1099-R
Commissions:		Severance pay	W-2
Employee	W-2	Sick pay	W-2
Nonemployee	1099-MISC	Tips	W-2
Compensation:		Unemployment benefits	1099-G
Employee	W-2	Vacation pay—employee	W-2
Nonemployee	1099-MISC	Wages	W-2

* * *

Specific instructions for completing the return are provided with the form. In addition, further instructions can be found in IRS Pub. 15, "Circular E, Employer's Tax Guide." (Employers making advanced payments of the earned income credit should also review that publication.) Best practices for completing the return are as follows (The line number references are to the April 2010 version of Form 941.):

- *Use the Original Form 941 Provided by the IRS.* The following suggestions will allow the IRS to process Form 941 faster and more accurately: (a) make dollar entries without the dollar sign and the decimal point, commas are optional (Report dollars to the left of the preprinted decimal point and cents to the right of it.), (b) enter negative amounts with a "minus" sign (if possible, otherwise use parentheses), (c) file the Form 941 that has the company's preprinted name and address, (d) type or machine print entries in black ink (do not handwrite the entries), and (e) do not tear the form.
- *Review the Employer Information on the Preprinted Forms.* Make sure that the preprinted heading includes the correct employer identification number, employer's name and address, and the quarterly period being reported. If preprinted forms are not available, review the information for accuracy after it has been entered on a blank Form 941.
- *Address Changes.* Report address changes by changing the preprinted headings as necessary and completing and mailing Form 8822 (Change of Address) to the IRS.
- *Include Only One Quarter on One Return.* The appropriate box at the top of the form should be checked to indicate the quarter that is being reported.
- *Line 1.* Enter the number of employees paid during the pay period that includes March 12, June 12, September 12, or December 12 for the quarter indicated at the top of the return. An entry of 250 or more indicates a need to file Forms W-2 electronically.
- *Line 2.* Enter total wages, tips, taxable fringe benefits, and other compensation paid during the period even if no income or social security and Medicare taxes were withheld from them. Also, include any third-party sick pay paid to employees if timely notice about the payments was received from the insurance carrier. Do not include pensions, annuities, supplemental unemployment compensation benefits, or gambling winnings, however, even if income taxes were withheld on them.
- *Line 3.* Enter the federal income tax the company withheld on the wages reported on line 2 as well as any income tax withheld from supplemental unemployment compensation benefits. Insurance companies should also include the amount of income taxes they withheld on third-party sick leave on this line.
- *Line 4.* If none of the payments made to employees are subject to social security or Medicare tax check the appropriate box and go to line 6.
- *Line 5.* Taxable social security wages, social security tips, and Medicare wages and tips should be reported in the spaces provided in lines 5a, 5b, and 5c, respectively. (Make sure that no employee's wages in excess of the social security wage base are included in lines 5a and 5b.) Social security and Medicare taxes on those amounts should then be computed and entered in column 2 of lines 5a, 5b, and 5c. Enter the total social security and Medicare taxes on line 5d.
- *Lines 6a–d.* These lines are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act.
- *Line 6e.* Enter the total of line 3 plus 5d less line 6d.
- *Line 7a.* This line is used to adjust for differences caused by adding or dropping fractions of cents (i.e., rounding) in collecting the tax.
- *Line 7b.* The employee share of social security and Medicare taxes on third party sick pay for which the employer is not responsible is entered on this line.

- *Line 7c.* This line is used for Current Quarter's Adjustments for Tips and Group-term Life Insurance.
- *Line 8.* Enter the total of lines 6e through 7c.
- *Line 9.* Advance payments of the earned income credit are entered on this line and, as a result, deducted from the employer's net employment tax liability. (The earned income credit is available to certain low-income taxpayers when they file their income tax returns. They may receive payments of the credit in advance from their employer, however. See discussion in Lesson 1 regarding the earned income credit.)
- *Line 10.* Subtract line 9 from line 8. This represents the net withholdings that the company must remit to the IRS.
- *Line 11.* Enter the total payroll tax deposits made by the company for the quarter (including any overpayment applied from the previous quarter). Also include any overpayment applied from filing Form 941-X or Form 944-X in the current quarter to correct errors in income tax withheld from wages paid in earlier quarters of the same calendar year. Do not include deposits for the quarter that have not been made.
- *Line 12a.* This line is used to report 65% of the COBRA premium assistance payments for assistance eligible individuals. Only take the COBRA premium assistance credit on this line after the assistance eligible individual's 35% share of the premium has been paid.
- *Line 12b.* This line is used for the number of individuals provided COBRA premium assistance as reported on line 12a.
- *Lines 12c–e.* These lines only apply to the second quarter of 2010 and are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act that were allowed for the first quarter of 2010.
- *Line 13.* Enter the total of lines 11, 12a, and 12e.
- *Line 14.* If line 13 is less than line 10, subtract line 13 from line 10 and enter that amount on this line. If the balance due that is shown on this line is \$2,500 or greater, the employer must deposit the payment at a federally authorized bank or electronically. (Lesson 2 discusses depositing payroll taxes.) If less than \$2,500 is due, the employer may pay the balance due directly to the IRS when Form 941 is filed. Employers with a balance due on Form 941 can pay the amount by credit card either over the phone or the internet.
- *Line 15.* If line 13 is greater than line 10, payroll taxes for the quarter were overpaid. Enter the amount of the overpayment on this line and indicate whether it should be refunded or applied to the next return by marking the appropriate box.
- *Line 16.* Since states observe different holidays, this line helps the IRS verify timely filing. In the spaces on line 16, employers should write the Postal Service two-letter state abbreviation for the state where their employment tax deposits were made either by using Form 8109 or by initiating an electronic transfer. If the employer made deposits in multiple states, "MU" should be entered in the spaces on line 16.
- *Line 17.* The first box on line 17 is checked if the amount on line 10 is less than \$2,500. If the employer is a monthly depositor for the entire quarter, the second box is checked and the amount of the tax liability, not tax deposit, is entered on line 17 for each month in the quarter. If the employer is a semiweekly depositor during any part of the quarter, the third box should be checked and Schedule B should be completed. See Lesson 2 for an explanation of the semiweekly and monthly deposit rules. Only one box on line 17 should be checked.
- *Line 18.* If this is a final return, check the box on line 18 and enter the date that final wages were paid on this line. A statement showing the name of the person keeping the payroll records and the address where those records will be kept should also be attached to the final return.

- *Line 19.* If the return is being filed for a seasonal employer, check the box on line 19. Seasonal employers are only required to file Form 941 when they have paid wages and they should check the box for every quarter that a return is filed. It is important to check this box when filing seasonally; otherwise the IRS will expect a return to be filed each quarter.
- *Part 4, Third-party Designee Section.* A taxpayer that wants to allow the IRS to discuss its Form 941 with a designated third-party should check the "Yes" box in Part 4 of the return. Common third-party designees include an employee or a paid tax preparer. The name and five-digit personal identification number (PIN) of the specific person to contact are entered on the form. Do not enter the name of the firm who prepared the tax return. Checking the "Yes" box authorizes the IRS to call the designee with questions that may arise during the processing of Form 941. If the taxpayer does not want to make a third-party designation, the "No" box in Part 4 should be checked.
- *Part 5, Section for Signature.* Form 941 must be signed and dated. See the discussion on the individuals eligible to sign the form later in this lesson.
- *Section for Paid Preparers.* This section may be completed if the preparer was paid to prepare the Form 941 and is not an employee of the filing entity. The paid preparer may sign in the space provided and give the filing entity a copy of the return in addition to the copy to be filed with the IRS. The Paid Preparers section should not be completed if the preparer is the reporting agent and has a valid Form 8655 (Reporting Agent Authorization) on file with the IRS. Completion of this section is optional by the paid preparer.

Reconciliations. After preparing Form 941, the accountants should reconcile it to the payroll register to determine that all amounts have been reported. Specifically, they should reconcile the following amounts reported on Form 941 to the payroll register.

- Federal income tax wages.
- Federal income tax withholdings.
- Social security wages.
- Social security taxes (both employees' and employer's).
- Medicare wages.
- Medicare taxes (both employees' and employer's).
- Tax deposits.
- Tax liabilities.

The accountants should also recalculate the social security and Medicare taxes and determine that the employer's portion of the FICA taxes equals the employees' withholdings.

The accountants should also reconcile information within the Form 941 itself. The compensation subject to federal income tax withholdings (line 2) should be reconciled to compensation subject to Medicare taxes (line 5c) and social security taxes (lines 5a and 5b). The reconciliation is necessary to ensure that the wage information is properly reported. The primary differences arise from the handling of the following items:

- *401(k) or 403(b) Plan Pretax Contributions.* Such amounts are excluded from line 2 but included in lines 5a, 5b, and 5c. (Note that pretax contributions are limited to \$16,500 in 2010 and taxpayers who are age 50 or over are also eligible for additional catch-up payments of up to \$5,500 in 2010.)
- *SEP and SIMPLE Employee Contributions.* Such amounts are excluded from line 2, but included in lines 5a, 5b, and 5c.

- *Deceased Worker's Wages Paid in Year of Death.* Such amounts are excluded from line 2, but included in lines 5a, 5b, and 5c.
- *Adoption Assistance.* Such amounts (not exceeding the \$13,170 limit for 2010) are excluded from line 2, but included in lines 5a, 5b, and 5c.
- *Nonqualified Deferred Compensation.* Generally, payments into the plan are excluded from line 2, but included in lines 5a, 5b, and 5c, while payments from the plan are included in line 2 but excluded from lines 5a, 5b, and 5c. The accountants should review the nonqualified deferred compensation plan to determine proper treatment.

Electronic Filing. The Form 941 e-file program enables authorized IRS e-file providers to electronically file certain Form 941 returns (i.e., generally current quarter returns or returns for the four preceding quarters). There are five categories of *authorized IRS e-file providers*: (a) Electronic Return Originators (EROs), (b) Intermediate Service Providers, (c) Software Developers, (d) Transmitters, and (e) Reporting Agents.

An *ERO* originates the electronic submission of returns. An *Intermediate Service Provider* receives tax return information from an ERO (or from a taxpayer or tax exempt organization that files electronically using a computer, modem or the internet, and commercial tax preparation software), processes the return information, and either forwards the information to a Transmitter, or sends the information back to the ERO (or taxpayer or exempt organization). A *Software Developer* develops software for the purposes of (a) formatting electronic return information according to publications issued by the IRS that set forth electronic return file specifications and record layouts for tax returns; and/or (b) transmitting electronic tax return information directly to the IRS. A *Transmitter* transmits electronic return information directly to the IRS. A *Reporting Agent* is an accounting service, franchiser, bank, service bureau, or other entity that complies with Rev. Proc. 2007-38, and is authorized to prepare and electronically file a taxpayer's Form 941. The five categories of authorized IRS e-file providers are not mutually exclusive. For example, an ERO can, at the same time, be a Transmitter, Software Developer, or Intermediate Service Provider depending on the function(s) performed.

Taxpayers interested in becoming authorized IRS e-file providers must apply for participation and must be accepted by the IRS. Applications to participate in the e-file program can be made online or in paper form. An online application to participate in the e-file program can be completed after registering online at <https://ia1.www4.irs.gov/e-services/Registration/index.htm> and receiving confirmation from the IRS. Alternatively, Form 8633 (Application to Participate in the IRS e-file Program) can be submitted in paper form to the Andover Submission Processing Center even though the IRS encourages the use of the online application. After application is approved, a Personal Identification Number (PIN) is assigned that is used to sign the electronically filed Form 941. For additional information, visit the IRS website at www.irs.gov and click the e-file icon on the main home page, or call the e-file Help Desk at (866) 255-0654.

Registration of Websites for E-file Providers. The IRS has established e-file rules to enable it to more quickly identify fraud schemes including phishing. These rules apply to all authorized e-file providers that obtain taxpayer information via the internet (directly or through third parties) in order to e-file federal returns.

Authorized IRS e-file Providers not affected by this rule include those that: (a) have a website for informational and/or marketing purposes only, (b) only receive or send taxpayer information via email, (c) do not use websites to collect taxpayer information and transmit the returns through third party transmitters, (d) prepare returns and use provider's website to e-file their returns, or (e) only provide a hotlink to another company's website that allows taxpayers to input taxpayer information.

Under the rules, affected providers had to submit to the IRS by September 10, 2007, an Excel spreadsheet that was encrypted using WINZIP 9 with password protection. The spreadsheet should have included the following information: (a) the provider's EFIN; (b) the name of a principal or responsible official shown on the e-file application for the EFIN; and (c) the uniform resource locators (URLs) of all websites that: (1) the provider uses for e-file of federal returns; (2) are portals or allow access to the providers' online e-file software; or (3) are used to obtain taxpayer information for the purpose of preparing and e-filing federal returns. The Excel spreadsheet and the password should have been submitted via separate email messages to efileurlreg@irs.gov.

Providers are now required to submit this information to the IRS prior to the website being accessible on the internet, and are further required to submit to the IRS, within three business days, any changes to previously provided information.

Failure to provide the required information timely and accurately may result in the IRS, its agents, or the Treasury Inspector General for Tax Administration (TIGTA) shutting down and seizing the contents of non-validated websites that appear to be engaging in fraudulent schemes. Also, an authorized IRS e-file provider that fails to comply with these IRS e-file rules may be suspended or expelled from participation in IRS e-file.

Employers do not have to become authorized IRS e-file providers in order to file their Forms 941 electronically. Instead, employers can electronically file Forms 941 by using authorized IRS payroll service providers (i.e., Reporting Agents) that offer electronic filing services. A list of authorized IRS payroll service providers is available at www.irs.gov/efile/article/0,,id=118516,00.html. Employers who have a computer, modem or the internet, and commercial tax preparation software can also file their Forms 941 electronically by using an authorized Intermediate Service Provider through the Form 941 On-Line Filing (941OLF) program, which is discussed in the following paragraphs.

The Form 941 On-Line Filing (941OLF) program is part of the Employment Tax e-file system. The 941OLF program is an online system that allows business filers to prepare, sign, and file Form 941 by using a computer, modem or the internet, and commercial tax preparation software to submit their tax return information to an authorized IRS Intermediate Service Provider (as previously discussed). An employer who wants to be an online filer must apply for a Personal Identification Number (PIN) by completing the electronic Letter of Application (LOA) online to register through an approved IRS e-file provider of their choice. The employer receives its PIN by mail from the IRS in three to five business days. The PIN is used in lieu of the employer's signature to file a return electronically.

Due Date. Form 941 generally is due on the last day of the month following the quarter. For example, the Form 941 for the quarter ended March 31, 20X3, generally is due April 30, 20X3. If all payroll taxes are deposited when due during the quarter, however Form 941 is not due until the 10th day of the second month following the quarter. Thus, in the preceding example, if all payroll taxes are deposited when due, the Form 941 would be due May 10, 20X3.

Penalties. The IRS may assess penalties for filing a return late unless there is a reasonable cause. For each whole or partial month the employer fails to file a return when required, the IRS imposes a penalty of 5% (up to a maximum of 25%) of the amount the employer should have reported on the return.

Form 944 (Employer's Annual Federal Tax Return)

To reduce the tax filing burden, the IRS issued temporary regulations that require certain small employers to file the new Form 944 (Employer's Annual Federal Tax Return) annually instead of filing Form 941 quarterly. In addition, employers that qualify to file Form 944 will pay their employment taxes once a year instead of every quarter. Only employers whose estimated annual employment tax liability is \$1,000 or less are eligible to file Form 944. Typically this includes very small employers that pay no more than \$4,000 in annual wages that are subject to federal income tax withholding and FICA taxes. Employers that have been notified by the IRS must file Form 944.

If an eligible employer's employment tax liability exceeds \$1,000, the employer would still file Form 944 for that tax year, but would start filing Form 941 at the beginning of the next tax year. The IRS will send the employer a notice advising them of the change to Form 941 quarterly filing requirements.

If an employer anticipates that its annual tax liability will exceed \$1,000, or the employer prefers to electronically file Forms 941 quarterly instead of filing Form 944 annually, the employer may continue to file 941 only if written permission is obtained from the IRS. To obtain permission, the IRS should be contacted by telephone at (800) 829-0115.

Specific instructions for completing the return are provided with the form. Best practices for completing the return are as follows (The line number references are to the 2010 version of Form 944.):

- *Use the Original Form 944 Provided by the IRS.* The following suggestions will allow the IRS to process Form 944 faster and more accurately: (a) make dollar entries without the dollar sign and the decimal point,

commas are optional (Report dollars to the left of the preprinted decimal point and cents to the right of it.), (b) enter negative amounts with a "minus" sign (if possible, otherwise use parentheses), (c) file the Form 944 that has the company's preprinted name and address, (d) type or machine print entries in black ink (do not handwrite the entries), and (e) do not tear the form.

- *Review the Employer Information on the Preprinted Forms.* Make sure that the preprinted heading includes the correct employer identification number, employer's name and address, and the period being reported. If preprinted forms are not available, review the information for accuracy after it has been entered on a blank Form 944.
- *Address Changes.* Report address changes by changing the preprinted headings as necessary.
- *Line 1, Wages, Tips, and Other Compensation.* The amounts entered on line 1 would also be included in box 1 of the employees' Forms W-2.
- *Line 2, Income Tax Withheld.* This line includes federal income tax withheld on wages, tips, and other compensation such as taxable fringe benefits and supplemental unemployment compensation benefits.
- *No Wages, Tips, and Other Compensation Subject to Social Security or Medicare Tax.* If wages, tips and other compensation reported on line 1 are not subject to social security or Medicare tax, check the box on line 3 and go to line 5.
- *Line 4a, Taxable Social Security Wages.* Wages and other compensatory items subject to (not net of) social security tax of 12.4% are shown on this line, but not reported or allocated tips. The sum of wages and tips (i.e., lines 4a and 4b) for each employee should not be more than the maximum social security wage base for the year (\$106,800 in 2010).
- *Line 4b, Taxable Social Security Tips.* This line reflects tips reported by employees to the employer on Form 4070 (Employee's Report of Tips to Employer) or a written statement. The sum of tips and wages (i.e., lines 4a and 4b) is limited to the maximum social security wage base for each employee (\$106,800 in 2010). Include reported tips (up to the maximum social security wage base) even if the employer is unable to withhold the employee's share of the tax.
- *Line 4c, Taxable Medicare Wages and Tips.* Wages and other compensatory items (including reported tips) subject to (not net of) the 2.9% Medicare (hospital insurance) tax are shown on this line. Include reported tips even if the employer is unable to withhold the employee portion of Medicare tax. The amounts reported are not subject to a maximum wage base (i.e., there is no limit on Medicare wages).
- *Lines 5a–c.* These lines are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act.
- *Line 6, Current Year's Adjustments.* This line is used to adjust for differences caused by adding or dropping fractions of cents, reporting taxes on third party sick pay, and uncollected taxes on tips and group-term life insurance. (Corrections must be reported by filing Form 944-X.)
- *Line 8, Advance Earned Income Credit (EIC) Payments Made to Employees.* This line shows the total amount of advance earned income credit (EIC) paid to employees during the year. See Lesson 1 for further discussion of the earned income credit.
- *Line 10.* This line should also include any overpayment applied from filing Form 944-X or Form 941-X.
- *Line 11a.* This line is used to report 65% of the COBRA premium assistance payments for assistance eligible individuals. Only take the COBRA premium assistance credit on this line after the assistance eligible individual's 35% share of the premium has been paid.
- *Line 11b.* This line is used for the number of individuals provided COBRA premium assistance as reported on line 11a.

- *Lines 11c–e.* These lines only apply to the second quarter of 2010 and are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act that were allowed for the first quarter of 2010.
- *Line 13, Balance Due.* This line shows any balance due with the return. If this line is under \$1 it does not have to be paid. An employer should have a balance due only if their net tax liability for the year (line 9) is less than \$2,500. If line 9 is \$2,500 or more the employer should already have deposited all taxes due which will make the amount on line 13 (balance due) zero. Employers owing \$2,500 or more that fail to make the required deposits and then pay these amounts with the return may be subject to penalties.
- *Line 15, Monthly Summary of Federal Tax Liability.* The first box on line 15 is checked if the amount on line 9 is less than \$2,500. If the amount on line 9 is \$2,500 or more, the second box is checked and the amount of the tax liability, not tax deposit, is entered on lines 15a to 15l for each month in the year. The total tax liability on line 15m must equal the total taxes on line 9. If the employer accumulated a tax liability of \$100,000 or more on any day during a deposit period, Form 945-A should be completed instead of boxes 15a–15l.
- *Line 16, State Abbreviation.* Since states observe different holidays, this line helps the IRS verify timely filing. If taxes reported on Form 944 were deposited, employers should write in the spaces on line 16 the Postal Service two-letter state abbreviation for the state where their employment tax deposits were made either by using Form 8109 or by initiating an electronic transfer. If the employer made deposits in multiple states, "MU" should be entered in the spaces on line 16.
- *Line 17, Final Return.* If this is a final return, check the box on line 17 and enter the date that final wages were paid on this line. A statement showing the name of the person keeping the payroll records and the address where those records will be kept should also be attached to the final return.
- *Part 4, Third-party Designee Section.* A taxpayer that wants to allow the IRS to discuss its Form 944 with a designated third party should check the "Yes" box in Part 4 of the return. Common third-party designees include an employee or a paid tax preparer. The name and the five-digit personal identification number (PIN) of the specific person to contact are entered on the form. Do not enter the name of the firm who prepared the tax return. Checking the "Yes" box authorizes the IRS to call the designee with questions relating to the information reported on Form 944. If the taxpayer does not want to make a third-party designation, the "No" box in Part 4 should be checked.
- *Part 5, Section for Signature.* Form 944 must be signed and dated. See the discussion on the individuals eligible to sign the form later in this lesson.
- *Section for Paid Preparers.* This section may be completed if the preparer was paid to prepare the Form 944 and is not an employee of the filing entity. The paid preparer may sign in the space provided and give the filing entity a copy of the return in addition to the copy to be filed with the IRS. This section should not be completed if the preparer is the reporting agent and has a valid Form 8655 (Reporting Agent Authorization) on file with the IRS. Completion of this section is optional by the paid preparer.

Reconciliations. After preparing Form 944, the accountant should reconcile it to the payroll register to determine that all amounts have been reported. Specifically, he or she should reconcile the following amounts reported on Form 944 to the payroll register:

- Federal income tax wages.
- Federal income tax withholdings.
- Social security wages.
- Social security taxes (both employees' and employer's).

- Medicare wages.
- Medicare taxes (both employees' and employer's).
- Tax deposits.
- Tax liabilities.

The accountant should also recalculate the social security and Medicare taxes and determine that the employer's portion of the FICA taxes equals the employees' withholdings.

The accountant should also reconcile information within the Form 944 itself. The compensation subject to federal income tax withholdings (line 1) should be reconciled to compensation subject to Medicare taxes (line 4c) and social security taxes (lines 4a and 4b). The reconciliation is necessary to ensure that the wage information is properly reported. A list of primary differences that arise was provided earlier in this lesson.

Filing Paper Returns. Forms 944 filed on paper should be sent to the Internal Revenue Service Center serving the state where the employer's legal residence, principal place of business, or principal office or agency is located.

Electronic Filing. Form 944 can be filed electronically through the IRS's e-file program, which includes an online filing option that allows employers to electronically file Forms 944 through the internet. More information on the electronic filing options appears earlier in this lesson.

Paying the Taxes. A tax due of less than \$2,500 can be paid with Form 944 when it is filed. If the amount due is \$2,500 or more, it cannot be paid with the form but instead must be deposited with an authorized depository or by electronic funds transfer. An employer who wants to take advantage of the 10-day extension for filing Form 944 must deposit the amount of tax due by the form's original due date even if the tax due is less than \$2,500. Employers with a balance due on Form 944 of less than \$2,500 can also pay the amount owed by credit card either over the phone or the internet. If paying by credit card, Form 944-V is not used.

Due Date. Form 944 is due by January 31 following the end of the calendar year. If the due date falls on a Saturday, Sunday, or legal holiday, the return can be filed on the next business day. The IRS generally does not grant an extension for filing Form 944. However, Form 944 can be filed on or before the 10th day of the second calendar month following such period (i.e., a 10-day extension is allowed beyond the normal due date) if timely deposits have been made in full payment of taxes due for the period.

Schedule H (Form 1040, Household Employment Taxes)

The Social Security Domestic Employment Reform Act of 1994 (commonly called the "Nanny Tax") governs the way employers report and pay taxes withheld on wages paid to household employees.

Employers must report the taxes on wages paid to household employees on their annual tax return on Schedule H (Form 1040) (Household Employment Taxes). The required FICA and FUTA, as well as any federal income tax withholding payments, must be paid by increasing withholdings on the employer's wages or by making quarterly estimated tax payments.

Household employees are employees who perform services in or around the employer's private home (such as babysitters, housekeepers, maids, janitors, etc.). For 2010, employers are required to pay employment taxes if the household workers are properly classified as employees (rather than independent contractors) and their wages are at least \$1,700 during the year.

Employers should not file Schedule H (Form 1040) to report and pay FICA taxes and federal income tax withholdings on wages paid to household employees if any of the following apply:

- The employer is a sole proprietor who files Form 941 or Form 944 for business employees. [Withheld taxes for household employees may be reported on the proprietor's Form 941 (Employer's Quarterly Federal Tax Return) or the proprietor's Form 944 (Employer's Annual Federal Tax Return).]

- The household employee worked in the employer's home on a farm operated for a profit. [Instead, the employer should file Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees).]
- The household employee worked for a college club, fraternity, or sorority. [Instead, the employer should file Form 941 (Employer's Quarterly Federal Tax Return) or Form 944 (Employer's Annual Federal Tax Return).]
- The household employee is a domestic employee under age 18. (In those cases, wages paid to the employee are normally exempt from payroll taxes. The only exception is for individuals whose principal occupation is household employment. For this purpose, being a student is considered an occupation.)

Due Date. Schedule H should be attached to the employer's Form 1040 (U.S. Individual Income Tax Return). Therefore, the filing deadline for Schedule H is the same as for Form 1040.

Penalties. Employers may have to pay a tax penalty if the employer does not prepay the household employment taxes and either of the following applies for the year:

- The employer has federal income tax withheld from his or her pay, pension, annuity, etc., or
- The employer would be required to make estimated tax payments (to avoid the penalty) even if he or she did not owe household employment taxes.

As discussed above, to prepay the employment taxes, the employer can either increase the federal income tax withheld from his or her pay or make estimated tax payments.

Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees)

Employers report wages, federal income tax withholding, and FICA taxes for agricultural employees to the IRS on Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees). Agricultural employees are employees who perform farmwork. In addition, Form 943 is used to report taxes on wages of household employees working in a private home on a farm operated for profit. (See IRS Pub. 51, "Circular A, Agricultural Employers Tax Guide," for a more detailed definition of agricultural workers.)

Employers are required to file Form 943 if (a) they paid an employee \$150 or more in a calendar year for farmwork or (b) they paid aggregate cash wages of \$2,500 or more to all of the combined farmworkers (the "\$2,500-or-more group test"). If an employer pays a farmworker less than \$150 in annual cash wages, the wages are not subject to social security and Medicare taxes even if the employer meets the \$2,500-or-more group test, if the farmworker—

- is employed in agriculture as a hand-harvest laborer,
- is paid piece rates in an operation that is usually paid on a piece-rate basis in the region of employment,
- commutes daily from his or her home to the farm, and
- has been employed in agriculture less than 13 weeks in the preceding calendar year.

The amounts the employer pays such workers should be included in the \$2,500-or-more group test, however.

Specific instructions for completing Form 943 are provided with the form. Best practices for completing the return are as follows:

- *Use the Original Form 943 Provided by the IRS.* The following suggestions will allow the IRS to process Form 943 faster and more accurately: (a) make dollar entries without the dollar sign and the decimal point, commas are optional (Report dollars to the left of the preprinted decimal point and cents to the right of it.), (b) enter negative amounts with a "minus" sign (if possible, otherwise use parentheses), (c) file the Form 943 that has the company's preprinted name and address, (d) type or machine print entries in black ink (do not handwrite the entries), and (e) do not tear the form.

- *Review the Employer Information on the Preprinted Forms.* Make sure that the preprinted heading includes the correct employer's identification number, employer's name and address, and the calendar year being reported. If preprinted forms are not available, review the information for accuracy after it has been entered on a blank Form 943.
- *Address Changes.* Report address changes by changing the preprinted headings as necessary and completing and mailing Form 8822 (Change of Address) to the IRS. Then, check the box on Form 943 that indicates an address change.
- *State Code.* If the employer made tax deposits by FTD coupon (Form 8109) or by using the Electronic Federal Tax Payment System (EFTPS) (see Lesson 2 for information on making tax deposits) in a state other than that shown in its address on Form 943, the Postal Service two-letter state abbreviation for the state where the deposits or initiated EFTPS transfers were made is entered in this box. Enter "MU" in the state code box if deposits were made in more than one state or leave the box blank if deposits are made only in the state shown in the address.
- *Final Return.* If the employer does not expect to file Form 943 in the future, it should check the appropriate box on the return.
- *Line 1.* Enter the number of agricultural workers employed during the pay period that includes March 12. The information need only be entered on the Form 943 for the first calendar quarter.
- *Line 2.* Enter the total cash wages paid during the year to agricultural employees excluding (a) the value of noncash items such as food or lodging, (b) payment for services other than farmwork, and (c) wages paid to employees that exceed the social security wage base limit for the applicable year.
- *Line 3.* Enter social security taxes computed on the wages reported on line 2.
- *Line 4.* Enter the total cash wages paid during the year to agricultural employees excluding (a) the value of noncash items such as food or lodging and (b) payment for services other than farmwork.
- *Line 5.* Enter Medicare taxes computed on the wages reported on line 4.
- *Line 6.* Enter the federal income taxes the employer withheld from taxable wages for the year.
- *Lines 7a–c.* These lines are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act.
- *Line 7d.* Enter the total of lines 3, 5, 6, and 7c.
- *Line 8.* This line should be used for current year adjustments. The line should also be used to deduct social security and Medicare taxes reported on lines 3 and 5 for which the employer is not responsible for withholding (such as withholdings on third-party sick pay). In addition, the line should be used to adjust for difference between lines 3, 5, and 6 caused by rounding fractions of cents. (Form 943-X should be used to correct errors to previously filed Forms 943.)
- *Line 9.* Enter the total of lines 7d and 8.
- *Line 10.* Advance payments of the earned income credit are entered on this line and, as a result, deducted from the employer's net employment tax liability. (The earned income credit is available to certain low-income taxpayers when they file their income tax returns. They may receive payments of the credit in advance from their employer, however. See Lesson 1 for further discussion of the earned income credit.)
- *Line 11.* Subtract line 10 from line 9. This represents the net taxes that the employer must remit to the IRS.
- *Line 12.* Enter the total payroll tax deposits made by the employer for the year (including any overpayment applied from the previous year and any overpayment applied from filing Form 943-X).

- *Line 13a.* This line is used to report 65% of the COBRA premium assistance payments for assistance eligible individuals. Only take the COBRA premium assistance credit on this line after the assistance eligible individual's 35% share of the premium has been paid.
- *Line 13b.* This line is used for the number of individuals provided COBRA premium assistance as reported on line 13a.
- *Lines 13c–e.* These lines only apply to the second quarter of 2010 and are used to determine the payroll tax exemption for the employer's share (6.2%) of social security tax on wages/tips paid to one or more qualified employees under the Hiring Incentives to Restore Employment (HIRE) Act that were allowed for the first quarter of 2010.
- *Line 14.* Enter the total of lines 12, 13a, and 13e.
- *Line 15.* If line 14 is less than line 11, subtract line 14 from line 11 and enter that amount on this line. If the balance due that is shown on this line is \$2,500 or greater, the employer must deposit the payment at a federally authorized bank or electronically. (Lesson 2 discusses depositing payroll taxes.) If less than \$2,500 is due, the employer may pay the balance due directly to the IRS when Form 943 is filed.
- *Line 16.* If line 14 is greater than line 11, payroll taxes for the year were overpaid. Enter the amount of the overpayment on this line and indicate whether it should be refunded or applied to the next return by marking the appropriate box.
- *Line 17.* Monthly Summary of Federal Tax Liability should be completed only if the net taxes withheld and incurred during the year shown on line 11 are greater than or equal to \$2,500. Monthly depositors should enter their monthly tax liability on the monthly summary of federal tax liability at the bottom of Form 943. Semiweekly depositors or depositors that had an accumulated tax liability of \$100,000 or more on any day in the month should complete Form 943-A (Agricultural Employer's Record of Federal Tax Liability). The amounts entered on the schedule at the bottom of Form 943 or Form 943-A should represent the liabilities for taxes and withholdings (not the deposits of taxes and withholdings). Their total should equal the amount reported on line 11.
- *Third-party Designee Section.* A taxpayer that wants to allow the IRS to discuss its Form 943 with a designated third party should check the "Yes" box in the third-party designee section of the return. Common third-party designees include an employee or a paid tax preparer. The name and five-digit personal identification number (PIN) of the specific person to contact are entered on the form. Do not enter the name of the firm that prepared the tax return. Checking the "Yes" box authorizes the IRS to call the designee with questions that may arise during the processing of Form 943. If the taxpayer does not want to make a third-party designation, the "No" box in this section should be checked.
- *Section for Signature.* Form 943 must be signed and dated. Individuals eligible to sign the form are discussed later in this lesson.

Due Date. Form 943 is due by January 31st of the following year. Employers that deposit all taxes properly and on time receive an additional 10 days to file the return.

Penalties. The IRS may assess penalties for filing a return late unless there is a reasonable cause. For each whole or partial month the employer fails to file a return when required, the IRS can impose a penalty of 5% (up to a maximum of 25%) of the amount the employer should have reported on the return.

Form 945 (Annual Return of Withheld Federal Income Tax)

Employers are required to report income taxes withheld from nonpayroll items to the IRS on Form 945 (Annual Return of Withheld Federal Income Tax). Nonpayroll items include the following:

- Pensions, annuities, and IRAs.

- Military retirement.
- Indian gaming profits.
- Divorce-related transfers to a nonemployee spouse.
- Voluntary withholding on certain government payments.
- Gambling winnings.
- Payments to nonemployees that are subject to backup withholding.

Specific instructions for completing Form 945 are provided with the form. Best practices for completing the return are as follows:

- *Use the Original Form 945 Provided by the IRS.* The following suggestions will allow the IRS to process Form 945 faster and more accurately: (a) make dollar entries without the dollar sign and the decimal point, commas are optional (Report dollars to the left of the preprinted decimal point and cents to the right of it.), (b) enter negative amounts with a “minus” sign (if possible, otherwise use a parentheses), (c) file the Form 945 that has the company’s preprinted name and address, (d) type or machine print entries in black ink (do not handwrite the entries), and (e) do not tear the form.
- *Review the Employer Information on the Preprinted Forms.* Make sure that the preprinted heading includes the employer’s correct identification number, name, and address. If preprinted forms are not available, review the information for accuracy after it has been entered on a blank Form 945.
- *Address Changes.* Report address changes by changing the preprinted headings as necessary and completing and mailing Form 8822 (Change of Address) to the IRS. Then, check the box on Form 945 that indicates an address change.
- *State Code.* If the employer made tax deposits by FTD coupon (Form 8109) or by using the Electronic Federal Tax Payment System (EFTPS) (see Lesson 2 for information on making tax deposits) in a state other than that shown in its address on Form 945, the Postal Service two-letter state abbreviation for the state where the deposits or initiated EFTPS transfers were made is entered in this box. Enter “MU” in the state code box if deposits were made in more than one state or leave the box blank if deposits are made only in the state shown in the address.
- *Final Return.* If the employer does not expect to file Form 945 in the future, it should mark the appropriate box and enter the date the final payments were made on Line A.
- *Line 1.* Enter the income tax the employer withheld from pensions, annuities, IRAs, military retirement, Indian gaming profits, divorce-related transfers to a nonemployee spouse, certain government payments, and gambling winnings.
- *Line 2.* Enter the income tax the employer withheld as backup withholding (including backup withholding on gambling winnings).
- *Line 3.* Enter the total of lines 1 and 2.
- *Line 4.* Enter the total Form 945 payroll tax deposits made by the company for the year including any overpayment applied from the prior year and any overpayment applied from filing Form 945-X.
- *Line 5.* If line 4 is less than line 3, subtract line 4 from line 3 and enter that amount on this line. If the balance due that is shown on this line is \$2,500 or greater, the employer must deposit the payment at a federally authorized bank or electronically. (Lesson 2 discusses depositing payroll taxes.) If less than \$2,500 is due, the employer should pay the balance due directly to the IRS when Form 945 is filed.

- **Line 6.** If line 4 is greater than line 3, payroll taxes for the year were overpaid. Enter the amount of the overpayment on this line, and indicate whether it should be refunded or applied to the next return by marking the appropriate box.
- **Line 7.** This line should be completed only if the net taxes withheld and incurred during the year shown on line 3 are greater than or equal to \$2,500. Monthly depositors should check the appropriate box and enter their monthly tax liabilities on lines 7A–7L. Semiweekly depositors or depositors that had an accumulated tax liability of \$100,000 or more on any day in the month should check the appropriate box and complete Form 945-A (Annual Record of Federal Tax Liability). The amounts entered on the schedule at the bottom of Form 945 or Form 945-A should represent the liabilities for withholdings (not the deposits of withholdings). Their total should equal the amount reported on line 3.
- **Third-party Designee Section.** A taxpayer that wants to allow the IRS to discuss its Form 945 with a designated third party should check the “Yes” box in the third-party designee section of the return. Common third-party designees include an employee or a paid tax preparer. The name and five-digit personal identification number (PIN) of the specific person to contact are entered on the form. Do not enter the name of the firm who prepared the tax return. Checking the “Yes” box authorizes the IRS to call the designee with questions that may arise during the processing of Form 945. If the taxpayer does not want to make a third-party designation, the “No” box in this section should be checked.
- **Section for Signature.** Form 945 must be signed and dated. Individuals eligible to sign the form are discussed later in this lesson.

Due Date. Generally, Form 945 is not required to be filed unless a company has a nonpayroll tax liability. Form 945 generally is due by January 31st of the following year. If all payroll taxes are deposited when due during the year, however, Form 945 is not due until February 10th of the following year. The IRS requests that taxpayers use Form 945-V (Form 945 Payment Voucher) when making a payment with Form 945.

Penalties. The IRS may assess penalties for filing a return late unless there is a reasonable cause. For each whole or partial month the employer fails to file a return when required, the IRS can impose a penalty of 5% (up to a maximum of 25%) of the amount the employer should have reported on the return.

Form 940 (Unemployment Tax Return)

Federal unemployment taxes are reported to the IRS annually, generally on Form 940. Employers (other than household or agricultural employers) must file the form if they paid wages of \$1,500 or more in any calendar quarter or had at least one employee (including part-time and temporary employees, but excluding partners if a partnership) for at least some part of a day in any 20 or more different weeks during the current or prior year.

Employers that receive Form 940 from the IRS and are not liable for federal unemployment taxes during the year should check box “c” in the top corner of the form, sign it, and return it to the IRS. If returns will not be required in the future, employers should check box “d” in the top corner of the form indicating that the return is a final return.

Under a *de minimis* exception to the FUTA deposit rules, an employer is not required to deposit FUTA taxes for any quarter if its employment tax [i.e., FICA (social security and Medicare) and withheld income taxes] liability is less than \$2,500 (even if it has an accumulated FUTA tax liability greater than \$500) and those taxes are remitted with the employer’s timely filed quarterly employment tax return (e.g., Form 941). Instead, employers accumulate the liability and must only make a deposit when both the employment tax due for a quarter is at least \$2,500 and the accumulated FUTA tax for the year exceeds \$500. An employer qualifying for the *de minimis* exception in the fourth quarter can remit its FUTA tax liability with a timely filed Form 940 (i.e., January 31).

Specific instructions for completing the return are provided with the form. In addition, further instructions can be found in IRS Pub. 15, “Circular E, Employer’s Tax Guide.”

Electronic Filing. Form 940 can be filed electronically through the IRS’s e-file program, which includes an online filing option that allows employers to electronically file Forms 940 through the internet. See the discussion of filing electronically that appears earlier in this lesson.

Due Date. Form 940 is due by January 31st of the following year. Employers that deposit all taxes properly and on time receive an additional 10 days to file the return. A 90-day filing extension may be obtained by submitting a written request to the IRS.

Form W-2 (Wage and Tax Statement) and Form W-3 (Transmittal of Wage and Tax Statements)

Employers report the wages and payroll taxes withheld from each employee on Form W-2, (Wage and Tax Statement.) Copies of the form are sent to each employee, and one copy is sent to the Social Security Administration (SSA). A Form W-2 should be prepared for each employee from whom the employer:

- a. Withheld income tax.
- b. Would have withheld income tax if the employee had not claimed two or more exemptions (including total exemption).
- c. Withheld social security and Medicare taxes.
- d. Paid amounts for advance earned income credit.

Also, every employer engaged in a trade or business who compensates an employee for services performed by the employee, including noncash payments, must furnish a Form W-2 to each employee. This applies to any employee even if the employee is related to the employer.

Form W-3 (Transmittal of Wage and Tax Statements) is a summary form that should be used when submitting Forms W-2 to the SSA.

Due Date. Forms W-2 are due to employees by the earlier of the following:

- January 31. No extension beyond the January 31st deadline is permitted.
- If requested by a terminated employee, 30 days after the employee's request or after the final wage payment.

If an employer has attempted to deliver W-2s by mail but has been unsuccessful, the returned envelope (which is proof of the attempt) should be kept on file until the form is claimed. Forms that cannot be delivered should be kept on file for four years.

A copy of Forms W-2, along with Form W-3, is due to the SSA by the last day of February (March 31, if filed electronically). Thus, employers have the month of February to correct any errors noticed by employees on their W-2s.

Forms W-2 must also be filed with certain states and cities. The dates that Forms W-2 are due to states and cities vary, but generally range from January 31st to March 31st. When a terminated employee requests a wage statement, note that some states have deadlines for the issuance of the wage statements that are shorter than the federal deadlines.

Penalties. Penalties may be assessed for failing to file Forms W-2. In Publication 1586 (Reasonable Cause Regulations and Requirements for Missing and Incorrect Name/TINS), the IRS provides guidance on the steps employers can take to avoid penalties due to filing Forms W-2 with incorrect or mismatched names and Social Security numbers. For example, valid paper or electronic Forms W-4 will satisfy the reasonable cause exception for penalty purposes and a documented Forms W-4 solicitation will be considered adequate due diligence. Once an employer is aware of an incorrect TIN, the employer must resolicit information from the employee. An employer who establishes that it made proper solicitation may also avoid the penalty even if the employee does not complete the Form W-4. In addition, the SSA offers assistance to employers in verifying the social security numbers of employees. For more information on these verification programs, see Lesson 1. Exhibit 3-2 contains the federal penalties for failure to file Forms W-2.

Exhibit 3-2

Federal Penalties for Failure to File Forms W-2

Penalty	Maximum Annual Penalty	
	Regular	Small Business^a
\$50 per each failure to furnish an employee a correct return by the due date	\$ 100,000	\$ 100,000
At least \$100 per each intentional failure to provide employees or the SSA with correct returns	N/A	N/A
\$15 for each return if correctly filed with the SSA within 30 days of due date	\$ 75,000	\$ 25,000
\$30 for each return if correctly filed with the SSA over 30 days after the due date but before August 1st	\$ 150,000	\$ 50,000
\$50 for each return not correctly filed with the SSA by August 1st	\$ 250,000	\$ 100,000

Note:

^a A small business is a company with average annual gross receipts of \$5 million or less for the three most recent taxable years.

* * *

In November 2009, the Department of Homeland Security (DHS) rescinded its regulations issued in 2007 regarding no-match letters. When the employee’s SSN on Form W-2 does not match SSA records, the SSA may send a letter, commonly called a *no-match letter*, to an employer to obtain corrected information. In 2007, the DHS issued regulations that described the employer’s legal obligations after receiving a no-match letter and also established safe-harbor procedures for such employers. The regulations required employers to fix the discrepancies within 90 days or terminate the employment of the worker in question. A preliminary injunction issued by a U.S. district court prevented the 2007 regulations from being implemented. The DHS has now rescinded these 2007 regulations. Instead, the DHS determined that it should use its resources to focus on increased participation in other enforcement programs such as E-Verify. It is possible that the SSA will soon resume sending employers no-match letters. It had stopped doing so after the DHS issued the controversial regulations. In addition, the SSA will continue to send letters (known as *Decentralized Correspondence* or *DECOR letters*) to employees whose names and SSNs on Forms W-2 do not match SSA’s records.

New Cost of Health Coverage Reporting Requirement. The 2010 Patient Protection and Affordable Care Act (Affordable Care Act) included a new reporting requirement that is intended to be informational only and to provide employees with more information about overall health care costs. The IRS issued a draft Form W-2 for 2011 that employers will use to report wages and employee tax withholding. The draft Form W-2 includes the codes that employers may use to report the cost of coverage under an employer-sponsored group health plan. The IRS also announced that it will defer this new reporting requirement and make reporting the cost of coverage under an employer-sponsored group health plan optional for 2011. The Treasury Department and IRS determined that this deferral was necessary to provide employers adequate time to make changes to their payroll systems or procedures in preparation for compliance with the new reporting requirement. The IRS indicated that it will publish guidance on the new requirement by the end of 2010.

Electronic Filing. In general, employers that file 250 or more returns are required to transmit the information to the SSA electronically. (Employers should not file the same returns on paper.) If filed electronically, the forms must meet the requirements described in the SSA’s Specifications for Filing Forms W-2s Electronically (EFW2) publication, which can be downloaded at www.socialsecurity.gov/employer/pub.htm. Employers filing electronically for the

first time should file Form 4419 [Application for Filing Information Returns Electronically (FIRE)] at least 30 days before the deadline for filing the returns (February 28). Form 4419 is available at www.irs.gov.

If filing electronically would be an undue hardship, a waiver from the requirement may be obtained. (The waiver must be obtained each year.) Waivers should be requested from the IRS at least 45 days before the due date of the returns using Form 8508, (Request for Waiver from Filing Information Returns Electronically).

Reporting instructions for electronic filing may differ from paper reporting instructions. For example, electronic filers may enter more than four items in box 12 in one individual's wage report, but paper filers are limited to four items. EFW2 filers can use the SSA's AccuWage software program to check their Form W-2 and Form W-2c reports for errors before filing them with the SSA. AccuWage can be downloaded for free from the SSA's website at www.socialsecurity.gov/employer/accuwage.

Electronic filing offers the advantages of immediate confirmation of receipt, reduced handling costs, and an extended filing period. Electronic filing options include (a) Electronic File Upload through Business Services Online (BSO) and (b) Electronic Data Transfer (EDT). Employers can transmit Form W-2 data directly to the SSA over the internet using BSO but must follow the specifications found in the EFW2. Registration is required before employers can use BSO and may be completed online at www.socialsecurity.gov/bsowelcome.htm or by phone at (800) 772-6270. Additional information about BSO can be found in the SSA's Business Services Online User Handbook for Tax Year 2009, which is available at www.socialsecurity.gov/employer/bsohbnew.htm. As of the date of this course, a more recent version of the Handbook was not available.

Online Preparation and Filing. *W-2 Online*, a feature of BSO, allows employers to manually enter data and then electronically submit Forms W-2 to the SSA over the internet. Employers may create, save, resume, print, and submit up to 20 Forms W-2 per Form W-3 per session, with no limit on the number of sessions, and may have up to 50 saved reports before being required to submit the data to the SSA. BSO will only allow employers to save Forms W-2 that they have been working on for up to 90 days. The *W-2 Online* process will format the wage report from the data entered and prepare printable copies of the Forms W-2 and W-3. The Form W-2 copies are suitable for distribution to employees. The program is intended for single employer reports from filers who do not use software to file reports. Various restrictions exist, such as the inability to file for a tax year other than 2010. Further information, including registration details, is available online at www.socialsecurity.gov/employer/bsohbnew.htm.

Filing Employee W-2s Electronically. Employers may provide Form W-2 to employees through any electronic means to which the employee consents, including email. To be treated as furnishing the Form W-2 in a timely manner to the employee, each of the following requirements must be satisfied:

- a. The employee must consent to electronically receive the Form W-2 and not have withdrawn that consent before the Form W-2 is furnished. The consent must be made electronically in a way that shows the employee can access the Form W-2 in the electronic format in which it will be furnished.
- b. The employer must notify the employee, prior to a change in hardware or software required to access the Form W-2, if such change creates a material risk that the employee will not be able to access the Form W-2. The notice must describe the revised hardware or software and inform the employee that a new consent to receive the Form W-2 in the revised electronic format must be provided. Once the new hardware or software is in place, the employer must obtain the new consent or confirmation of consent in the same way described in item a.
- c. Before or at the time of an employee's consent, the employer must provide the employee with a disclosure statement that contains the following information:
 - (1) A statement that the Form W-2 will be furnished on paper if the employee does not consent to receive it electronically.
 - (2) The scope and duration of the consent. For example, the employee must be informed whether the consent applies to Forms W-2 furnished every year after the consent is given until it is withdrawn or only to the first Form W-2 required to be furnished after consent is given.

- (3) The procedure for obtaining a paper copy of the employee's Form W-2 after giving consent to receive it electronically.
 - (4) How to withdraw the consent. The employee may withdraw consent to receive Forms W-2 electronically at any time by furnishing the withdrawal in writing (either electronically or on paper) to the person or department whose name, mailing address, telephone number, and email address are provided in the disclosure statement. Also, the employee must be informed that the employer will confirm the withdrawal in writing (either electronically or on paper), and that a withdrawal of consent does not apply to a Form W-2 that was furnished electronically before the withdrawal took place.
 - (5) The conditions under which an employer will stop furnishing statements electronically to the employee (e.g., upon the termination of the employee's employment).
 - (6) The procedures for updating the information needed by the employer to contact the employee.
 - (7) A description of the hardware and software required to access, print, and retain the Form W-2 and the date when the Form W-2 will no longer be available on the website. Also, the employee must be informed that the Form W-2 may be required to be printed and attached to a federal, state, or local income tax return.
- d. The electronic version of the Form W-2 must contain all required information and comply with applicable revenue procedures relating to substitute forms.
 - e. The Form W-2 must be posted on a website accessible to the employee on or before January 31 of the year following the calendar year to which it relates.
 - f. No later than January 31, the employer must notify the employee via postal mail, email, or in person that the Form W-2 is posted on a website and give the employee instructions on how to access and print the statement. The notice must include the following statement in capital letters, "IMPORTANT TAX RETURN DOCUMENT AVAILABLE." If the notice is given by email, this statement should be on the subject line of the email, which must be sent with high importance.

If email is used to provide notice that the Form W-2 is available, the email is returned as undeliverable, and the correct email address cannot be located, then the employer must provide notice by postal mail or in person within 30 days after the original email notice is returned.

If the employer issues corrected Forms W-2, the employer must notify the employee that it has posted the corrected forms on a website within 30 days of posting. The employer may make the notice by email, postal mail, or in person. However, if providing notice by email and the email is returned as undeliverable, unless the employer locates the correct email address for the employee, notice must be provided by postal mail or in person.

- g. The employer must maintain access to the Forms W-2 on the website through October 15 of the year following the calendar year to which the Forms W-2 relate. If the Forms W-2 have been corrected, they must be maintained until the later of October 15 of the year following the calendar year to which the Forms W-22 relate, or 90 days after the corrected forms are posted.

Replacements. A lost or damaged employee copy of Form W-2 may be replaced by issuing another Form W-2 and marking the reissued form "REISSUED STATEMENT." Employers should not send reissued statements to the SSA. While employers cannot charge employees a fee for supplying original and corrected Forms W-2, the IRS has announced that employers can charge a fee for supplying reissued copies of the form.

Corrections. How an employer corrects errors on Forms W-2 depends on whether the returns and Form W-3 have been filed with the SSA.

- If the employer corrects the form before filing Forms W-2 and Form W-3 with the SSA, it should (a) give a corrected copy of Form W-2 to the employee, after marking the employee's copies (Copy B, C, and 2)

“Corrected,” (b) void Copy A of the original Form W-2 by marking the appropriate box at the top of the form, and (c) send the original Copy A and the corrected Copy A to the SSA when all of the Forms W-2 are filed. The corrected Copy A should not be marked corrected.

- If the employer corrects the form after filing Forms W-2 and Form W-3 with the SSA, it should issue a Form W-2c to the employee and the SSA. (Form W-3c should be used to transmit Form W-2c to the SSA.)

Avoiding Common Errors. The following tips may help employers avoid errors when preparing Forms W-2 and Form W-3:

- Verify employee names and social security numbers.
- Include bonuses in social security and Medicare wages.
- Use only the current year's versions of Forms W-2 and W-3.
- File Forms W-2 with the Social Security Administration, not the IRS.
- Report both social security and Medicare wages and taxes separately for each employee.
- Verify that the current year maximum social security wage amount (\$106,500 in 2009) is used for the current year's Form W-2 reporting.
- Verify that the amount of wages and taxes withheld are reported in the appropriate box on Form W-2.
- Mark “Retirement Plan” in Box 13 of the W-2s of all employees that are active in the company's pension plan. If the box is not marked, the employee may make a contribution to an IRA that may later be ruled nondeductible. Form W-2 provides instructions.

Reconciliation to Forms 941 or 944. Accountants should reconcile the year's four quarterly Forms 941 (or the annual Form 944, if applicable) to the annual Form W-3. The reconciliation is necessary because the IRS and SSA will require the employer to explain discrepancies between the following information reported on the forms:

- Total compensation.
- Income tax withheld.
- Social security wages.
- Social security tips.
- Social security taxes.
- Medicare wages and tips.
- Medicare taxes.
- Advance earned income credit.

Correcting Errors in Forms 941, 944, or W-2. The following are common errors that create differences between the reports that must be corrected:

- Properly applying the social security wage base limit on the Forms W-2, but mistakenly not applying the limit to the data reported on Forms 941 or 944.
- Properly including other compensation or taxable fringe benefits (such as auto usage or group term life insurance exceeding \$50,000) on Forms W-2 but improperly omitting the amounts from the Form 941 or Form 944 return.

Lesson 2 discusses correcting errors on Forms 941 and Form 944. Correcting errors on Forms W-2 or Form W-3 is discussed later in this lesson.

Reconciliation to Form 940. The IRS will compare the total compensation reported on Form W-3 to total compensation reported on Form 940 and require employers to explain any differences. Therefore, after preparing Form W-3, accountants should reconcile it to Form 940. Proper reconciling differences between the Form W-3, box 1 (wages, tips, and other compensation) and Form 940, Part 2, line 3 (Total payments to all employees) include—

- *401(k) Plan Pre-tax Contributions.* Such amounts are excluded from the Form W-3 but included in the Form 940.
- *403(b) Plan Pre-tax Contributions.* Such amounts are excluded from the Form W-3 but are included in the Form 940.
- *Medical Savings Accounts (MSAs).* Such amounts are excluded from Form W-3 but included in the Form 940.
- *Health Savings Accounts (HSAs).* Such amounts are excluded from Form W-3 but included in the Form 940.
- *SEP and SIMPLE Employee Contributions.* Such amounts are excluded from the Form W-3 but included in the Form 940.
- *Section 125 Plan Pre-tax Contributions.* Such amounts are excluded from the Form W-3 but included in the Form 940 as an amount for line 1 and exclusion in line 2.
- *Deceased Worker Wages Paid in Year of Death.* Such amounts are excluded from the Form W-3 but included in the Form 940.
- *Dependent Care Assistance.* Amounts under \$5,000 (\$2,500 for employees married and filing separately) are excluded from the Form W-3 but included in Form 940 as an amount for line 3 and exclusion in line 4. (Amounts in excess of \$5,000 are included in both figures.)
- *Nontaxable Portion of Third-party Sick Pay.* Certain amounts of third-party sick pay are excluded from Form W-3 but included in Form 940.
- *Adoption Assistance.* Amounts under the \$13,170 limit are excluded from Form W-3 but included in Form 940.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. The Pretzel Company, a chain of restaurants, has tips, wages, FICA taxes, and federal income tax withholding as part of its payroll function. The company has an estimated annual employment tax liability of \$10,000. What form should the company use to report these items to the IRS?
- Form 941.
 - Form 943.
 - Form 944.
 - Form 945.
26. Which of the following companies has correctly followed best practices for filing Form 941?
- Company A uses a copy of the form for recording its information.
 - Company B includes multiple quarters on the same form.
 - Company C enters the number of employees paid during the appropriate pay period on line 2.
 - Company D excludes income taxes withheld from employee pensions from the amount recorded on line 2.
27. First National is a bank that is authorized to prepare and electronically file the Form 941 for taxpayers. What type of authorized IRS e-file provider is First National?
- Electronic return originator.
 - Intermediate service provider.
 - Transmitter.
 - Reporting agent.
28. Armstrong & Banes (A&B) is an authorized IRS e-file provider. As part of helping taxpayers file their Form 941s, A&B obtains taxpayer information through its website. Is A&B required adhere to the e-file rules?
- Yes.
 - No.
29. Pickle Town files its Form 941 three months after the due date and does not have reasonable cause for the delay. The reporting amount on the form is \$7,000. Calculate the penalty that the IRS could assess.
- \$350.
 - \$700.
 - \$1,050.
 - \$1,750.

30. Rose Cottage needs to file Form 944 for 2011. It has not made full payment of taxes due for the period yet. What is the employer's due date for this form?
- It has the same due date as the employer's Form 1040.
 - January 31, 2012.
 - February 10, 2012.
 - April 30, 2012.
31. In which of the following circumstances should the employer file a Schedule H?
- Marianne employs a full-time housekeeper, Greta, to perform domestic tasks in her private home. Greta makes \$10,000 per year.
 - Lois employs an au pair, Jody. Jody is a full-time student who does child care in her off hours. Jody is 17 years old.
 - Robert lives in a private home on his farm. He operates the farm for profit. He also employs a full-time housekeeper who makes \$15,000 per year.
 - Sheila is a member of the Alpha Beta sorority and employs a full-time housekeeper for the sorority house.
32. Grant employs a household employee. Federal income tax is withheld from his paycheck on a regular basis, but Grant does not prepay his household employment taxes. Could the IRS assess a penalty under these circumstances?
- Yes.
 - No.
33. Bascomb Enterprises moved to a new location during the year, and now the preprinted headings on its Form 945 are incorrect. What is one thing Bascomb will have to do to correct this information with the IRS?
- Request a new preprinted form from the IRS.
 - Complete Line 1 of Form 945.
 - File Schedule H.
 - Change the preprinted headings.
34. Are all employers required to File Form 945?
- Yes.
 - No.
35. Which of the following employers qualifies for the *de minimis* exception to the FUTA deposit rules?
- Employer B's quarterly employment tax is less than \$2,500.
 - Employer C is not liable for federal unemployment taxes during the year.
 - Employer D files Form 940 electronically.

36. Awnings & Banners (A&B) is considered a small business by the IRS. What is the maximum annual penalty the IRS can assess if A&B fails to furnish correct Forms W-2 to its employees by the due date?
- a. \$25,000.
 - b. \$50,000.
 - c. \$75,000.
 - d. \$100,000.
37. In which of the following scenarios has the employer correctly dealt with an issue related to Form W-2?
- a. After making an announcement to employees, Paisley Patterns commences filing employee Forms W-2 to them electronically.
 - b. After correcting an error on a Form W-2, Flutterby Fashions issues a new copy of the form and marks it as a reissued statement.
 - c. Because it files more than 250 Forms W-2, Trim Swim Trunks transmits the information to the Social Security Administration electronically.
 - d. Tidepool Topcoats has its accountant reconcile its quarterly Forms 941 to each of its annual Forms W-2.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. The Pretzel Company, a chain of restaurants, has tips, wages, FICA taxes, and federal income tax withholding as part of its payroll function. The company has an estimated annual employment tax liability of \$10,000. What form should the company use to report these items to the IRS? **(Page 75)**
- Form 941. [This answer is correct. Most employers report wages, tips, and payroll related federal income tax withholding and FICA taxes to the IRS quarterly using Form 941 (Employer's Quarterly Federal Tax Return). In this scenario, the Pretzel Company would be required to use Form 941 by the IRS guidelines.]**
 - Form 943. [This answer is incorrect. Employers report wages, federal income tax withholding, and FICA taxes for agricultural employees to the IRS on Form 943 (Employer's Annual Federal Tax Return for Agricultural Employees). Agricultural employees are employees who perform farmwork.]
 - Form 944. [This answer is incorrect. To reduce the tax filing burden, the IRS issued temporary regulations that require certain small businesses to file the new Form 944 (Employer's Annual Federal Tax Return) annually. Only employers whose estimated annual employment tax liability is \$1,000 or less are eligible to file Form 944. Because the Pretzel Company's annual employment tax liability exceeds \$1,000, it is not eligible to use Form 944 in this scenario.]
 - Form 945. [This answer is incorrect. Employers are required to report income taxes withheld from nonpayroll items to the IRS on Form 945 (Annual Return of Withheld Federal Income Tax). The items listed in this scenario are not considered nonpayroll items.]
26. Which of the following companies has correctly followed best practices for filing Form 941? **(Page 77)**
- Company A uses a copy of the form for recording its information. [This answer is incorrect. As a best practice, the company should use the original Form 941 provided by the IRS. This allows the IRS to process the form faster and more accurately.]
 - Company B includes multiple quarters on the same form. [This answer is incorrect. The company should include only one quarter on each return, as the form is intended for only a single quarter. The appropriate box at the top of the form should be checked to indicate the quarter that is being reported.]
 - Company C enters the number of employees paid during the appropriate pay period on line 2. [This answer is incorrect. According to the form, the number of employees paid during the pay period that includes March 12, June 12, September 12, or December 12 for the quarter is indicated at the top of the form on line 1, not line 2.]
 - Company D excludes income taxes withheld from employee pensions from the amount recorded on line 2. [This answer is correct. Companies enter total wages, tips, taxable fringe benefits, and other compensation paid during the period on line 2, even if no income or social security and Medicare taxes were withheld from them. Items such as pensions and annuities are not included, even if income taxes were withheld on them.]**
27. First National is a bank that is authorized to prepare and electronically file the Form 941 for taxpayers. What type of authorized IRS e-file provider is First National? **(Page 80)**
- Electronic return originator. [This answer is incorrect. According to the Form 941 e-file program, an *electronic return originator (ERO)* is the term for an entity that originates the electronic submission of returns. That is not the type of entity described above.]
 - Intermediate service provider. [This answer is incorrect. According to the Form 941 e-file program, an *intermediate service provider* is an entity that receives tax return information from an ERO, processes the

- return information, and either forwards the information to another entity. That is not the type of entity described above.]
- c. Transmitter. [This answer is incorrect. According to the Form 941 e-file program, a *transmitter transmits* electronic return information directly to the IRS. That is not the type of entity described above.]
- d. **Reporting agent.** [This answer is correct. According to the Form 941 e-file program, a *reporting agent is an accounting service, franchiser, bank, service bureau, or other entity that complies with Rev. Proc. 2007-38, and is authorized to prepare and electronically file a taxpayer's Form 941. This accurately describes First National in the scenario above.*]
28. Armstrong & Banes (A&B) is an authorized IRS e-file provider. As part of helping taxpayers file their Form 941s, A&B obtains taxpayer information through its website. Is A&B required adhere to the e-file rules? **(Page 80)**
- a. **Yes.** [This answer is correct. The IRS has established e-file rules to enable it to more quickly identify fraud schemes including phishing. These rules apply to all authorized e-file providers that obtain taxpayer information via the internet (directly or through third parties) in order to e-file federal returns. As described in this scenario, A&B falls into this category, so it does not fit the exceptions to the IRS's e-file rules.]
- b. No. [This answer is incorrect. Authorized e-file providers not affected by the IRS's e-file rules include those that: (1) have a website for information and/or marketing purposes only, (2) only receive or send taxpayer information via email, (3) do not use websites to collect taxpayer information and transmit the returns through third party transmitters, (4) prepare returns and use provider's website to e-file their returns, or (5) only provide a hotlink to another company's website that allows taxpayers to input taxpayer information. In the scenario above, A&B does not fit into any of these exceptions to the IRS's e-file rules.]
29. Pickle Town files its Form 941 three months after the due date and does not have reasonable cause for the delay. The reporting amount on the form is \$7,000. Calculate the penalty that the IRS could assess. **(Page 81)**
- a. \$350. [This answer is incorrect. This is 5% of the amount Pickle Town should have reported to the IRS. This amount would be assessed if Pickle Town filed its form one month late.]
- b. \$700. [This answer is incorrect. This is 10% of the amount Pickle Town should have reported to the IRS. This amount would be assessed if Pickle Town filed its form two months late.]
- c. **\$1,050.** [This answer is correct. The IRS may assess penalties for filing a return late unless there is a reasonable cause. For each whole or partial month the employer fails to file a return when required, the IRS imposes a penalty of 5% (up to a maximum of 25%) of the amount the employer should have reported on the return. Therefore, the correct calculation in this scenario is $\$7,000 \times .15 = \$1,050$, because 5% for each of the three months is 15%.]
- d. \$1,750. [This answer is incorrect. This is 25% of the amount Pickle Town should have reported to the IRS. This is the maximum amount of a penalty that the IRS is entitled to assess. However, it would only be appropriate if Pickle town filed its form a minimum of five months late.]
30. Rose Cottage needs to file Form 944 for 2011. It has not made full payment of taxes due for the period yet. What is the employer's due date for this form? **(Page 84)**
- a. It has the same due date as the employer's Form 1040. [This answer is incorrect. This is the due date for the Schedule H of Form 1040. Because Rose Cottage is not filing Schedule H in this scenario, this due date would not apply.]
- b. **January 31, 2012.** [This answer is correct. Form 944 is due by January 31 following the end of the calendar year. Therefore, according to the IRS, since Rose Cottage is required to file Form 944 for 2011, it has until January 31, 2012 to file the form. If that date is a Saturday, Sunday, or legal holiday, the return can be filed on the next business day.]

- c. February 10, 2012. [This answer is incorrect. Form 944 can be filed on or before the 10th day of the second calendar month following such period if timely deposits have been made in full payment of taxes due for the period. However, since Rose Cottage did not make such deposits, this extension is not applicable.]
- d. April 30, 2012. [This answer is incorrect. Employers filing Form 940 can get a 90-day filing extension by submitting a written draft to the IRS. However, there is no 90-day extension for the Form 944, so Rose Cottage could not use this due date.]
31. In which of the following circumstances should the employer file a Schedule H? **(Page 84)**
- a. **Marianne employs a full-time housekeeper, Greta, to perform domestic tasks in her private home. Greta makes \$10,000 per year. [This answer is correct. Under the Social Security Domestic Employment Reform Act of 1994 (the Nanny Tax), household employees are employees who perform services in or around the employer's private home (such as babysitters, housekeepers, maids, janitors, etc.). For 2010, employers are required to pay employment taxes if the household workers are properly classified as employees (rather than independent contractors) and their wages are at least \$1,700 during the year. Employers must report the taxes on wages paid to household employees on their annual tax return on Schedule H (Form 1040) (Household Employment Taxes).]**
- b. Lois employs an au pair, Jody. Jody is a full-time student who does child care in her off hours. Jody is 17 years old. [This answer is incorrect. Under the Nanny Tax, the employer should not file Schedule H if the household employee is a domestic employee under age 18. In those cases, wages paid to the employee are normally exempt from payroll taxes. The only exception is for individuals whose principal occupation is household employment. For this purpose, being a student is considered an occupation.]
- c. Robert lives in a private home on his farm. He operates the farm for profit. He also employs a full-time housekeeper who makes \$15,000 per year. [This answer is incorrect. Under the Nanny Tax, the employer should not file Schedule H if the household employee worked in the employer's home on a farm operated for a profit. Instead, the employer should file Form 943.]
- d. Sheila is a member of the Alpha Beta sorority and employs a full-time housekeeper for the sorority house. [This answer is incorrect. Under the Nanny Tax, the employer should not file a Schedule H if the household employee worked for a college club, fraternity, or sorority. Instead the employer should file Form 941 or 944.]
32. Grant employs a household employee. Federal income tax is withheld from his paycheck on a regular basis, but Grant does not prepay his household employment taxes. Could the IRS assess a penalty under these circumstances? **(Page 85)**
- a. **Yes. [This answer is correct. The IRS would have the ability to assess a penalty on Grant in this scenario. A household employer who has federal income tax withheld from his or her pay, pension, annuity, etc., should prepay household employment tax.]**
- b. No. [This answer is incorrect. In the scenario above, Grant should have prepaid his household employment taxes. Because he did not, the IRS has the ability to assess a penalty. Another instance when the IRS could assess a penalty when household employment taxes are not prepaid is if the employer would be required to make estimated tax payments even if he or she did not owe household employment taxes.]
33. Bascomb Enterprises moved to a new location during the year, and now the preprinted headings on its Form 945 are incorrect. What is one thing Bascomb will have to do to correct this information with the IRS? **(Page 88)**
- a. Request a new preprinted form from the IRS. [This answer is incorrect. The forms provided by the IRS can be used even if there has been an address change. Therefore, Bascomb does not need to request replacement forms before filing its Form 945. It should consult the form itself for instructions.]

- b. Complete Line 1 of Form 945. [This answer is incorrect. Line 1 of Form 945 is where the company enters income from nonpayroll items. Address change information is gathered elsewhere on Form 945, according to the form.]
 - c. File Schedule H. [This answer is incorrect. Because of its address change, Bascomb will have to file a separate form with the IRS; however, the form it must file is Form 8822 (Change of Address), not Schedule H. Schedule H is associated with Form 1040, not Form 945.]
 - d. **Change the preprinted headings. [This answer is correct. According to the information provided by the IRS, Bascomb must perform the following steps to change its address with the IRS: (1) change the preprinted headings as necessary, (2) complete and mail Form 8822 to the IRS, and (3) check the box on Form 945 that indicates an address change.]**
34. Are all employers required to File Form 945? **(Page 89)**
- a. Yes. [This answer is incorrect. According to the IRS, there are circumstances under which an employer would not be required to file Form 945.]
 - b. **No. [This answer is correct. Generally, according to the IRS, Form 945 is not required to be filed unless a company has a nonpayroll tax liability.]**
35. Which of the following employers qualifies for the *de minimis* exception to the FUTA deposit rules? **(Page 89)**
- a. **Employer B's quarterly employment tax is less than \$2,500. [This answer is correct. Under a *de minimis* exception to the FUTA deposit rules, an employer is not required to deposit FUTA taxes for any quarter if its employment tax [i.e., FICA (social security and Medicare) and withheld income taxes] liability is less than \$2,500 (even if it has an accumulated FUTA tax liability greater than \$500) and those taxes are remitted with the employer's timely filed quarterly employment tax return.]**
 - b. Employer C is not liable for federal unemployment taxes during the year. [This answer is incorrect. Under these circumstances, Employer C would check box "c" in the top corner of Form 940, sign it, and return it to the IRS. However, this is not the *de minimis* exception.]
 - c. Employer D files Form 940 electronically. [This answer is incorrect. Form 940 can be filed electronically through the IRS's e-file program; however, this is not one of the qualifications for the *de minimis* exception.]
36. Awnings & Banners (A&B) is considered a small business by the IRS. What is the maximum annual penalty the IRS can assess if A&B fails to furnish correct Forms W-2 to its employees by the due date? **(Page 91)**
- a. \$25,000. [This answer is incorrect. This is the maximum annual penalty a small business can be assessed (\$15 for each Form W-2) if the forms are correctly filed with the Social Security Administration (SSA) within 30 days of the due date. Because A&B's penalty is assessed for another reason, this penalty maximum would not apply.]
 - b. \$50,000. [This answer is incorrect. This is the maximum annual penalty a small business can be assessed (\$30 for each Form W-2) if the forms are correctly filed with the SSA over 30 days after the due date but before August 1st. Because A&B's penalty is assessed for a different reason, this maximum penalty amount would not apply.]
 - c. \$75,000. [This answer is incorrect. This is the regular maximum annual penalty an employer can be assessed (\$15 for each Form W-2) if the forms are correctly filed with the SSA within 30 days of the due date. Because A&B is a small business, this maximum penalty would not apply under any circumstances. Also, since A&B's penalty was assessed for a different reason in this scenario, this penalty would not apply even if A&B were not considered a small business.]
 - d. **\$100,000. [This answer is correct. The maximum penalty the IRS can assess for failure to furnish an employee a correct return by the due date is \$100,000 (\$50 for each Form W-2). Though A&B is**

considered a small business (average annual gross receipts of \$5 million or less for the three most recent taxable years), under these circumstances, the maximum penalty does not differ for a small business or a regular business.]

37. In which of the following scenarios has the employer correctly dealt with an issue related to Form W-2? **(Page 91)**
- a. After making an announcement to employees, Paisley Patterns commences filing employee Forms W-2 to them electronically. [This answer is incorrect. Not only must the employer notify the employee of this change, but the employee must consent to electronically receive the Form W-2. Paisley Patters would have to satisfy other requirements, as well.]
 - b. After correcting an error on a Form W-2, Flutterby Fashions issues a new copy of the form and marks it as a reissued statement. [This answer is incorrect. How an employer corrects errors on Forms W-2 depends on whether the returns and Form W-3 have been filed with the SSA. However, a reissued statement is different from error correction. A lost or damaged employee copy of Form W-2 may be replaced by issuing another Form W-2 and marking the reissued form "REISSUED STATEMENT."]
 - c. **Because it files more than 250 Forms W-2, Trim Swim Trunks transmits the information to the Social Security Administration electronically. [This answer is correct. In general, employers that file 250 or more returns are required to transmit the information to the SSA electronically. If filed electronically, the forms must meet the requirements described in the SSA's Specification for Filing Forms W-2 Electronically publication.]**
 - d. Tidepool Topcoats has its accountant reconcile its quarterly Forms 941 to each of its annual Forms W-2. [This answer is incorrect. Accountants should reconcile the year's four quarterly Forms 941 to the annual Form W-3, not each Form W-2. Such a reconciliation is necessary because the IRS and the SSA will require the employer to explain any discrepancies related to certain information.]

INFORMATION RETURNS AND PAYROLL TAX RETURN DELIVERY

Information Returns

The federal government requires businesses to report payments to many nonemployees. The form that should be used depends on the type of payment being reported. The following paragraphs discuss the various information returns that may be required.

Form 1099-MISC, Miscellaneous Income. For many small to medium-sized businesses, payments will most often be reported on Form 1099-MISC (Miscellaneous Income). A Form 1099-MISC is required if, in the course of the company's trade or business, it—

- made payments for nonemployee compensation of \$600 or more;
- made royalty payments of \$10 or more;
- made rent payments of \$600 or more (other than to real estate agents);
- gave prizes or awards of \$600 or more that were not for services rendered;
- made cash payments of \$600 or more for fish (or other aquatic life) from anyone in the trade or business of catching fish;
- made direct sales of \$5,000 or more of consumer products for resale;
- withheld federal income tax on miscellaneous income under the backup withholding rules;
- made payments of \$600 or more to physicians or other suppliers or providers of health care services in connection with medical assistance programs, or health, accident, and sickness insurance programs;
- made payments in connection with the sale of a fishing catch, or made a distribution in-kind reported at the fair market value of the catch, to each crew member of fishing boats with normally fewer than 10 members;
- made payments to attorneys; or
- received payments of \$10 or more from a broker on behalf of a customer, in lieu of a dividend or tax-exempt interest, as a result of the transfer of a customer's securities for use in a short sale.

The following payments do not need to be reported on Form 1099-MISC, however:

- Payments to a corporation before January 1, 2012, although there are exceptions.
- Payments before January 1, 2012, for merchandise, telegrams, telephone, freight, storage, and similar payments.
- Payments of rent to real estate agents.
- Wages paid to employees.
- Payments to a tax-exempt organization, the United States, a state, the District of Columbia, a U.S. possession, or a foreign government.
- Certain payment card transactions.

Under current law, payments to corporations, except those made for medical or health care services, are not required to be reported on Form 1099-MISC. However, the Affordable Care Act includes a provision that, effective

for payments made after 2011, requires a business to file an information return for all payments aggregating \$600 or more in a calendar year to a single payee (other than a payee that is a tax-exempt corporation), including corporations.

Form 1099-MISC contains separate boxes to report each of the types of payments listed above. Therefore, companies should report the total of each type of payment made to an individual. For example, if a company paid royalties of \$3,000 and nonemployee compensation of \$5,000 to an individual, it would report the total of each type of payment separately on Form 1099-MISC (rather than report a single \$8,000 amount to the individual).

The business must include a phone number on Form 1099-MISC that gives direct access to a contact that can answer any recipient's question about the information return. The contact phone number should be included in the space provided on Copy B of the form.

Other Information Returns. Although many small to medium-sized companies will be required to file Form 1099-MISC most often, the following information returns may also be required:

- *Form 1097-BTC* for regulated investments companies to elect to distribute tax credit bond credits to shareholders as allowed by the American Recovery and Reinvestment Act of 2009.
- *Form 1098* for mortgage interest (including certain points) of \$600 or more that were received in the course of trade or business from individuals.
- *Form 1098-E* for student loan interest of \$600 or more received in the course of trade or business.
- *Form 1099-A* for lenders to report acquisitions or abandonment of property that secures a loan.
- *Form 1099-B* for (a) brokers to report the gross proceeds from the sale of stocks, bonds, commodities, regulated futures or forward contracts, debt instruments, etc., or (b) barter exchanges to report the exchange of property or services.
- *Form 1099-C* for cancellation of a debt owed of \$600 or more to a financial institution, credit union, FDIC, NCUA, or federal government agency.
- *Form 1099-CAP* for information about cash, stock, or other property from an acquisition of control or the substantial change in capital structure of a corporation.
- *Form 1099-DIV* for (a) payments of \$10 or more in gross dividends and other distributions on stock, (b) withheld foreign tax eligible for the recipient's foreign tax credit on dividends and other distributions on stock, or (c) distributions of \$600 or more in liquidation.
- *Form 1099-G* for certain payments made by a unit of a federal, state, or local government, such as unemployment compensation and state and local income tax refunds.
- *Form 1099-H* for health insurance premiums paid on behalf of certain individuals.
- *Form 1099-INT* for (a) interest of \$10 or more paid or credited by a financial institution or similar organization on deposits, life insurance, or indebtedness; (b) interest of \$600 or more from sources other than those listed in (a) if paid in the course of trade or business; (c) forfeited interest due to premature withdrawals of time deposits; (d) withheld foreign tax eligible for the recipient's foreign tax credit on interest; or (e) payments of any interest on bearer certificates of deposit.
- *Form 1099-LTC* for payments under a long-term care insurance contract and accelerated death benefits paid under a life insurance contract or by a viatical settlement provider.
- *Form 1099-OID* for original issue discount of \$10 or more on obligations including bonds or other evidences of indebtedness, time and savings deposits, and certificates of deposit made, purchased, or renewed after 1970 if the term of the obligation or deposit arrangement is more than one year.

- *Form 1099-PATR* for patronage dividends or other distributions of \$10 or more by cooperatives.
- *Form 1099-Q* for earnings from a qualified tuition program.
- *Form 1099-R* for distributions of \$10 or more from retirement or profit-sharing plans, IRAs, SEPs, or insurance contracts.
- *Form 1099-S* for most real estate transactions.
- *Form 1099-SA* for distributions from an HSA, Archer MSA or Medicare Advantage MSA.
- *Form W-2G* for certain gambling winnings.
- *Form 3921* for the exercise of an incentive stock option.
- *Form 3922* for the transfer of stock acquired through an employee stock purchase plan.
- *Form 4789* for cash payments or transfers by, through, or to a financial institution of \$10,000 or more.
- *Form 5498* for contributions to an individual retirement arrangement (IRA) and the value of an IRA or simplified employee pension (SEP).
- *Form 5498-ESA* for contributions (including rollover contributions) to a Coverdell ESA.
- *Form 5498-SA* for contributions to an HSA, Archer MSA or Medicare Advantage MSA.
- *Form 8300* for cash payments of over \$10,000 received in the course of trade or business.
- *Form 8308* for the sale or exchange of a partnership interest involving unrealized receivables or substantially appreciated inventory items.

Instructions for completing the returns generally are included with the forms.

Capturing the Necessary Information. Bookkeeping systems should be designed to capture the information necessary to prepare tax returns (including information returns). The system can be designed to capture the needed information in a variety of ways. In some instances, the chart of accounts can be structured to accumulate the payment information. For example, if a company uses contract labor, separate subaccounts could be used to capture the nonemployee compensation paid to each individual as follows:

5230-00	Contract Labor
5230-01	Tom James
5230-02	Margaret Smith
5230-03	Walt Wilson
5230-04	Greg Johnson

If designed in that way, the balances in subaccounts 5230-01 to 5230-04 would equal the total balance of contract labor that appears in account 5230-00. (Generally, only one amount would be presented on the balance sheet for contract labor—the balance in account 5230-00. The subaccounts would appear only on the general ledger.)

Alternatively, a company could maintain subledgers that list each payee and the payments made to them. The totals from subledgers would then be posted to the general ledger account. As another alternative, the company could simply maintain files or manual schedules listing payments made to each payee. (If the information is accumulated in that manner, the schedules or files should be totaled and reconciled to general ledger amounts to ensure that all payments are reflected.)

Form 1096. When companies transmit Forms 1099, 1098, 5498, and W-2G to the IRS, they must summarize the information using Form 1096 (Annual Summary and Transmittal of U.S. Information Returns). A separate Form 1096 should be used for each type of information return submitted to the IRS. (Boxes are provided on the form to indicate the types of information returns being submitted.) For example, a company that issues Form 1098 and 1099-A should complete one Form 1096 to accompany the Form 1098 (and check the Form Form 1098 box on that Form 1096) and another Form 1096 to accompany the Forms 1099-A (and check the Forms 1099-A A box on that Form 1096).

In addition to the boxes indicating the type of information returns being transmitted, Form 1096 contains the following five boxes:

- *Box 1 and 2* request the payor's employer identification number or social security number. (The social security number should only be entered if the payor is an individual or sole proprietor and does not have an employer identification number.)
- *Box 3* requests the number of forms being submitted with the Form 1096. Blank or voided forms should not be included in the total. For example, if a page containing three Forms 1099-MISC is submitted, but only two of those forms are completed, 2 would be entered in Box 3 of Form 1096.
- *Box 4* requests the total amount of federal income tax withheld that is reported on the information returns being submitted.
- *Box 5* requests the total amount reported on the accompanying information returns. That amount should be the total of the following boxes on the information returns, depending on the type of information return being submitted:

Form W-2G	Box 1
Form 1097-BTC	Boxes 4a, 4b, 4c, and 4d
Form 1098	Boxes 1 and 2
Form 1098-C	Box 4c
Form 1098-E	Box 1
Form 1098-T	Boxes 1, 2, 4, 5, 6, and 10
Form 1099-B	Boxes 2 and 3
Form 1099-C	Box 2
Form 1099-CAP	Box 2
Form 1099-DIV	Boxes 1a, 2a, 3, 8, and 9
Form 1099-H	Box 1
Form 1099-INT	Boxes 1, 3, and 8
Form 1099-LTC	Boxes 1 and 2
Form 1099-MISC	Boxes 1, 2, 3, 5, 6, 7, 8, 10, 13, and 14
Form 1099-OID	Boxes 1, 2, and 6
Form 1099-PATR	Boxes 1, 2, 3, and 5
Form 1099-Q	Box 1
Form 1099-R	Box 1
Form 1099-S	Box 2
Form 1099-SA	Box 1
Form 3921	Boxes 3 and 4
Form 3922	Boxes 3, 4, and 5
Form 5498	Boxes 1, 2, 3, 4, 5, 8, 9, 10, 12b, 13a, and 14a
Form 5498-ESA	Boxes 1 and 2
Form 5498-SA	Box 1

No entry is necessary if the company is filing Forms 1099-A or 1099-G.

Due Dates. Information returns generally should be sent to the payment recipient by January 31st and to the IRS by the last day of February. Some exceptions to that general rule are as follows:

- If filed electronically, Form 1099 is due to the IRS on March 31st.
- Form 4789 is due to the IRS within 15 days after the transaction. A form need not be sent to the payment recipient.
- Forms 5498 are due to the IRS and the IRA or SEP participant on May 31st. (A form showing the value of the participant’s account should be sent to the participant by January 31st, however.)
- Form 8300 is due to the IRS within 15 days after the transaction. A copy should be sent to the payer before January 31st.
- Form 8308 should be attached to the partnership return and mailed to the IRS when that return is due. A copy should be sent to the transferor and transferee by January 31st.

Penalties. Penalties may be assessed for failing to file information returns. Exhibit 3-3 lists the penalties for failure to file information returns.

Electronic Filing. In general, companies that file 250 or more returns must file electronically. See additional discussion of electronic filing earlier in this lesson. (Companies should not file the same returns on paper.) If filing electronically would be an undue hardship, a waiver from the requirement may be obtained. (The waiver must be obtained each year.) Waivers should be requested from the IRS at least 45 days before the due date of the returns using Form 8508 (Request for Waiver from Filing Information Returns Electronically). Companies filing Forms 1099, 1098, 5498, or W-2G electronically for the first time must obtain IRS approval of the data format they plan to use.

Exhibit 3-3

Federal Penalties for Failure to File Forms 1099

Penalty	Maximum Annual Penalty	
	Regular	Small Business ^a
\$50 per each failure to furnish an employee a correct return by the due date	\$ 100,000	\$ 100,000
At least \$100 per each intentional failure to provide payees or the IRS with correct returns	N/A	N/A
\$15 for each return if correctly filed with the IRS within 30 days of due date	\$ 75,000	\$ 25,000
\$30 for each return if correctly filed with the IRS over 30 days after the due date but before August 1st	\$ 150,000	\$ 50,000
\$50 for each return not correctly filed with the IRS by August 1st	\$ 250,000	\$ 100,000

Note:

^a A small business is a company with average annual gross receipts of \$5 million or less for the three most recent taxable years.

* * *

Forms 1099 are filed electronically using a system called FIRE (Filing Information Returns Electronically). The FIRE system is accessed via the internet at <http://fire.irs.gov>. However, users must have software that can produce a file in the proper format according to Rev. Proc. 2008-30. The FIRE system does not provide a fill-in form option. The FIRE system allows high-speed secure transmissions and operates 24 hours a day, 7 days a week. After one to two

business days, the results of the electronic submission will be emailed to the payer if an accurate email address was provided on the "Verify Your Filing Information" screen. If the email indicated the payer's file is bad, the payer must access the check file status area of the FIRE system to determine what the errors are in the file. It is the payer's responsibility to check the acceptability of the file; therefore, the payer should check back into the system in one to two business days even if no email is received. Further information is available at www.irs.gov/efile or by contacting the Information Reporting Program Customer Service section at (866) 455-7438 (toll-free) [(304) 267-3367 for the hearing impaired].

Filing Recipient Information Returns Electronically. Companies may provide information returns to recipients electronically (including by email) rather than on paper. Form 1098-C may not be furnished electronically. To be treated as furnishing the information returns in a timely manner to the recipient, each of the following requirements must be satisfied:

- a. The recipient must consent to electronically receive the information return and not have withdrawn that consent before the information returned is furnished. The consent must be made electronically in a way that shows the recipient can access the information return in the electronic format in which it will be furnished.
- b. The company must notify the recipient prior to a change in hardware or software required to access the information return if such change creates a material risk that the recipient will not be able to access the information return. The notice must describe the revised hardware or software and inform the recipient that a new consent to receive the information return in the revised electronic format must be provided. Once the new hardware or software is in place, the company must obtain the new consent or confirmation of consent in the same way described in item a.
- c. Before or at the time of an recipient's consent, the company must provide the recipient with a disclosure statement that contains the following information:
 - (1) A statement that the information return will be furnished on paper if the recipient does not consent to receive it electronically.
 - (2) The scope and duration of the consent. For example, the recipient must be informed whether the consent applies to information returns furnished every year after the consent is given until it is withdrawn or only to the first information return required to be furnished after consent is given.
 - (3) The procedure for obtaining a paper copy of the recipient's information return after giving consent to receive it electronically.
 - (4) How to withdraw the consent. The recipient may withdraw consent to receive information returns electronically at any time by furnishing the withdrawal in writing (either electronically or on paper) to the person or department whose name, mailing address, telephone number, and email address are provided in the disclosure statement. Also, the recipient must be informed that the company will confirm the withdrawal in writing (either electronically or on paper), and that a withdrawal of consent does not apply to an information return that was furnished electronically before the withdrawal took place.
 - (5) The conditions under which a company will stop furnishing statements electronically to the recipient.
 - (6) The procedures for updating the information needed by the company to contact the recipient.
 - (7) A description of the hardware and software required to access, print, and retain the information return and the date when the information return will no longer be available on the website.
- d. The electronic version of the information return must contain all required information and comply with applicable revenue procedures relating to substitute forms.
- e. The information return must be posted on a website accessible to the recipient on or before January 31 of the year following the calendar year to which it relates.

- f. No later than January 31, the company must notify the recipient via postal mail, email, or in person that the information return is posted on a website and give the recipient instructions on how to access and print the statement. The notice must include the following statement in capital letters, "IMPORTANT TAX RETURN DOCUMENT AVAILABLE." If the notice is given by email, this statement should be on the subject line of the email, which must be sent with high importance.

If email is used to provide notice that the information return is available, the email is returned as undeliverable, and the correct email address cannot be located, then the company must provide notice by postal mail or in person within 30 days after the original email notice is returned.

- g. The company must maintain access to the information return on the website through October 15 of the year following the calendar year to which the information return relates. If the information returns have been corrected, they must be maintained until the later of October 15 of the year following the calendar year to which the information returns relate, or 90 days after the corrected forms are posted.

Replacements. A lost or damaged recipient copy of an information return may be replaced by issuing another information return and marking the reissued form "REISSUED STATEMENT." Companies should not send reissued statements to the IRS.

Corrections. How a company corrects errors on information returns depends on whether the returns have been filed with the IRS.

- If the company corrects the form before filing the return, it should (a) give a corrected copy of the return to the payee (mark the form "Corrected" only if the incorrect form was previously furnished to the recipient), (b) void Copy A of the original information return by marking the appropriate box at the top of the form, and (c) send the original Copy A and the corrected Copy A to the IRS when all of the information returns are filed. The corrected Copy A should not be marked corrected.
- If the company corrects the form after filing the returns, it should issue a new information return to the payee and the IRS. The company should indicate that the new return is a corrected return by marking the appropriate box at the top of the form.

Delivering the Payroll Tax Returns

The client should be given two copies of its returns—one to file with the appropriate government agency and one to keep in its files. Because many clients are unfamiliar with payroll tax returns and filing procedures, accountants should also provide specific instructions when they deliver the returns. The client should be told:

- a. Who should sign the returns.
- b. The amount of any payments required or refunds due.
- c. When the returns must be filed.
- d. Where the returns and payments should be mailed.

Accountants may deliver a letter with the payroll tax returns to communicate those instructions to the client.

Who Should Sign the Returns? The accountants should not sign the returns. Depending on the type of entity, payroll tax returns generally should only be signed by one of the following individuals:

- Proprietorship—the owner.
- Corporation—the president, vice-president, or other principal officer.

- Partnership—an authorized partner.
- Unincorporated organization—an informed officer.

However, the authorized signer may authorize an agent to sign employment tax returns by filing the current edition of IRS Form 2678 (Employer Appointment of Agent), or authorize an employee to sign the returns by filing IRS Form 2848 (Power of Attorney and Declaration of Representative). Corporate officers or duly authorized agents may sign the forms by facsimile (i.e., by rubber stamp, mechanical device, or computer software program). The person filing the forms must retain a letter, signed by the officer or agent authorized to sign the return, declaring under penalties of perjury that the facsimile signature appearing on the form is the officer's or agent's signature and that the facsimile signature was affixed to the form by the officer or agent or at his or her direction. This letter is not sent to the IRS but should be kept for four years after the later of the due date of the tax or the date the tax is paid.

Exhibit 3-4

Common Form 1099 Errors and Corrections

According to the instructions to the Form 1099, payors should check their forms to avoid the following common form preparation and submission errors:

1. Sending the same information to the IRS more than once (e.g., sending the same information on paper and electronically).
2. Entering the payee's name, address, and/or taxpayer identification number (TIN) differently on the transmittal Form 1096 from that entered on the Forms 1099 being transmitted with the Form 1096.
3. Omitting the decimal point showing dollars and cents (1000.00 is correct, not 1000).
4. Submitting two or more types of returns with one Form 1096 (e.g., sending Forms 1099-INT and 1099-MISC with one Form 1096). Each type of form should be submitted with a separate Form 1096.
5. If after Forms 1099 are filed the payer discovers additional forms are required to be filed, the additional forms should be filed with a new Form 1096. Copies or information on previously filed returns should not be included.
6. Not sending the forms in the required format. Because paper forms are read by optical character recognition equipment, all Forms 1096 and copies A of Forms 1099 must be prepared in accordance with the following instructions. Otherwise, the payer may be subject to a penalty of up to \$100 per incorrectly filed document:
 - a. Never send photocopies of forms. Payers must submit either an official form (which can be obtained from any IRS district office), or an IRS-approved substitute form that meets the specifications listed in the most recent version of IRS Pub. 1179, "General Rules and Specifications for Substitute Forms 1096, 1098, 1099, 3921, 3922, 5498, W-2G, 1042-S, and 8935." Official forms can be obtained at many IRS offices, post offices, and libraries or by calling (800) TAX-FORM [(800) 829-3676].
 - b. Do not cut or separate the forms that are printed two or three to a sheet (except Forms W-2G and 1098-C). Forms 1099 are printed two or three to an 8-inch by 11-inch sheet. Form 1096 is printed one to an 8-inch by 11-inch sheet. If at least one form on the page is correctly completed, the entire page should be submitted.
 - c. Send the forms flat (not folded), and do not staple, tear, or tape any of the forms because doing so will interfere with the IRS's ability to optically scan the documents.
 - d. Remove pinfeed holes/strips before submission, without tearing the form. Substitute forms prepared in continuous or strip form must be burst and stripped to conform to the size specified for a single sheet before they are filed with the IRS.

- e. Do not change the title of any box on any form, and report information only in the appropriate boxes provided on the forms. Make only one entry in each box unless instructed to do otherwise. Do not use a form to report information that is not properly reportable on that form.
- f. Only submit Copy A to the IRS.
- g. Do not use a prior year form unless you are reporting prior year information; similarly, do not use a subsequent year form for the current year.
- h. Do not use dollar signs (\$) (which are preprinted on the forms), ampersands (&), asterisks (*), commas (,), or other special characters in the money amount boxes.
- i. Do not use apostrophes ('), asterisks (*), or other special characters on the payee name line.
- j. Do not enter number signs (#); for example, enter Rt. 2, not Rt. #2.
- k. Do not enter 0 (zero) or "None" in money amount boxes when no entry is required. Leave the boxes blank unless the instructions specifically require that a 0 (zero) be entered. For example, in some cases 0 (zero) must be entered to make corrections.
- l. Although handwritten forms are acceptable, they must be completely legible and accurate to avoid processing errors. Use block print, not script characters. Insert data in the middle of the blocks well separated from other printing and guidelines. Black ink must be used, so that the entries can be machine read.
- m. Typed forms or forms completed using a computer should be prepared using 12-point Courier font and black ink.
- n. Verify the correct postage before mailing. Large envelopes may require extra postage.
- o. With the exception of the electronic tax logo (i.e., the IRS e-file logo), do not use slogans, advertising, and other logos on Forms 1099 or any payee statements reporting amounts paid beginning with the 2010 calendar year.

The following are step-by-step instructions for filing paper forms to correct two common Form 1099 errors. (See also the Form 1099 instructions.)

Filing Corrected Returns on Paper Forms

Identify the correction needed based on **Error Type 1 or 2**; then follow the steps to make the corrections and file the form(s). Also see Part H on page 6.

Error Type 1	Correction
<p>Incorrect money amount(s), code, or checkbox, or Incorrect address, or Incorrect payee name, or A return was filed when one should not have been filed.</p> <p>These errors require only one return to make the correction.</p> <p>Caution: <i>If you must correct a TIN and/or a name and address, follow the instructions under Error 2.</i></p>	<p>A. Form 1098, 1099, 3921, 3922, 5498, or W-2G</p> <ol style="list-style-type: none"> 1. Prepare a new information return. 2. Enter an "X" in the "CORRECTED" box (and date (optional)) at the top of the form. 3. Correct any recipient information such as money amounts and address. Report other information as per original return. <p>B. Form 1096</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Provide all requested information on the form as it applies to Part A, 1 and 2. 3. File Form 1096 and Copy A of the return with the appropriate service center. 4. Do not include a copy of the original return that was filed incorrectly.

Error Type 2	Correction
<p>No payee TIN (SSN, EIN, QI-EIN, or ITIN), or Incorrect payee TIN, or Incorrect name and address or Original return filed using wrong type of return (for example, a Form 1099-DIV was filed when a Form 1099-INT should have been filed).</p> <p>Two separate returns are required to make the correction properly. Follow all instructions for both Steps 1 and 2.</p>	<p>Step 1. Identify incorrect return submitted.</p> <ol style="list-style-type: none"> 1. Prepare a new information return. 2. Enter an "X" in the "CORRECTED" box (and date (optional)) at the top of the form. 3. Enter the payer, recipient, and account number information exactly as it appeared on the original incorrect return; however, enter 0 (zero) for all money amounts. <hr/> <p>Step 2. Report correct information.</p> <p>A. Form 1098, 1099, 3921, 3922, 5498, or W-2G</p> <ol style="list-style-type: none"> 1. Prepare a new information return. 2. Do not enter an "X" in the "CORRECTED" box at the top of the form. Prepare the new return as though it is an original. 3. Include all the correct information on the form including the correct TIN, name, and address. <p>B. Form 1096</p> <ol style="list-style-type: none"> 1. Prepare a new transmittal Form 1096. 2. Enter the words "Filed To Correct TIN," "Filed to Correct Name and Address," or "Filed to Correct Return" in the bottom margin of the form. 3. Provide all requested information on the form as it applies to the returns prepared in Steps 1 and 2. 4. File Form 1096 and Copy A of the return with the appropriate service center. 5. Do not include a copy of the original return that was filed incorrectly.

SOURCE: 2010 General Instructions for IRS Forms 1099, 1098, 3921, 3922, 5498, and W-2G.

* * *

Mailing Procedures. All employment tax returns should be mailed on or before the due date. The employer should keep a copy of the return in the payroll files. The employer should be able to substantiate timely payment of taxes and filing of documents. Previously, only certified U.S. mail, return receipt requested, was acceptable proof. However, private deliverers can be designated as acceptable alternatives. The IRS has designated certain service levels provided by Federal Express, United Parcel Service, and DHL Worldwide Express as acceptable alternatives to the United States Postal Service. However, while the IRS has designated these as acceptable alternatives, the list of filing locations for payroll tax returns generally does not include street addresses. Since delivery services must have a street address, the use of a private delivery service is only an option if the taxpayer is able to obtain a street address from the IRS.

Attachments to Form 941. Any attachments, such as Forms W-4 from employers claiming exempt withholding or more than 10 exemptions, sent with the Form 941 should be marked with the employer's name, EIN, and address. As discussed in Lesson 1, employers are no longer required to submit copies of Forms W-4 with Form 941. Instead, employers must send Forms W-4 to the IRS only if (a) the employer receives a written notice from the IRS directing it to do so, or (b) published guidance (i.e., a revenue ruling or IRS notice) directs the employer to do so.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

38. Ivory Keys, a small business, exercises an incentive stock option. Which information form should the company file?
- a. Form 1098.
 - b. Form 3921.
 - c. Form 4789.
 - d. Form 8300.
39. The Style Depot is a proprietorship. Who should sign its payroll tax returns?
- a. The accountant.
 - b. The president.
 - c. The owner.
 - d. An authorized partner.
40. Which of the following companies has avoided a common error on its Form 1099?
- a. Cumberland Arms sends information to the IRS on paper and electronically to make sure it is received.
 - b. Hampton & Mills shows amounts without a decimal point if the dollar amount is even.
 - c. The Phillips Corporation separates forms for submission if multiple forms are printed on the same sheet.
 - d. Blakewood Enterprises submits a separate Form 1096 with each type of Form 1099.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

38. Ivory Keys, a small business, exercises an incentive stock option. Which information form should the company file? **(Page 106)**
- a. Form 1098. [This answer is incorrect. Form 1098 is required for mortgage interest (including certain points) of \$600 or more that were received in the course of trade or business from individuals. Therefore, this form does not apply to Ivory Keys in the scenario above.]
 - b. Form 3921. [This answer is correct. Although many small to medium-sized companies are required to file Form 1099-MISC most often, other information returns may also be required. According to the IRS, Form 3921 is required for the exercise of an incentive stock option.]**
 - c. Form 4789. [This answer is incorrect. Form 4789 is required for cash payments or transfers by, through, or to a financial institution of \$10,000 or more. Therefore, Ivory Keys would not file this form under the circumstances described above.]
 - d. Form 8300. [This answer is incorrect. Form 8300 is required for cash payments of over \$10,000 received in the course of trade or business. Therefore, this form would not apply to Ivory Keys in this situation.]
39. The Style Depot is a proprietorship. Who should sign its payroll tax returns? **(Page 111)**
- a. The accountant. [This answer is incorrect. Who signs the tax returns depends on what type of entity is filing those returns. However, no matter what type of entity is in question, best practices indicate that the accountant should not sign the returns, since the accountant is not the responsible party to the entity.]
 - b. The president. [This answer is incorrect. If the Style Depot were a corporation, its president, vice president, or other principal officer should sign the payroll tax returns. As the company is a proprietorship, it will not have a president.]
 - c. The owner. [This answer is correct. Because the Style Depot is a proprietorship, as opposed to another type of business entity (e.g., corporation or partnership), it is most appropriate for the owner to sign the payroll tax returns, since the owner is the one primarily responsible for the entity.]**
 - d. An authorized partner. [This answer is incorrect. If the Style Depot were a partnership, an authorized partner should sign its payroll tax returns. As the company is a proprietorship, it will not have partners.]
40. Which of the following companies has avoided a common error on its Form 1099? **(Page 112)**
- a. Cumberland Arms sends information to the IRS on paper and electronically to make sure it is received. [This answer is incorrect. According to the instructions of Form 1099, payors should ensure that they do not send the same information to the IRS more than once, as Cumberland has done in this scenario.]
 - b. Hampton & Mills shows amounts without a decimal point if the dollar amount is even. [This answer is incorrect. According to the instructions of Form 1099, the decimal point showing dollars and cents should not be omitted (i.e., amounts should be written as 1000.00, not 1000). In this scenario, Hampton & Mills has committed a common Form 1099 error.]
 - c. The Phillips Corporation separates forms for submission if multiple forms are printed on the same sheet. [This answer is incorrect. According to the instructions of Form 1099, not sending forms in the required format is a common error. Forms that are printed two or three to a sheet should not be cut or separated, as the Phillips Corporation has done in this scenario.]
 - d. Blakewood Enterprises submits a separate Form 1096 with each type of Form 1099. [This answer is correct. According to the instructions of Form 1099, submitting two or more types of returns with one Form 1096 is a common error (e.g., sending Forms 1099-INT and 1099-MISC with one Form 1096). Each type of form should be submitted with a separate Form 1096, as Blakewood Enterprises has done in this scenario and avoided the error.]**

EXAMINATION FOR CPE CREDIT**Lesson 3 (WUSTG101)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

25. Special compensation must be recorded for payroll tax purposes. Match the following payments with the payroll form on which they are recorded.

<u>Forms</u>	<u>Payments</u>
1. W-2	i. Nonemployee auto reimbursements
2. 1099-G	ii. Allocated tips
3. 1099-R	iii. Directors fees
4. 1099-DIV	iv. Unemployment benefits
5. 1099-MISC	v. Death benefits
	vi. Pension plan distributions
	vii. 401(k) contributions
	viii. Liquidation distributions
	ix. Sick pay
	x. Dividends

- a. 1. –iii. and v.; 2. –i. and x.; 3. –viii.; 4. –ii., vi., and ix.; 5. –iv. and vii.
- b. 1.– vii., and ix.; 2. –ii. and iv.; 3. –x. and vi.; 4. –iii. and v.; 5. –i. and viii.
- c. 1.–ii., vii., and ix.; 2. –iv.; 3. –v. and vi.; 4. –viii. and x.; 5. –i. and iii.
- d. 1.– iv.; 2. – v. and vi.; 3. – ii., vii., and ix.; 4. – i. and iii.; 5. –viii. and x.
26. Halfway through the fiscal quarter, Company Y sells Business A to Company Z. How should the companies handle filing Form 941?
- a. Both companies must file Form 941 for all of Business A's payroll for the quarter.
- b. Company Y must file Form 941 for all of Business A's payroll for the quarter.
- c. Company Z must file Form 941 for all of Business A's payroll for the quarter.
- d. Company Y must file Form 941 for Business A's payroll prior to the sale, and Company Z must file Form 941 for Business A's payroll after the sale.

27. Batteries Limited is filing its final Form 941. On which line of the form will the company provide information related to these circumstances?
- a. Line 1.
 - b. Line 6e.
 - c. Line 14.
 - d. Line 18.
28. List all of the following items that accountants should reconcile between Form 941 and the payroll register.
- | | |
|---|--|
| i. Federal income tax wages and withholdings. | v. Wages and taxes related to household employees. |
| ii. Indian gaming profits. | vi. Military retirement. |
| iii. Medicare wages and taxes. | vii. Tax deposits and liabilities. |
| iv. Social security wages and taxes. | viii. Pensions, annuities, and IRAs. |
- a. i., iii., iv., and vii.
 - b. i., ii., vii., and viii.
 - c. ii., vi., vii., and viii.
 - d. iii., iv., vi., and viii.
29. Peach & Pear Limited (P&P) must file a Form 941 for its first quarter, which ends on March 31, 2011. The company has deposited all payroll taxes when due during this quarter. What is the due date for P&P's Form 941?
- a. March 31, 2011.
 - b. April 10, 2011.
 - c. April 30, 2011.
 - d. May 10, 2011.
30. In previous years, Bertram Enterprises has qualified to file Form 944 instead of Form 941. However, in the middle of the current year, it anticipates that its annual tax liability may exceed \$1,000. How should the company proceed?
- a. It must immediately switch to filing Form 941 quarterly.
 - b. It must start filing Form 941 at the beginning of the next tax year.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

31. Rebecca and John employ a full-time nanny and a housekeeper. What form should they use to report and pay taxes on these household employees?
- a. Schedule H of Form 1040.
 - b. Form 941.
 - c. Form 943.
 - d. Form W-2.
32. Hans owns and operates a farm for profit. As part of his farming operation, he employs agricultural workers on a limited basis. Assuming each employee makes less than \$150 per year, what amount of total wages must Hans pay the workers to be required to file Form 943?
- a. \$150.
 - b. \$1,000.
 - c. \$2,000.
 - d. \$2,500.
33. Assuming Hans paid all his taxes properly and on time, by what date must he file his Form 943 for 2011?
- a. December 31, 2011.
 - b. January 31, 2012.
 - c. February 10, 2012.
 - d. February 28, 2012.
34. Baby Bungalows withholds income taxes on pensions provided to its employees. Which form should the company file under these circumstances?
- a. Form 940.
 - b. Form 941.
 - c. Form 944.
 - d. Form 945.
35. What would Baby Bungalows report on Form 940?
- a. Federal unemployment taxes.
 - b. Wages and payroll taxes that were withheld from each employee.
 - c. All items of special compensation.
 - d. All quarterly wages, tips, and federal income tax withholding related to payroll and FICA.

36. Which of the following employers has correctly dealt with an issue related to Form W-2?
- Muffin Tops files a Form W-2 for all employees from whom it withheld income taxes.
 - Barker Brothers provides Forms W-2 to all employees by February 28th.
 - Lawn Army provides Forms W-2 to the applicable states and cities by April 30th.
 - Monkey See files a Form W-3 to satisfy the reasonable cause exemption regarding any IRS penalties related to its Forms W-2.
37. Which of the following is an error that requires a corrected form?
- Company Q excludes pre-tax contributions to a 401(k) plan from Form W-3 and includes them on Form 940.
 - Company R excludes taxable fringe benefits from Form 941 and includes them on Forms W-2.
 - Company S applies the social security wage base limit to Forms W-2 and 941.
 - Company T excludes dependent care assistance of under \$5,000 from Form W-3 and includes it on Form 940.
38. The Trust Company is a medium-sized business. Under which of the following circumstances should the company file Form 1099-MISC?
- It makes payments to attorneys.
 - It makes payments to a corporation before January 1, 2012.
 - It pays wages to its employees.
 - It pays rent to a real estate agent.
39. In addition to its Form 1099-MISC, the Trust Company must also file the following information returns: Form 1099-C, Form 1099-H, Form 3922, and Form W-2G. The company does not file electronically. What due dates apply?
- The forms must all be sent to the IRS by March 31st.
 - The forms are all due to the IRS within 15 days of the transaction, and the payment recipient does not need a copy.
 - The forms are all due to the IRS within 15 days of the transaction, and the payor's copy must be sent by January 31st.
 - The forms must be sent to payment recipients by January 31st and to the IRS by the last day of February.
40. Which of the following companies has correctly followed appropriate mailing procedures for its payroll tax returns?
- BioChem mails all of its returns by 10 days after the due date.
 - BigCo destroys all copies of its returns after they have been filed with the IRS.
 - GlitterCorp sends its tax returns to an IRS post office box using Federal Express.
 - LittleCo can substantiate timely payment of taxes with a U.S. mail return receipt.

GLOSSARY

Agricultural employees: Employees who perform farmwork.

Electronic return originators (ERO): One of the five authorized IRS e-file providers. An ERO originates the electronic submission of returns.

Employer Identification Number (EIN): The federal employment tax system identifies employers by their EIN, a nine-digit number in the form xx-xxxxxx. This identification number is also referred to as a taxpayer identification number (TIN).

Employer information: For payroll processing purposes, certain employer information is needed, including (1) employer identification number (EIN), (2) the workweek, (3) the pay period.

Employee information: For payroll processing purposes, certain employee information is needed, including (1) name, address, and social security number; (2) work authorization status; (3) pay type; (4) salary or hourly rate; (5) pay frequency; (6) amount of federal income tax that should be withheld from each payroll check; (7) advanced earned income credit (EIC) status; (8) amount of other authorized payroll deductions; and (9) number of normal and overtime hours worked.

Federal income tax withholding: Employers must withhold personal income taxes from employees' wages and remit the withholdings directly to the federal government or its depository bank.

Form 940: Federal unemployment taxes are reported to the IRS annually, generally on this form.

Form 941: Most employers report wages, tips, and payroll related federal income tax withholding and FICA taxes to the IRS quarterly using this form.

Form 943: Employers report wages, federal income tax withholding, and FICA taxes for agricultural employees to the IRS using this form.

Form 944: The IRS allows certain small businesses to reduce their tax filing burden by filing this form annually instead of filing Form 941 quarterly.

Form 945: Employers are required to report income taxes withheld from nonpayroll items to the IRS on this form.

Form W-2: Employers report the wages and payroll taxes withheld from each employee on Form W-2. Copies of the form are sent to each employee, and one copy is sent to the Social Security Administration.

Household employees: Employees who perform services in or around the employer's private home (such as babysitters, housekeepers, maids, janitors, etc.).

Includable compensation: The employee's basic hourly wages for the workweek plus commissions; incentive, on-call, attendance, quality, production, and hazard bonuses; suggestion awards; and noncash compensation.

Information returns: The federal government requires businesses to report payments to many nonemployees. The form that should be used depends on the type of payment being reported. Many use Form 1099-MISC, but other information returns include Form 1098, Form 1099-CAP, Form 1099-INT, Form 1099-LTC, Form W-2G, Form 3921, Form 4789, and Form 8300.

Intermediate service provider: One of the five authorized IRS e-file providers. An intermediate service provider receives tax return information from an ERO (or from a taxpayer or tax exempt organization that files electronically using a computer, modem or the internet, and commercial tax preparation software), processes the return information, and either forwards the information to a transmitter or sends the information back to the ERO (or taxpayer or exempt organization).

Monthly depositor: Employers reporting employment taxes of \$50,000 or less during the lookback period. They must pay each month's employment taxes by the 15th of the following month.

Nonpayroll items: Items including the following: pensions, annuities, IRAs, military retirement, Indian gaming profits, divorce-related transfers to a nonemployee spouse, voluntary withholding on certain government payments, gambling winnings, and payments to nonemployees that are subject to backup withholding.

Payroll services: Accountants often provide the following payroll services: (1) processing payrolls, (2) posting payroll records, (3) computing payroll tax deposits, and (4) preparing payroll tax returns.

Pay period: A grouping of workweeks or days. Those most commonly used by companies are (1) weekly (52 pay periods annually), (2) biweekly (26 pay periods annually), (3) semimonthly (24 pay periods annually), and (4) monthly (12 pay periods annually).

Processing payroll: Preparing payroll checks and recording payroll on the general ledger.

Regular rate: The workweek's total includable compensation before any overtime pay divided by the workweek's total hours worked.

Reporting agents: One of the five authorized IRS e-file providers. A reporting agent is an accounting service, franchiser, bank service bureau, or other entity that complies with Rev. Proc. 2007-38, and is authorized to prepare and electronically file a taxpayer's Form 941.

Schedule H: Employers must report the taxes on wages paid to household employees on their annual tax return on Schedule H (Form 1040).

Semiweekly depositor: Employers reporting employment taxes of over \$50,000 during the lookback period. Semiweekly depositors must deposit employment taxes after each payday, and deposits are due based on the day of the week that the payday falls.

Service providers: Independent companies that provide payroll processing services.

Social security and Medicare taxes (FICA): Employers and employees are subject to FICA taxes. Employers must withhold the taxes from employee wages and pay a matching amount. Employers then must remit their payments, along with employee withholdings, directly to the federal government or its depository bank.

Software developers: One of the five authorized IRS e-file providers. A software developer develops software for the purposes of (1) formatting electronic return information according to publications issued by the IRS that set forth electronic return file specifications and record layouts for tax returns; and/or (2) transmitting electronic tax return information directly to the IRS.

Supplemental wages: Compensation paid to employees in addition to their regular wages, such as bonuses, commissions, tips, overtime pay, awards, prizes, backpay, retroactive pay increases, accumulated sick leave, severance pay, vacation pay, reimbursed employee business expenses (under a nonaccountable plan), taxable fringe benefits, and payment of reimbursed nondeductible moving expenses.

Transmitters: One of the five authorized IRS e-file providers. A transmitter transmits electronic return information directly to the IRS.

Unemployment taxes: Only employers are subject to federal and state unemployment taxes; no amounts are withheld from employees.

Worker classification: The process of determining whether a worker is an employee or an independent contractor.

Workweek: The Fair Labor Standards Act (FLSA) requires employers to designate and document the day and time when the workweek begins. The workweek consists of the seven consecutive 24-hour periods (168 consecutive hours) following the designated time.

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COMPANION TO PPC'S GUIDE TO WRITE-UP SERVICES
COURSE 2
MANAGING A WRITE-UP PRACTICE (WUSTG102)

OVERVIEW

COURSE DESCRIPTION: This course offers guidance on designing a successful write-up practice. This course presents general information about obtaining and retaining clients and staff. The course takes the learner through the entire process, from engagement letter to report delivery. In addition, there is a discussion addressing quality control standards, disaster recovery and succession planning.

PUBLICATION/REVISION DATE: November 2010

RECOMMENDED FOR: Users of *Users of PPC's Guide to Write-Up Services*

PREREQUISITE/ADVANCE PREPARATION: Basic knowledge of accounting.

CPE CREDIT: 6 QAS Hours, 6 Registry Hours

Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.

FIELD OF STUDY: Business Management & Organization

EXPIRATION DATE: Postmark by **November 30, 2011**

KNOWLEDGE LEVEL: Overview

LEARNING OBJECTIVES:

Lesson 1—The Elements of a Successful Write-up Practice

Completion of this lesson will enable you to:

- Recognize the characteristics of a successful write-up practice and describe the development process of planning for a firm.
- Identify methods to develop and retain qualified staff.
- Identify engagement continuation and termination factors.
- Discuss the use of engagement letters to help determine the client's needs and the intended use of the financial statements.
- Identify the considerations for preparing firm reports and correspondence.
- Describe the need for due date monitoring systems and implement billing and collecting procedures.

Lesson 2—Quality Control Standards, Disaster Recovery and Succession Planning

Completion of this lesson will enable you to:

- Recognize the quality control standards that contribute to a successful write-up engagement process.
- Determine the risks and responsibilities in an engagement.
- Identify the features of a disaster recovery plan and a succession plan for a firm.

TO COMPLETE THIS LEARNING PROCESS:

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
WUSTG102 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

See the test instructions included with the course materials for more information.

ADMINISTRATIVE POLICIES:

For information regarding refunds and complaint resolutions, dial (800) 431-9025 for Customer Service and your questions or concerns will be promptly addressed.

Lesson 1: The Elements of a Successful Write-up Practice

INTRODUCTION

The services provided during each write-up engagement may vary. For example, some engagements may only require bookkeeping services while others may require bookkeeping, payroll, and compilation services. Even if the same write-up services are provided for each engagement, the complexity of each engagement may vary depending on the client's size and industry and on the sophistication of the client's accounting system. This course discusses the administrative procedures that should be considered on all engagements regardless of their complexity or the services provided. The course also provides general considerations for managing a write-up practice. Although some of the issues discussed apply primarily to accountants in public practice (such as the discussions on engagement acceptance and continuance, engagement letters, marketing write-up services, billing and collecting write-up services, and professional liability insurance), many of the concepts discussed apply to accountants both in industry and public practice. The following topics are covered in this course:

- Developing a Successful Write-up Practice.
- How to Obtain and Retain a Qualified Staff.
- Accepting and Continuing an Engagement.
- What to Consider in an Engagement.
- Processing Reports, Tax Returns, and Correspondence.
- Implementing a Due Date Monitoring System.
- Billing and Collecting.
- When to apply Quality Control Standards to Write-up Engagements.
- Practice Issues in Write-up Engagements.
- Disaster Recovery Planning.
- Succession Planning.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the characteristics of a successful write-up practice and describe the development process of planning for a firm.
- Identify methods to develop and retain qualified staff.
- Identify engagement continuation and termination factors.
- Discuss the use of engagement letters to help determine the client's needs and the intended use of the financial statements.
- Identify the considerations for preparing firm reports and correspondence.
- Describe the need for due date monitoring systems and billing and collecting procedures.

DEVELOPING A SUCCESSFUL WRITE-UP PRACTICE

Characteristics of a Successful Practice

Successful write-up practices possess characteristics that distinguish them from others. Some of those characteristics are discussed in the following paragraphs.

Commitment. To be successful, a firm must commit sufficient financial, personnel, and other physical resources to its write-up practice. The nature and extent of the necessary resources depends on the types of write-up services the firm intends to provide and the types of clients and industries that the firm intends to serve. That does not mean that a substantial amount of resources must be committed, however. Since much of the work can be performed by paraprofessionals and entry level accountants, a write-up practice often requires less resources than an audit, tax, or consulting practice.

Leadership. Effective leadership is an essential ingredient for success. Although much of the write-up engagement may be performed by the professional staff or paraprofessionals, a partner should be involved in and ultimately responsible for each engagement. The involvement of a partner demonstrates the firm's commitment to the client. It also provides the personal contact that is necessary to maintain strong relationships with clients and to identify other services that clients may need.

Philosophy. A critical element of a successful write-up practice is its philosophy about write-up services. Are they viewed as routine bookkeeping engagements or as important services that can provide many opportunities for firm growth? The philosophy bears directly on the extent of the firm's commitment to its write-up practice. Elements of a successful firm's philosophy include a marketing orientation, adaptability, and a cooperative attitude among partners and staff.

Reputation. A successful firm must have a reputation within the community of being able to effectively meet the needs of its clients. Once developed, a firm's reputation can be one of its greatest assets for obtaining new clients. Achieving a good reputation requires strong marketing techniques as well as the ability to continually provide the needed services.

Planning for a Successful Practice

It has often been said that accounting firms that "fail to plan, plan to fail." This may be somewhat of an exaggeration, but, experience shows, firms that take the time to develop comprehensive business plans are usually more successful than firms that do not. At least firms that have gone through the planning process described in this lesson know where they want to go and how they intend to get there.

Many small to mid-sized accounting firms believe that strategic planning is strictly for the larger firms. However, this lesson discusses the planning process that CPA firms of all sizes should periodically go through. This process is designed to help a firm grow by focusing on its strengths and overcoming its weaknesses. Only by going through a comprehensive planning process can a firm determine where it wants to go in the future and how it is going to get there.

In simple terms, a comprehensive planning system is designed to accomplish the following tasks:

- a. Develop a firm's goals (strategic planning).
- b. Quantify the financial impact of those goals (budgeting).
- c. Define how the firm ensures continuity in key practice areas and plans for the transfer of ownership (succession planning).
- d. Obtain commitment to achieve the firm's goals (individual performance planning).
- e. Evaluate the success or failure of its plan (plan review).

By investing time in the planning process described in this lesson, accounting firms can usually improve their operations by focusing on where they want to go in the future and developing a detailed plan that will help them get there. Once a business plan has been developed and endorsed by the firm's partners and employees, it should then be updated continuously and revised as necessary.

There are two basic approaches to strategic planning: the top-down approach and the participative approach. In a top-down approach, the managing partner (or managing partners) develops the plan based upon his or her own perception of the goals, making all the decisions about the direction and strategies the firm will take to reach its goals. In a participative approach, all of the stakeholders participate in the development of the firm's goals, direction, and strategies. A plan developed using a top-down approach is limited by its lack of input from other partners, managers, and employees and therefore a firm could face a myriad of problems in implementing it. Because the participative approach is a collaborative one, it should be easy to gain general acceptance and commitment from all the members of the firm. The remainder of this lesson discusses the steps involved in developing a strategic plan assuming that the firm is using a participative approach.

The planning process an accounting firm should go through will generally vary little from one firm to the next. There are certain steps that all firms should perform regardless of size or areas of specialization. Those steps are summarized in Exhibit 1-1.

Exhibit 1-1

Overview of the Planning Process

- I. Develop a strategic plan:
 - A. Prepare a vision statement.
 - B. Prepare a mission statement.
 - C. Perform a SWOT analysis:^a
 1. Solicit employee ideas.
 2. Solicit client feed back.
 3. Assess the firm's strengths.
 4. Identify the firm's weaknesses.
 5. Determine future opportunities.
 6. Identify threats.
 - D. Establish objectives.
 - E. Develop strategies that will help the firm accomplish its objectives.
 - F. Formulate an action plan that will involve all partners and employees in the strategic plan.
- II. Develop a budget based on the strategic plan.
- III. Develop a succession plan.

- IV. Assign to all partners and employees individual performance goals that are based on achieving the firm objectives.
- V. Monitor the effectiveness of the business plan on an ongoing basis, and modify it as needed.

Note:

- ^a The SWOT analysis is discussed further later in this lesson.

* * *

Strategic Planning and Budgeting. Business planning is a continuous process, not just something that a firm does once a year. The three primary components of an effective business plan are as follows:

- a. *Strategic Plan.* A strategic plan can be described as a road map of where a firm wants to go during the next three to five years. In developing such a plan, the firm defines its current status and where the firm plans to go in the future. The firm then develops strategies and a detailed action plan that will help it achieve its long-term goals. On a quarterly basis, the firm should reassess the long-term goals contained in the strategic plan. In addition, the firm should make sure that the goals are still attractive and that the firm is on the right track for accomplishing those goals.
- b. *Budget.* A budget is shorter in scope than a strategic plan—it usually covers only a one-year to three-year term rather than a three-year to five-year term. A budget translates a strategic plan into numbers against which a firm's future performance can be measured. It has been described as a tool that quantifies a firm's goals and serves as a yardstick for measuring its degree of success.
- c. *Succession Plan.* A succession plan is a key element of the firm's overall strategic objectives. An effective succession planning process should encompass how the firm ensures that it has qualified employees for each key position in the firm, how it protects itself from potential damage that could result from the loss of key employees, and how the owners plan to transfer ownership of the firm when they retire. Like the strategic plan, the firm should periodically reassess the elements of the succession plan and make modifications as the firm changes its organization or objectives.

It is important to distinguish that while a strategic plan, a budget, and a succession plan are valuable tools for managing a firm, it is the strategic plan that ultimately drives the success of a firm. The budget can measure the financial success of a firm, but it does little to create success for a firm. An effective succession plan supports the strategic plan by providing the continuity needed for the firm to achieve its strategic objectives. Exhibit 1-1 presents an overview of the entire planning process. The main steps that are usually followed in developing a strategic plan are discussed in the following paragraphs.

Performance Management and Individual Performance Goals. A firm cannot develop and monitor a strategic plan without measurable goals supplemented with the information necessary to measure the achievement of those goals. *Performance management* is what the firm does with information developed from measuring performance. It includes establishing individual performance goals for each of the firm's partners and employees to obtain commitment and create accountability for achieving the firm's objectives. Small firm owners often have concerns about whether the benefits of a performance measurement system will outweigh the costs in both time and money necessary to implement the process. Even if a smaller firm is unable to afford the time or resources necessary to implement a comprehensive performance measurement process, it still might benefit from even one of the phases of this process.

The Vision Statement. The vision statement is a written commitment to the firm's goal to succeed. It sets the framework for strategic planning by creating a clear vision for the future of the firm. It is a description in words that conjures up a similar picture for each member of the firm of the destination the firm desires. The vision statement is a motivational tool, including phrasing and activities to which the organization aspires.

The Mission Statement. The mission statement answers three very important questions that a firm must address early in the planning process. Those questions are as follows:

- a. What business are we in?
- b. What business do we want to be in?
- c. What do we want to achieve?

A simple answer to the first two questions might be public accounting. This is not descriptive enough to be useful, however, and it does not allow a firm to differentiate itself from other public accounting firms. Mission statements often focus on a firm's services, its clients, and its growth prospects.

The mission statement should be brief—perhaps just one sentence, but never more than one paragraph. A properly drafted mission statement should reflect the firm's business focus and provide both direction for the firm and motivation for its partners and employees.

The SWOT Analysis. Once the firm has developed its vision and mission statements, the next planning step is to thoroughly analyze its current operating conditions. This process is commonly called a SWOT analysis. SWOT is an acronym for strengths, weaknesses, opportunities, and threats. Strengths and weaknesses are internal firm characteristics. Opportunities and threats generally relate to factors outside the firm over which the firm has little control.

- A *strength* may be defined as a factor that contributes to a firm's competitive edge.
- In identifying a firm's *weaknesses*, the firm is searching for ways it does not measure up well competitively.
- Once the firm has identified its strengths and weaknesses, the next step in the planning process is to look outside the firm for factors that create *opportunities*. Areas worth considering include the firm's markets, its competitors, and the possibility of technological innovation. For instance, a competitor that has lost several clients recently because of fee and service disputes might create an opportunity for the firm to pick up new business. The importance of thoroughly evaluating a firm's opportunities cannot be overstated. The weaker a firm's competitors are, the more growth opportunities the firm will enjoy. An important key to success for an accounting firm is to know its competition.
- *Threats* represent potential external events that could adversely affect the firm's operations and profitability. Threats are often discovered in the same places as opportunities—in the marketplace, among the firm's competitors, from technological developments, and even from regulatory and governmental agencies. After listing all of the threats, the firm should compare the threats to the opportunities previously listed for any inconsistencies. The threats should then be prioritized.

Objectives and Strategies. The next step is to use the firm's strengths, weaknesses, opportunities, and threats discussed thus far to develop objectives and strategies. The real success or failure of the overall strategic planning process hinges on determining objectives, identifying strategies to help the firm achieve its objectives, and developing an effective action plan that will serve as marching orders for the firm's partners and employees. Objectives and strategies are discussed separately in this lesson, but in reality, they are often discussed together during planning sessions. It is hard to suggest an objective without also discussing possible strategies that will help the firm achieve the objective.

Objectives represent the general or high-level goals for improving the firm. Typically, objectives are motivated by profitable growth, however, the firm may also need to develop some defensive objectives. Best practices indicate a firm should have only four to six objectives.

Objectives indicate a firm's chosen direction, and strategies spell out in more details what results are expected. A well-written strategy should have the following characteristics:

- Attainability.

- Difficulty.
- Measurability.
- Controllability.
- Understandability.
- Time boundaries.

Strategies should not be too easy to reach nor should they be impossible to attain. They must be measurable over a specified period of time and within the controllability of the responsible partners and employees. Finally, they should be understandable. If the strategies are not clearly written, disagreements may occur over success or failure.

The world is constantly changing, partly due to technological innovations. CPA firms must keep up with technology, and the firm's response to technological innovations should be included in the strategic plan. The firm's vision of itself in the future should include the vision of how it will do business in terms of technology.

Once the strategies have been written and the financial and other implications have been assessed, the planners should prioritize the strategies. The rating system should be tied to risk and potential reward. Relatively safe projects that are likely to be highly profitable should obviously get the highest ratings. Riskier, less profitable strategies should be ranked lower.

Action Plan. After developing the firm's objectives and strategies, the next step is for the planning team to develop detailed action plans for each strategy that the firm wishes to pursue. Basically, action plans apply more detail to the top-rated strategies so that the projects become more manageable. Action plans serve several basic purposes, including the following:

- Individual responsibilities are assigned.
- Tasks can be prioritized and sequenced so that conflicts and delays will be minimized.
- Some tasks may surface that affect the related cost/benefit analysis.
- Monitoring the progress of the project is easier because due dates are established.

The Budgeting Process. A firm's budget can be described as the strategic plan put into numbers. As discussed earlier, the strategic plan is primarily the narrative part of the business plan that contains ideas, assumptions, strategies, strengths, weaknesses, goals, and other target information. The budget is the part of the business plan that contains the financial data and quantitatively reflects management's plans and direction for the firm.

It is difficult to develop a reliable budget without first going through the strategic planning process. By the same token, a firm can develop a good strategic plan, but it will be difficult for the firm to implement that plan without developing a budget. Both components of a comprehensive business plan are therefore important and should be analyzed in detail at least on an annual basis. In addition, as discussed later, it is recommended that a firm should periodically monitor the success of its business plan—usually on a quarterly basis.

The Succession Planning Process. Significant attention has been given recently to the importance of planning for succession. Succession planning involves an integrated, systematic approach to identify, develop, and retain talent for key positions and areas in line with current and projected business objectives. Lesson 2 discusses succession planning as it relates to the transfer of ownership of the firm. But a firm must plan for the succession of all its key employees, not just for the firm's owners. If the firm does not develop an appropriate action plan, it may be incapable of achieving its short- and long-term strategic goals and future succession plans.

Following are some of the benefits of succession planning:

- a. The firm's ability to achieve its strategic plan is enhanced by ensuring that it has qualified employees for each key position and area.

- b. Employee retention is improved through career planning, creative work assignments, training and development, and career advancement.
- c. The firm gains a better appreciation of the skills, competencies, and interests of the staff which contributes to overall job enrichment.
- d. The firm gets protection against loss of valuable training and knowledge when employees leave the firm.
- e. There is potential for the firm to increase profitability by fostering a more productive and motivated workforce.

It is important that employees have input into the succession planning process as well. Their input should help the firm gain a better understanding of employees' skills, competencies, career interests, and career plans. This understanding is critical to the success of the succession plan. It is also critical that all stakeholders embrace the plan and are fully committed to it. Key steps and considerations required to develop an effective succession plan include the following:

- *Identify key areas and key positions.* Key areas and key positions should be the focus of the firm's succession planning efforts.
- *Identify competencies for the key areas and key positions.* Once the key areas and positions have been identified, the next step is to identify the critical duties of each of the key positions.
- *Identify interested employees and assess them against the key position requirements.* The next step in the succession planning process is to match the competencies and interests of existing employees with those needed for key positions and key areas.
- *Identify a temporary back-up for each key position.* After determining the critical duties that must be performed without interruption, and matching those duties with existing employee competencies, the firm should identify a temporary back-up for each key position who is capable of performing the duties or who can be trained to assume the duties in the case of an emergency.
- *Develop and implement succession and knowledge transfer plans.* Based on the firm's assessment of the skills, knowledge, and experience it requires for key positions and key areas, the firm should prepare an overall career development plan for each key position linking the requirements to appropriate action plans that will ensure that employees have or can acquire and develop the necessary knowledge and skills to advance within the firm and fill the key positions.
- *Implement a leadership development program.* A leadership development program is a critical component for extending the firm's lifecycle. The process of implementing a leadership development program is essential to succession plans for advancement, key positions, and transfer of ownership. The process is the same regardless of whether the plan is for advancement, to fill key positions, or to establish a long-term ownership plan.
- *Evaluate effectiveness.* A succession plan should not be static. The firm should continuously monitor and evaluate it, making modifications as new information is gathered or as its strategic objectives change.

Performance Management and Individual Performance Goals. At this point in the planning process, the firm has prepared or updated its strategic plan and completed its financial budget for the coming year. The firm has also developed vision and mission statements and a succession plan for key positions. The next step is usually to create a performance management system and to establish individual performance goals for each of the firm's partners and employees. By involving the entire firm in the work that needs to be done in setting and accomplishing its goals, the firm increases its chances of success. In order for the firm to achieve its vision and mission, owners must set goals and be accountable. Setting goals for owners and evaluating owner performance are key elements of the strategic planning process and the firm's management. It is also important that day-to-day operations are aligned with the firm's vision and mission and that its core values are defined and incorporated in the performance evaluation program. Overall, the firm's performance management process must be an integral part of the firm's strategic goals.

The firm should obtain personal commitments from all of its partners and employees that they will help the firm accomplish its goals. Specific tasks should be assigned to each partner and employee based on each person's skills, past successes, and other factors. Goals should be reasonable and attainable, both individually and as a whole. They should allow individuals to increase their capabilities and contribute to the firm. Once the partners and employees have accepted the responsibility for their assigned tasks, their performance during the coming year should be evaluated based partly on their ability to achieve their performance goals relating to the firm's business plan.

Employees usually respond well to financial rewards and personal recognition at the end of the evaluation period. The firm should therefore ensure that top performers are adequately rewarded. If some employees succeed in accomplishing their goals while others do not, and everybody is treated the same at review time, there will be no perceived incentive for anyone to strive for goal achievement. In fact, such treatment often creates a disincentive for those employees who are capable of accomplishing aggressive goals. Such employees may become discouraged and not operate at their full potential. Worse yet, such employees may leave the firm if they feel they have not been properly recognized for their accomplishments.

Monitoring the Effectiveness of the Business Plan. Business plans are intended to be working documents. If a firm spends the time necessary to develop a comprehensive business plan, it needs to use it in managing its future operations. It is just as important to the firm's success that the individuals who participated in creating the business plan periodically and regularly analyze whether the firm is on track to achieving the plan goals.

Best practices indicate that an accounting firm should review its strategic plan and any progress made in accomplishing its goals at least quarterly. This review should include the following:

- a. Evaluation of year-to-date financial results.
- b. Discussion of planned or potential activities related to the objectives defined in the firm's strategic plan.
- c. Discussion of any issues that may have surfaced related to the retention of key employees and the effectiveness of the succession plan.

Occasionally, a quarterly review session reveals that an objective needs to be changed. Perhaps an expansion effort has gotten ahead of itself and requires more resources than originally planned. More likely, an objective will be behind schedule for one reason or another, requiring a change of plans. By making sure that changes are incorporated into the plan as they are needed, the firm can ensure that the plan remains an effective management tool throughout the year and into the future.

Expanding or Establishing a Write-up Practice

A firm should develop a comprehensive approach to expanding or establishing a write-up practice that considers its strengths and expertise and the need for the services that it can provide. Because write-up engagements often lead to other services, the firm's approach should include strategies to market all of its services. Generally, such a marketing plan includes the following steps:

- a. Evaluate the firm's capabilities.
- b. Analyze the competition.
- c. Identify the target market.
- d. Develop a marketing strategy.
- e. Select specific marketing methods.

Evaluate Firm's Capabilities. The firm should assess its ability to deliver write-up services. Does the firm have adequate staff to deliver the services on time? Will the firm need to make a significant investment in computer equipment and software? The skills of the professional staff and paraprofessionals also should be assessed and additional training provided as needed. This course provides an excellent source for such training.

In addition, the firm should determine whether it possesses other unique capabilities. For example:

- a. *Does the Firm Have Experience in a Particular Industry?* Clients have more confidence in a firm that is familiar with the unique accounting and reporting requirements of their industry. Also, the firm may have contacts within a particular industry that can result in a valuable network for referrals.
- b. *What Other Services Can the Firm Provide in Addition to Write-up Services?* Clients often need more than just write-up services. For example, they may need the firm to perform tax-planning and prepare tax returns; review, audit, or provide agreed-upon procedures to financial information; assist in developing forecasts and projections; design compensation arrangements; or help them establish banking relationships and obtain financing. Selling write-up services to a prospective client is easier if the firm can demonstrate that it is capable of providing other services that may be needed in the future.

Analyze the Competition. A successful marketing plan should consider the nature and extent of competition. Questions to be investigated include the following:

- a. What services are other firms providing?
- b. For whom are they providing the services?
- c. What rates are they charging?
- d. Are there needs that are not being met?

The existence of competition should not necessarily be considered an impediment to entering the market. In some cases, just the opposite may be true. The existence of competing firms may indicate a need for such services. The key is to determine what services are being offered. The firm can then determine whether it can offer those same services more effectively, offer services that are not currently being offered, or both.

Identify the Target Market. The target market should be defined in detail. A marketing strategy has a better chance of being successful if the firm has a clear understanding and identification of its target market. Defining the target market precisely is a good method for developing a niche that can later be expanded. For example, the firm may decide to target a specific industry in which it has experience. As discussed earlier, the firm may develop a strong referral network within a particular industry that can provide excellent opportunities for practice expansion.

Develop a Marketing Strategy. A marketing strategy is a broad plan that forms the basis for selecting specific marketing methods. It should be tailored to a specific service definition and a specific market definition. It should also include goals that are expressed in measurable terms. For example, goals might be expressed in terms of the number of new clients or billable hours obtained within a definite time period. That gives the firm a yardstick by which to measure results. If possible, the strategy should contain approaches to market differentiation. That enables the firm to differentiate itself from its competitors. Market differentiation plays a significant role in attracting new clients.

Select Specific Marketing Methods. Marketing methods are specific techniques for initiating discussion with a prospective client about a potential engagement. The methods used should be consistent with the marketing strategy, the market definition, and the services the firm plans to offer. Methods should be evaluated in light of the firm's ability to use them properly, their appropriateness for the target market, and the cost/benefit associated with them. Reliance should not be placed on any one method; a combination of techniques is the most effective means of reaching the targeted market. Also, the firm should only use the methods with which it is comfortable and that are consistent with its professional image. The following are some of the more effective marketing methods:

- *Quality Service.* Firms must provide quality service to their clients if they expect to receive referrals from them. Quality write-up service involves not only providing error-free financial information, but also being accessible to clients, delivering services on time, being courteous, and charging fair prices for services rendered.

- *Referrals.* One of the most effective methods of obtaining new clients is through referrals. Obviously, referrals from existing clients can be particularly effective. Other professionals familiar with the firm's services, such as bankers or attorneys, also can be valuable sources for new engagements, however.

Firms should feel free to ask for referrals rather than wait for them to occur. Often, clients or other professionals may not be aware of the firm's desire to expand or its ability to provide certain services. Firms should remember, however, that the referral system is a "two-way street." Those that provide referrals also expect to receive referrals.

- *Newsletters.* Newsletters can serve as an excellent vehicle for marketing the firm's services. They are an effective means of putting forth the firm's name to clients and other referral sources on a regular and continuous basis.

Newsletters can be developed internally or can be purchased from outside sources. The disadvantages of developing a newsletter internally are (a) the cost of professional time used to design, write, and edit the publication is substantial and (b) there is a continuing problem of having enough published articles on hand to fill the pages. Thus, many firms purchase a newsletter from outside sources. With a purchased publication, the product is delivered to the firm ready to be mailed.

- *Websites.* Many firms have their own Internet websites. By creating a relatively inexpensive web presence, a firm can have access to millions of potential customers. A website provides a firm with fresh leads that, when combined with appropriate firm contact and follow-up, can potentially result in new clients.
- *Firm Seminars.* Presenting firm services to small groups of clients and prospective clients is a good marketing technique. Each seminar should have no more than 30 participants (15–20 is preferred) for optimal results. The seminar should ordinarily cover financial and tax topics that are of interest to the target market, either personally or professionally.
- *Joint Seminars.* Joint seminars, like firm seminars, are presentations of firm services to small groups of clients and prospective clients. They are ordinarily presented in cooperation with other professionals, such as bankers and attorneys, and cover a wide variety of topics that are of interest to the target audience.
- *Webinars.* The Internet has made the use of Webinars an effective way to conduct seminars. A Webinar is a live seminar delivered and attended entirely over the internet. According to *PC Magazine*, executives believe that a vendor who invites them to a Web conference is technologically savvy, respectful of their time and budget, and smart and efficient.
- *Speaking Engagements.* Delivering speeches leverages the accountants' time by putting the speaker in front of a large number of prospective clients. Accountants may have frequent opportunities to deliver talks on services the firm provides because many groups are generally eager for such presentations.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Flourishing write-up practices share common traits that set them apart from other firms. Firms pledge numerous resources to the firm to ensure its viability and success. The obligation of the resources demonstrates which of the following characteristic of a successful firm?
 - a. Reputation.
 - b. Commitment.
 - c. Leadership.
 - d. Philosophy.
2. Brown and Briddle, a local write-up firm, is completing its SWOT analysis. Which of the following would be identified as a strength for the firm?
 - a. Langman, Chill and Durham, a competing write-up firm, has recently purchased and installed the latest accounting software.
 - b. Brown and Briddle is unable to recruit new talent to the firm because the firm is not as established as its competitors.
 - c. The partners of Brown and Briddle have several well-established clients that have been with the firm for the last few years.
 - d. Clark Brothers, a competing firm against Brown and Briddle has recently increased their fee structure to their clients.
3. Which of the following accurately describes the budget?
 - a. The budget is the strategic plan expressed financially.
 - b. A reliable budget can be developed outside of the strategic planning process.
 - c. The budget is not usually necessary in the implementation of the business plan.
 - d. The budget is a part of the strategic plan.
4. Establishing individual performance goals is a step in the planning process. Which of the following is an accurate statement?
 - a. An incentive program to recognize sales production is not necessary.
 - b. It is best to treat everyone equally at review time.
 - c. Success is best achieved if goals can only be obtained by a few top performers.
 - d. Success is best achieved if all employees participate in the work that needs to be done to accomplish the firm's goals.

5. A successful marketing plan will include which of the following steps?
- a. Prepare a mission statement and develop a budget.
 - b. Assess the firm's strengths and weaknesses.
 - c. Monitor the business plan and establish objectives.
 - d. Identify the target market and analyze the competition.
6. When selecting specific marketing methods, which of the following is the most accurate statement?
- a. Marketing methods should be chosen based on the firm's ability to use them properly.
 - b. A firm should select one marketing method.
 - c. Providing quality service to clients has no effect on the firm's marketing plan.
 - d. Producing a client newsletter is best when developed internally.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Flourishing write-up practices share common traits that set them apart from other firms. Firms pledge numerous resources to the firm to ensure its viability and success. The obligation of the resources demonstrates which of the following characteristic of a successful firm? **(Page 130)**
 - a. Reputation. [This answer is incorrect. Reputation is an important characteristic of a successful write-up firm. The firm needs to have a good reputation within the community of being able to effectively meet the needs of its clients, but by definition, the reputation of the firm is the opinion of the general public toward the firm and does not obligate the resources to a firm to ensure its viability and success.]
 - b. Commitment. [This answer is correct. To be successful, a firm must commit sufficient financial, personnel and other physical resources to a write-up practice to make sure that the work is completed timely and that all of the clients' needs are met. The nature and extent of the necessary resources depends on the types of write-up services the firm intends to provide and the types of clients and industries that the firm intends to service.]**
 - c. Leadership. [This answer is incorrect. Effective leadership is an essential ingredient of success, but leadership entails the process of social influence that the organizer of the firm can enlist the aid and support of others to accomplish a goal. Leadership does not obligate the resources of the firm, but with good leadership, the resources are used in the most efficient manner to complete the job.]
 - d. Philosophy. [This answer is incorrect. A critical element of a successful write-up practice is its philosophy about write-up services. Elements of a successful firm's philosophy includes a marketing orientation, adaptability, and a cooperative attitude among the partners and staff of the firm. A philosophy does not bind the resources of a firm.]
2. Brown and Briddle, a local write-up firm, is completing its SWOT analysis. Which of the following would be identified as a strength for the firm? **(Page 133)**
 - a. Langman, Chill and Durham, a competing write-up firm, has recently purchased and installed the latest accounting software. [This answer is incorrect. A technology development for a competitor would be classified as a threat for Brown and Briddle, not a strength. A threat is a component of the SWOT analysis. It represents potential external events that could adversely affect the firm's operations and profitability.]
 - b. Brown and Briddle is unable to recruit new talent to the firm because the firm is not as established as its competitors. [This answer is incorrect. Not being able to recruit new talent to the firm would be considered a weakness for Brown and Briddle. It showcases a way that the firm does not measure up well with its competitors and is not a strength in the SWOT analysis.]
 - c. The partners of Brown and Briddle have several well-established clients that have been with the firm for the last few years. [This answer is correct. Well-established clients give the firm a competitive edge in the market and is a strength for Brown and Briddle.]**
 - d. Clark Brothers, a competing firm against Brown and Briddle has recently increased their fee structure to their clients. [This answer is incorrect. A competitor increased their fee structure would be an opportunity for Brown and Briddle because it might cause a client of the competitor to analyze their current service and think about employing a new firm. Opportunity represents the "O" in SWOT.]

3. Which of the following accurately describes the budget? **(Page 134)**
- a. **The budget is the strategic plan expressed financially. [This answer is correct. The budget contains the financial data and quantitatively reflects management's plans and direction for the firm.]**
 - b. A reliable budget can be developed outside of the strategic planning process. [This answer is incorrect. It is difficult to develop a reliable budget without first going through the strategic planning process, since the strategic plan helps set the firm's goals and plans that influence the financial budget.]
 - c. The budget is not usually necessary in the implementation of the business plan. [This answer is incorrect. A firm can develop a good strategic plan, but it will be difficult to implement without first developing a budget. The firm will need the budget to measure the effectiveness of the strategic plan as it is put into motion.]
 - d. The budget is a part of the strategic plan. [This answer is incorrect. The budget planning and strategic planning are separate processes, but each is dependent on the other. The strategic plan is the long range plans of the firm and the budget encompasses a shorter scope. The budget has been described as a tool that quantifies a firm's goals and serves as a yardstick for measuring its degree of success.]
4. Establishing individual performance goals is a step in the planning process. Which of the following is an accurate statement? **(Page 135)**
- a. An incentive program to recognize sales production is not necessary. [This answer is incorrect. Employees usually respond well to financial rewards and personal recognition since rewarded employees usually achieve their objectives.]
 - b. It is best to treat everyone equally at review time. [This answer is incorrect. If some employees succeed in accomplishing their goals while others do not, yet everybody is treated the same at review time, there will be no perceived incentive for anyone to strive for goal achievement.]
 - c. Success is best achieved if goals can only be obtained by a few top performers. [This answer is incorrect. Goals should be reasonable and attainable; they should allow individuals to increase their capabilities and contribute to the firm.]
 - d. **Success is best achieved if all employees participate in the work that needs to be done to accomplish the firm's goals. [This answer is correct. By involving the entire firm in establishing the goals, all of the participants will commit to the process. Everyone involved will want to strive for completion of the goals. The firm's purpose will become personal for every employee and each person will want to assist in achieving the firm's goals.]**
5. A successful marketing plan will include which of the following steps? **(Page 137)**
- a. Prepare a mission statement and develop a budget. [This answer is incorrect. The mission statement is a step in the strategic plan and the budget is developed separately in the comprehensive planning process. Neither of these are included in the marketing plan.]
 - b. Assess the firm's strengths and weaknesses. [This answer is incorrect. The SWOT analysis is performed as part of the strategic plan and is not part of the marketing plan.]
 - c. Monitor the business plan and establish objectives. [This answer is incorrect. The business plan is monitored as a step in the overall planning process. Objectives are included in the strategic plan. A successful marketing plan does not include these steps.]
 - d. **Identify the target market and analyze the competition. [This answer is correct. Both of these are included in marketing planning. By defining the target market, a firm has a better chance of being successful. The competition should be investigated to know what services are provided and at what rates so that a marketing strategy can be developed.]**

6. When selecting specific marketing methods, which of the following is the most accurate statement? **(Page 137)**
- a. **Marketing methods should be chosen based on the firm's ability to use them properly. [This answer is correct. They should be consistent with the marketing strategy, the market definition and the services the firm plans to offer. The method should be comfortable for the firm and consistent with its professional image so the firm feels confident in their choice.]**
 - b. A firm should select one marketing method. [This answer is incorrect. Reliance should not be placed on any one method; a combination of techniques is the most effective means of reaching the targeted market.]
 - c. Providing quality service to clients has no effect on the firm's marketing plan. [This answer is incorrect. Quality service can lead to referrals from satisfied clients, which is a method of marketing.]
 - d. Producing a client newsletter is best when developed internally. [This answer is incorrect. Publishing a newsletter internally can be costly and difficult to produce on a consistent basis, since there can be a continuing problem of having enough published articles on hand to fill the pages.]

HOW TO OBTAIN AND RETAIN A QUALIFIED STAFF

To be successful, a CPA firm's write-up practice must be able to hire and retain competent staff. If client deadlines are consistently missed or staff work needs to be regularly corrected, a firm probably does not have a good chance of being successful. This lesson discusses procedures for recruiting, hiring, training, evaluating, and retaining write-up staff.

Recruiting

For most of 2008, the shortage of accounting professionals was a major issue for a majority of firms. However, as the economy has been declining, there has been a decrease in the number of available accounting positions, both in public accounting and industry accounting. This has led to an overall reduction in hiring, especially by the bigger firms. This creates a great opportunity for smaller firms to recruit candidates that previously would have only considered working for one of the big four firms, a large national firm, or a regional firm. Nevertheless, qualified professionals are difficult to find and to attract because of the heated competition among employers for their skills. Increased competition for employees and fewer accounting graduates coming out of college each year have combined to make the accounting profession's staffing crisis more acute over time. As a result, recruiting has become as important as marketing to many firms.

Many people think of recruiting as interviewing and making offers. On the contrary, recruiting encompasses much more than that. To an accounting firm, recruiting should represent a comprehensive program covering the various steps that culminate in hiring a particular individual to fill an identified job position. Those steps should be part of an ongoing program, even when the firm is not actively looking to hire.

The Supply of New and Experienced Accounting Staff. The accounting industry started to experience a turnaround in capturing the interest of college students. The changes in the accounting world that resulted from Sarbanes-Oxley have often not been considered positive for the accounting industry. However, due to the high profile fraudulent reporting and alleged criminal activities of firms such as Enron and WorldCom, which ultimately led to Sarbanes-Oxley, a career in accounting has again become prestigious and alluring to a higher percentage of college and university students.

According to the AICPA's Private Companies Practice Section (PCPS), finding and keeping professionally qualified staff has consistently been the most significant concern for private accounting firms. Despite the recent rebound in the number of accounting students, getting and keeping staff remains a serious issue and skilled professionals are still in demand. And according to a recent Robert Half International Survey, staff and senior accountants are particularly in high demand. Recruiting new graduates is not the only focus for firms today as there continues to be a shortage of experienced staff. There does not appear to be one specific reason or cause for the shortage of experienced accounting professionals. Instead, the shortage is attributable to a combination of factors working simultaneously to aggravate the situation. Although not all-encompassing, a list of those factors includes the following:

- Fewer experienced accounting professionals available in the market.
- Increased competition for professionals from national and regional firms.
- Improved national and regional firm cultures.
- Defection of staff to industry and more graduates hired directly into industry.
- Young professionals starting their own businesses.
- Professionals temporarily leaving the workforce.
- Changing attitudes of professionals.
- A general unwillingness of young professionals to work in traditional work environments.

What Can Be Done? Because of the need for staff, many firms now have formal, ongoing recruiting programs for both new graduates and experienced professionals at all levels. In addition, to respond to the demand for qualified candidates, many firms are as competitive in the recruiting process as they are for prospective clients. Recruiting is much like marketing. When marketing, the firm tries to sell services to potential clients. When recruiting, the firm tries to sell the firm as a desirable place to work to potential employees. Like marketing, recruiting should be thought of as an ongoing function. To recruit successfully, the firm has to favorably compete with other employers. The firm should try to position itself to job candidates as the “employer of choice.” In order to accomplish this task, it is important to understand what is important to the candidates.

What Are Job Candidates Seeking? The firm should evaluate what job candidates are looking for in an employer in key areas, such as the following:

- Benefits and incentive rewards.
- Personal development.
- Quality of life.

By determining what job candidates consider important in an employer, the firm can stress the positive aspects of how it addresses those areas.

Apart from salary, benefits and incentive rewards are typically two of the top factors that influence candidates to select one employer over another. As a result, it is important to be as competitive as possible in those areas. Flextime, casual dress, and hiring bonuses are a few of the more popular benefits that CPA firms have added to attract candidates.

Another important selection criterion for job candidates is how the job will affect their quality of life. A comprehensive staff retention program can enhance employee quality of life. The benefits of a staff retention program cannot be overemphasized. A functioning staff retention program both reduces existing staff turnover and serves as a powerful recruiting tool. It has considerable appeal to job candidates. In fact, it can be the decisive factor for some job candidates in selecting the firm over other employers. Firms have also increased vacation time and permitted more telecommuting in order to address quality of life issues.

Determining the Types of Candidates to Target. Before beginning the recruiting campaign, the firm needs to determine what type of candidates it wants to target. Job candidates come in many forms. They can be new graduates with little or no experience or highly experienced with specialized knowledge. The days of the “cookie-cutter accountant” are gone. To be successful, accounting firms should realize that a fundamental paradigm shift has taken place. There are no longer strict rules that define who a public accounting professional is or should be.

Before beginning the recruiting process, firms should identify the types of candidates who would most likely fit the profiled position. The types of possible job candidates a firm might target include the following:

- Recent accounting graduates.
- Experienced accounting professionals.
- Graduates who are not accounting majors.
- Older professionals.
- Retired professionals.
- Interns.
- Minorities.
- Paraprofessionals.

Delivering the Recruiting Message. To be effective, the firm should be creative and should deliver its recruiting message at every opportunity and in every available venue. The firm's commitment to recruiting directly affects its success in obtaining (and ultimately retaining) qualified staff. Fortunately, there are numerous sources for locating prospective employees. The following sources may be used to recruit candidates for most positions offered by CPA firms. The most appropriate source will vary with each position.

- *Soliciting Candidates through Advertisements.* Advertising in newspapers, business publications, trade journals, or school bulletin boards can be an effective method of reaching a broad range of potential applicants.
- *On-campus Recruiting.* Entry-level professional employees are often available through on-campus interviews. This technique is perhaps the most successful for obtaining qualified entry-level potential new employees. However, on-campus recruiting can be expensive because it often requires at least one member of the firm to spend a day conducting on-campus interviews at each college or university visited.
- *Using Employment Agencies and Search Firms.* Employment agencies or executive search firms may be helpful, particularly when firms are looking for experienced professional staff or staff with a particular expertise. Agencies and search firms may also be effective when firms lack the resources to screen many applicants or must quickly fill administrative positions.
- *Websites.* Many firms use their websites as recruiting tools. Because college students today are technologically savvy, the firm's use of technology may be an important job selection criterion. In addition to recruiting on its own website, a firm can list job openings on sophisticated recruiting websites.
- *Direct Contact Methods.* Positive direct contact with job candidates can tip the scale in the firm's favor. It is human nature for people to want to work with people they feel comfortable with. There is no substitute for direct contact in cultivating a positive impression about the firm. Direct contact usually occurs only after firms have identified key candidates. Unlike some other industries, accounting firms do not typically contact individuals personally before targeting them as desirable candidates.
- *Video.* In addition to using video as a marketing tool, some firms use it as a recruiting tool for prospective job candidates. Video can be a powerful medium, particularly for the college-aged audience. This can be a two-edged sword, however. Because they have typically spent years viewing cable and satellite television, that audience may be tough to impress. To be effective, the video must hold their interest. A poor quality or uninteresting video can potentially do more harm than good if it gives the viewer a negative impression of the firm.
- *Referrals.* Referrals from business contacts, clients, college professors, current employees, and other sources can be valuable resources for potential new employees. Such sources are often aware of individuals who are considering making an employment change. Additionally, firms may encourage current employees to refer friends or acquaintances for job openings. Presumably, employees know what the firm expects and will refer candidates with good work habits and other characteristics the firm seeks. Firms can encourage such referrals by providing staff with the tools they need as they come across individuals they would like to refer. Use of referral cards or an online form to report a prospect to the right person in the firm who will contact the referred candidate allows existing staff to more easily provide potential new employee recommendations. Consider implementing a monetary reward system for staff members who refer candidates that become part of the firm's staff, and make the rewards public. When other firm employees see the rewards being given, it will encourage more participation in the program.
- *Newspaper and Periodical Advertising.* Employment advertisements placed in local newspapers and professional periodicals are effective for attracting experienced personnel. State and local CPA societies often have a section in their magazines or newsletters for placing such advertisements. One of the problems with this process, however, is the large number of resumes that usually are received from unqualified applicants. Accordingly, the firm needs to carefully word these advertisements to pinpoint the specific type and level of applicant it seeks.
- *Social Media.* The use of social networks such as LinkedIn, Facebook, and Twitter to find potential candidates as well as to help potential candidates find the firm is rapidly replacing more traditional methods

of recruiting new employees. In fact, it is highly likely that recruiting in its current form is a dying profession. A distinct advantage to social networking is that, through user-created profiles that include contact information, employment history, hobbies, association memberships, and network connections, recruiters are able to conduct targeted searches when looking for candidates. And by developing a creative firm profile that allows potential candidates to understand the inner makeup of the firm, the firm will be able to attract compatible, qualified talent. And, social networking is highly cost effective since minimal resources are required to start and maintain a profile on most, if not all, of the popular social networks.

- *Other Methods.* As discussed previously, many firms are now recruiting graduates who are not accounting majors. Talented and motivated candidates with business, English, communications, or other areas of expertise may possess important qualifications for being successful in the accounting profession.
- *Rehiring.* Some firms make a concentrated effort to keep in touch with their former employees in the hope that they will return—especially if the new job at a competitor firm proves disappointing. Former employees are known quantities, they are familiar with the firm's clients, and the firm probably has expended significant resources to train them. In addition, rehired workers generally are very loyal to the firm.

Recruiting Employees

A CPA firm distinguishes itself from the competition by the quality of its people—their desire, initiative, ability, creativity, and loyalty. The best firms tend to employ the best people. As a result, hiring and retaining the best employees available is one of the most important tasks facing a CPA firm.

The following paragraphs offer advice for setting up or modifying the firm's procedures for hiring inexperienced professional staff, experienced professional staff, and administrative personnel. It describes a process that can (a) efficiently locate the person that best fits the job requirements and (b) lessen the firm's legal risks. Specifically, the following paragraphs cover the following topics:

- Quality control considerations.
- Avoiding discrimination.
- Identifying staffing needs.
- Screening candidates.
- The interview process.
- Contacting personal references and former employers.
- Pre-employment testing.
- Evaluating the candidates.
- Suggested documentation.
- Rejecting a candidate.

Quality Control Considerations. Firms subject to peer review must establish policies and procedures for hiring that provide reasonable assurance that employees possess the appropriate characteristics to perform competently. Specifically, SQCS No. 7, *A Firm's System of Quality Control*, (QC 10.37) indicates that the firm should establish policies and procedures over the human resources quality control (QC) element designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to (a) assure engagements are performed in accordance with professional standards and regulatory and legal requirements and (b) enable the firm to issue appropriate reports. The policies and procedures established in this regard should address recruitment and hiring.

Avoiding Discrimination. *Discrimination* can be defined as making a difference in treatment or favor on a basis other than individual merit. For example, historically, minority groups have been discriminated against in the workplace merely because of their race. Numerous federal, state and local laws have been passed over the years that make it illegal to discriminate in the workplace. Generally, firms can comply with the various laws by using common sense when hiring. However, even well-intentioned firms can go astray (with disastrous consequences) if they do not fully understand the statutory requirements. Although discrimination is a consideration of the hiring process, the concept extends well beyond hiring to include promotions, terminations, layoffs, recalls, transfers, leaves of absence, compensation, training, and all other aspects of the employee/employer relationship. For further discussion on employment discrimination see *PPC's Guide to Managing an Accounting Practice*.

Identifying Staffing Needs. The firm should first evaluate its current and anticipated future staffing needs before hiring new employees. Anticipated needs should consider an honest evaluation of the firm's current staffing situation. In today's competitive environment, each staff vacancy represents an opportunity to identify exactly what types and numbers of positions are currently needed or may be needed in the near future. Evaluating staffing levels requires creative management and, if additional duties are assigned to remaining staff, the cooperation of the affected employees.

Developing a Staffing Plan. To support its hiring and recruitment process, the firm should develop a staffing plan. Staffing plans are driven by the strategy of the organization. A beneficial staffing plan requires a prediction of current and anticipated future staffing needs, an assessment of staff availability in the job marketplace (based on supply and demand), and a method for reconciling needs with availability. Staffing forecasts rely on data collection, analysis, and judgment. Conducting demand, supply, gap, and solution analyses, and following up with continuous evaluations, all contribute to the success of the plan. Future needs may be forecasted based on projected attrition rates, potential recruitment sources, hiring strategies, etc. Often, the data collected for a staffing plan is incomplete, but is still suitable for use to devise staffing plans and strategies. Attempting to collect more data at great effort and expense should be avoided in favor of using existing data to the fullest extent possible.

Before hiring new employees, the firm should first evaluate its current and anticipated future staffing needs relative to its staffing plan. Anticipated needs should consider an honest evaluation of the firm's current staffing situation. In today's competitive environment, each staff vacancy represents an opportunity to identify exactly what types and numbers of positions are currently needed or may be needed in the near future. Evaluating staffing levels requires creative management and, if additional duties are assigned to remaining staff, the cooperation of the affected employees.

SQCS Requirements. As the firm addresses the personnel issues covered by the human resources element of the QC standard, the firm is able to determine the number and characteristics of the individuals needed to perform the firm's engagements. SQCS No. 7 (QC 10.39) states that effective recruitment processes help the firm select individuals of integrity who—

- Have the ability to develop the capabilities and competence necessary to perform the firm's work.
- Possess characteristics to enable them to perform competently. Such characteristics may include—
 - Meeting minimum academic requirements established by the firm.
 - Exhibiting maturity, integrity, and leadership traits.

Planning for the Firm's Personnel Needs. At least annually, firm personnel needs should be assessed by the individual responsible for staffing decisions (generally the partner, managing partner, or other individual assigned responsibility for recruitment and hiring). In determining the individual or group of individuals who will be involved in the recruitment and hiring process, the firm needs to remember that such individuals will be representing the firm and promoting its benefits against other prospective employers.

Among the criteria the firm may consider in performing a staffing assessment are the following:

- *Ability to Service Clientele.* The firm needs to evaluate the ability of its staff to provide quality services to its existing clients. Factors to consider include timely completion of engagements, needed expertise in specialized areas, and additional services that may be requested.

- *Anticipated Growth.* If the firm plans to pursue and promote growth of its client base, then the staffing necessary to support such growth needs to be considered and estimated.
- *Personnel Turnover.* In assessing staffing needs, turnover is a consideration. Although the timing of staff attrition is difficult (if not impossible) to predict, firms need to plan for turnover to occur as part of determining personnel needs.
- *Individual Advancement.* The ability of staff members to advance and assume greater responsibility depends, at least to a certain extent, on having qualified personnel to move into the job position left open by the advancement. Accordingly, the firm's advancement plans will often have an impact upon the need to hire a new staff person. Many of the considerations used in developing the firm's recruitment and hiring plan will be applicable in developing an advancement plan.
- *Anticipated Staff Workload.* Firms generally have at least one busy season with heavy workloads during the year that are followed by less busy times (and perhaps even occasional slack times) during other months. Various alternatives exist to handle changing workload demands, including (1) working planned overtime hours during the busy season and (2) hiring part-time or contract personnel. The approach and philosophy for handling busy season workloads has a major impact on hiring decisions.
- *Quality of Life.* Many candidates seeking employment today, especially younger candidates, value work/life balance. Firms with a work environment that does not allow some quality-of-life features may find it difficult to hire and retain younger employees.
- *Succession Plans.* Partner succession plans and succession plans for filling key positions within the firm need to be considered when designing both a hiring and advancement plan. If retirement of a key partner or manager is imminent, or if the loss of an employee in a key position could present a serious danger to the continuity of the firm, a special hiring need for an experienced professional will exist if the firm does not prepare an existing employee to fill that role.

Determining Attributes of New Employees. Once the firm assesses its projected personnel requirements, the firm can determine the qualities sought in potential new employees. It is important to the success of hiring a qualified candidate for the firm to know what traits and abilities they desire in an employee before the recruitment process begins. At the same time, it is unlikely that any one candidate will possess every attribute the firm is seeking. The following considerations enter into the determination of employee qualities sought:

- *Educational and Academic Requirements.* An individual's educational background gives insight into three concerns: (a) whether the individual has the intellectual capacity to perform the job and advance within the firm, (b) whether the individual possesses specialized academic training necessary for the job, and (c) whether the individual has the educational degree requirements to pass the CPA exam. Firms often require that potential candidates have a college degree, majored in accounting, and maintained a certain grade point average.
- *Considering Paraprofessionals.* While most firms desire degreed individuals who majored in accounting, firms should not overlook the many nondegreed candidates who, with proper supervision, can make excellent additions to the staff as paraprofessionals. Assistants and paraprofessionals are individuals who possess basic bookkeeping and accounting skills but lack the education or experience to be a member of the professional staff. Paraprofessionals may be hired to assist with routine accounting, bookkeeping, and tax engagements, allowing the firm's professional staff time to concentrate on more difficult assignments. When properly supervised, paraprofessionals often perform write-up services, tax return preparation, and client billing. Paraprofessionals often also train client bookkeeping staff and prepare depreciation and debt amortization schedules. Since paraprofessionals are generally less costly to hire and retain than professionals, they should not be summarily dismissed as an option. A recruiting and hiring procedure that addresses the requirements of potential new employees needs to give the firm a sound principle with flexible alternatives.
- *Experience Requirements.* The amount of prior experience the firm desires in potential candidates depends on the level of staff person the firm seeks to hire. Generally, when documenting the firm's annual hiring plan,

the firm can be more specific about the experience levels being sought for new employees. For example, a hiring plan might state that the firm plans to hire two entry-level, degreed accountants and one experienced accountant, who ideally has two to three years of public accounting experience.

- *Integrity, Honesty, Maturity, Motivation, Leadership Ability, etc.* Personality attributes are a very important consideration. However, like experience attributes, a specific emphasis on any one attribute over another in a recruitment and hiring procedure statement would make the firm's QC system too restrictive. A general statement about personality attributes the firm seeks in hiring employees can be made instead.

The attributes sought in potential employees should be included in the firm's documentation of its recruitment and hiring plan.

Documenting the Recruitment and Hiring Plan. The degree of documentation used by a firm depends on the size of the firm and the complexity of its annual recruitment and hiring needs. Obviously, a sole practitioner with a small staff of paraprofessionals normally would not need to document a recruitment and hiring plan. However, as a firm grows in size and additional staff is needed, the benefits of documenting such a plan become more apparent. Also, as part of its peer review, the firm will ordinarily be asked whether a recruitment and hiring plan was developed. Accordingly, firms are encouraged to annually document their considerations and plans for recruiting and hiring new staff. Documenting the hiring process is discussed later in this lesson.

Professional Staffing Alternatives. Many CPA firms need additional professional staff only during certain periods of the year. For example, a firm may need additional staff only to complete a special nonrecurring engagement. In those situations, adding full-time staff may not be warranted, and other staffing alternatives should be considered. The following are some alternatives to hiring full-time professional staff:

- a. Part-time or temporary professionals.
- b. Student interns.
- c. Paraprofessionals.

In addition to using part-time and temporary professionals, there are other flexible work options such as flextime and telecommuting that are successfully being used by firms today. Providing flexible work arrangements can be a powerful staff retention strategy. Once the firm has invested in recruiting and training an individual, it has a stake in retaining that person—even if not as a full-time, on-site employee. Instead of losing valued staff, the firm should consider offering them flexible work arrangements. One Fortune 500 company reported that 85% of full-time employees who were prepared to leave the company stayed when offered flexible work arrangements. That illustrates just how effective offering alternative work arrangements can be in retaining staff.

In addition to working a part-time or temporary schedule, there are other options to provide staff opportunities for flexibility. Best practices for firms considering alternative work arrangements are to take a long, hard look at each option. Do not limit the firm to what has been done in the past or to what might appear to be feasible. Strategize about how each option might help to create a flexible model that meets the needs and expectations of firm staff.

Administrative Staffing Alternatives. Many CPA firms with write-up practices also need additional administrative staff. Some of the alternatives to hiring full-time administrative staff include the following:

- *Hire Part-time and Temporary Employees.* Many CPA firms with write-up practices meet administrative staffing needs by hiring part-time or temporary employees. In addition to meeting the firm's immediate needs, such employees can be a source for filling future permanent staff positions.
- *Outsource Selected Administrative Functions.* Some firms utilize outside entities to perform certain administrative functions such as firm payroll processing. The outsourcing alternative is especially attractive if the firm can eliminate an administrative staff position by using outside entities.

Importance of Continuity in Part-time and Temporary Employees. Locating high quality part-time and seasonal professional staff can be difficult, and training new staff each busy season consumes valuable firm time and effort.

Consequently, firms that use seasonal employees should try to develop a group of competent, reliable seasonal professional staff that will return to work for the firm each busy season. Firms should also consider providing selected seasonal staff the opportunity to continue working for the firm on a part-time basis throughout the year if the work load supports it.

Firms may now encounter an increasing number of full-time professional staff, both men and women, who make the choice to work part-time. A part-time or alternative career path can be either temporary or long-term in duration. An individual's desire to go to a part-time status may be driven by family demands, lifestyle issues, or a variety of other factors. Because of the importance of staff continuity and the value of maintaining talented professionals in the work force, firms should consider creative, flexible staffing alternatives. In doing so, firms should evaluate each staff request on a case-by-case basis and arrive at a formal understanding with the individual about the terms and conditions of the arrangement before making the change.

Part-time employees should be made to feel that they are an integral part of the firm. Firms should discourage full-time employees from thinking of part-time staff simply as temporary help who do not require any investment of time or energy.

Screening Candidates. The hiring process may produce a large number of applicants. Firms can narrow the field of candidates by screening applicants in a nondiscriminatory fashion to identify individuals who appear to possess the desired qualifications. To help with the screening process, background information should be requested from each candidate. Generally, that information may be gathered by requesting employment applications and resumes. The following paragraphs discuss the screening process using resumes and employment applications.

Resumes. Resumes generally are the firm's first introduction to the group of aspiring candidates. From them, the firm selects a handful of seemingly qualified individuals for follow-up. Unfortunately, a resume does not always properly reflect the applicant's attributes. Applicants naturally attempt to portray events as favorably as possible, and, in some cases, they exaggerate the truth. Because a resume is essentially a personal advertisement that will rarely reveal anything negative about its author, firms often find themselves in the position of making initial decisions about candidates from information that cannot be considered 100% reliable.

When evaluating resumes, firms should consider the following:

- a. *Consider Removing Information Unrelated to the Job.* Unsolicited personal information often creeps into resumes, and, once known, becomes potentially discriminatory. For instance, a candidate who indicates 1980 as the year of high school graduation is over 40 years old and, consequently, is in a protected class. One solution to that problem is to have an individual who is familiar with the various discrimination criteria, but uninvolved in the resume culling process, sanitize all such information from the incoming resumes before decision makers review them. If the information is removed from consideration, alleging discrimination would be difficult—at least at this stage of the process.
- b. *Read the Experience Section First.* Experience is what matters most when filling non-entry-level jobs. Firms often find that the best indicator of what applicants will do is what they have done elsewhere. Firms should start reading the resume at the most current experience and proceed to earlier jobs. Unexplained gaps between jobs should be investigated. By following that pattern, the firm gives greater attention to the more current (and usually more relevant) experience and better understands the applicant's career progression and chronology.
- c. *Focus on Knowledge, Skills, and Abilities.* The firm should look for verifiable facts—titles, duties, dates, and salaries.
- d. *Look for Signs of Success.* A steady career progression, with increasing responsibilities indicates achievement. Employment while in school, volunteer activities, or special work projects indicate a willingness to work hard. Other desirable signs include bottom-line orientation, career direction, job stability, and descriptions of specific job content.
- e. *Ask the Following Three Questions:*

- (1) Does the applicant meet the minimum job qualifications as stated in the job description and advertisements?
- (2) Could the applicant meet the minimum job qualifications with additional training? Job qualifications usually span several areas; an employee may meet most qualification requirements but fall short in one or two areas. Firms should only ask this question if the applicant appears well qualified in most areas. In addition, this judgment should be applied consistently to all applicants.
- (3) Does the applicant have desirable additional qualifications as stated on the job description?

The firm should not document its review on the resume itself; under some state laws, applicants may have the right to obtain a copy of their resume (or application) at the conclusion of the evaluation process. A firm may use a "Candidate Screening Form" to document its evaluation. After the pool of potential candidates has been screened, the firm can then evaluate in more detail the candidates who pass the screening process.

Employment Applications. Using employment applications allows the firm to obtain answers to its uniform questions and secure as much relevant information about a candidate as is legally permitted. Generally, employment applications should be completed before any interviewing takes place. Exhibit 1-2 lists the type of information normally requested on employment applications.

Exhibit 1-2

Job Application Elements

Personal Data

- Name, address, and telephone number
- Other names used in prior employment
- Verification that candidate is at least 18 years old
- Verification that candidate is authorized to work in the United States
- Driver's license number (if needed to verify driving record)

General Data

- Position being applied for
- Date available to work
- Salary requirement
- Objection to overtime work
- Referral source, if applicable

Employment Data

- List of all prior employers (perhaps with a 10-year limitation)
- Addresses and telephone numbers of previous employers
- Job titles and dates of employment (with explanations of employment gaps)
- Duties and responsibilities
- Salary history
- Name and title of immediate supervisor
- Reason for termination
- Permission to verify employment data with each previous employer

Education Data

- List of all schools attended
- Degrees earned and course specialization

Special Skills Data

- Whether the applicant is a CPA
- Skills acquired on-the-job
- Honors received relevant to the position being sought
- Proficiency on various types of office equipment
- Computer literacy and specific software familiarity

Health Data

- Agreement to take a pre-employment drug test
- Agreement to take a post-employment physical examination

Personal References

- Name, address, telephone number, occupation, and how long known
- Relationships to other employees, if any

* * *

Firms often use employment applications to convey important information to applicants. For example, the application may:

- State that the completion of an application does not guarantee employment.
- Stress that the firm is an equal opportunity employer and will use all information provided on the application in a nondiscriminatory manner.
- Address the consequences of misrepresenting any information on the application (that is, dismissal, if subsequently hired).
- Obtain consent to verify all information on the application.
- Inform the applicant that the firm is an “at will” employer and, therefore, reserves the right to modify or end employment relationships at any time for any reason.
- Direct the applicant to follow all firm policies and procedures, if hired.

The applicant's signature on the form provides evidence acknowledging that the statements made are true.

The Interview Process. After screening and selecting qualified candidates, the interview process may begin. The interview is probably the most important part of the hiring process. It also is the most strenuous, since much information must be gleaned from the candidate in a very short period of time. In some instances, the interview may be conducted in two parts—an initial interview designed to evaluate the candidate's appearance, communication skills, attitude, maturity, and interest in the position and another interview to obtain answers to additional questions and meet other firm personnel.

When conducting an interview, the interviewer should:

- Try to Make the Candidate Feel Important.* The interviewer can make the candidate feel important by telling the candidate the importance of the job. The interviewer should also thank the candidate for attending the interview.
- Help the Candidate Relax.* Focusing on a minor but job-related item during this interview phase helps create a nonthreatening atmosphere. For example, the interviewer may comment on the candidate's college minor. Do not introduce personal topics unrelated to the job, however. Such comments and questions, although intended to be helpful, may unintentionally expose the firm to claims of discrimination.
- Explain the Firm's Hiring Process.* Generally this includes telling the candidate what happens after the initial interview and informing the candidate of the estimated timetable for filling the position.
- Describe the Job Requirements to the Candidate.* Providing this information to the candidate is useful because a common understanding helps create a basis for communication.

The interviewer should ask the candidate open-ended questions (that is, questions that require more than yes or no answers). Such questions require the candidate to answer with some detail and enable the interviewer to gauge the

candidate's verbal communication skills. Properly worded open-ended questions usually provide the interviewer with the best opportunity to learn how the candidate solves problems, makes decisions, and learns from experiences. All questions should be job-related so that problems with discrimination and privacy laws do not arise. The following are examples of questions that may be asked:

- Give a detailed explanation of what you do during a typical work day.
- How have your past job experiences prepared you for this job?
- How would your present employer describe your work habits?
- What subjects caused you the most problems in school and why?
- What kind of work best suits you and why?
- In your previous jobs, what kind of pressures did you encounter and how did you handle those situations?
- What personal qualities would you say have accounted for your success to date?
- Do you like working by yourself or in groups and why?
- What do you know about this firm?
- What are your short- and long-term career goals?

Some firms like to ask each candidate the same questions so that an equal basis exists for evaluating the candidates. The firms list several standard interview questions ahead of time on an interview question sheet. Using predetermined questions should not prevent the interviewer from asking additional questions that may arise during the interview. Additional questions should be noted on the candidate's interview question sheet.

The interviewer should prepare a written evaluation of each candidate interviewed. The evaluation should cover only topics that relate to the job description. For a bookkeeping position, those topics normally include the candidate's personal attributes (professional image, attitude, etc.) and the level of experience that the individual will bring to the job.

Contacting Personal References and Former Employers. Candidates will often provide listings of personal references or former employers that the firm may contact. Although such references may appear to be good sources of information about a candidate, the firm should keep the following in mind when contacting them:

- Personal references are hand-picked by the candidate. Thus, the firm should expect to hear mainly positive comments about the candidate.
- Many federal and state employment laws have been enacted to protect the rights of present and former employees. Often, employers are hesitant to provide detailed information on former employees for fear of becoming part of a possible future employment discrimination lawsuit.

Information requested from former employers should concentrate on the candidate's work habits, attendance record, dependability, personal qualities, and other job-related matters. The information should confirm what has already been provided by the candidate. To be fair, the same questions should be asked for all candidates when making inquiries to personal references and former employers.

Most firms conduct reference checks by telephone. Many attorneys, however, strongly recommend that reference checks be conducted in writing. Written reference checks encourage a response, help avoid learning irrelevant information, and help guard against asking questions that may be construed as discriminatory.

Hostile workplace events that have occurred since the early 1970's have prompted the need for more interviewing diligence. Firms may want to consider performing more than the basic reference checks. In addition to reference checks, firms may consider verifying employment history, including salaries, and performing criminal background checks. Additionally, performing a Social Security check provides every locality where the prospective employee has lived in the last seven years. A full pre-employment check is only necessary on those two or three final candidates the firm desires to know more about.

Pre-employment Testing. Some firms require job applicants to take a skills test to determine whether they possesses the necessary skill and knowledge to perform the job. For example, candidates for a bookkeeping position may be asked to take an accounting knowledge test. Other firms require such tests only if a candidate does not have enough work experience. If pre-employment tests are used, care should be taken to ensure that they are nondiscriminatory. Such tests should be given to all candidates and be relevant to the specific job. (For example, it may be considered discriminatory to administer an accounting skills test to some, but not all, applicants for a bookkeeping position. It also may be considered discriminatory to administer an accounting skills test to applicants for a position that requires no accounting skills.) A test may be used to evaluate the accounting skills of candidates for a bookkeeping position. Because testing is sometimes controversial and regulated both by the Equal Employment Opportunity Commission and individual states, employers should consult an employment law attorney before adopting any testing program.

Evaluating the Candidates. The most critical step in the recruitment and hiring process is evaluating prospective employees. Previous paragraphs have discussed attributes that many firms seek in candidates. During the evaluation stage, the individual in the firm responsible for hiring makes a judgment of whether or not the candidate possesses those attributes. In making this judgment, both objective considerations (grade point averages, college courses, prior work experience, aptitude tests, etc.) and subjective considerations (the individual's personal appearance and response to questions, how references respond, and the interviewer's *general perceptions*) are evaluated.

Many firms attempt to define in their recruitment and hiring system specific criteria that are to be met when evaluating a potential employee. For example, some firms stipulate that a college transcript be obtained for every candidate, that a certain number of references be obtained from each candidate, and that every reference be contacted and those communications documented. While the authors believe that a sound evaluation procedure is necessary, they also believe that, for small to medium-sized firms, the evaluation procedures should be stated in terms of general guidelines, not specific requirements. At the same time, the evaluation procedures should not be too vague or unstructured.

To obtain proper structure and yet maintain flexibility, the authors recommend that a firm adopt an evaluation checklist to guide the process. Such a checklist helps ensure that the firm presents itself in a formal, structured manner to a potential employee instead of in a disorganized, haphazard manner. The use of a checklist may be incorporated into the candidate evaluation procedures.

The evaluation process for an individual with prior professional work experience will be somewhat different than the process for a recent college graduate. When seeking an individual with prior professional work experience, the firm may devote much of its efforts to learning and substantiating that work experience. Firms may want to consider performing more than the basic reference checks. Firms may consider verifying employment history, including salaries, and performing criminal background checks, including inquiring about any outstanding regulatory actions. When requesting information from former employers, concentrate on the candidate's work habits, attendance record, dependability, personal qualities, and other job-related matters. The intent is for the information to confirm what has already been provided by the candidate. A full pre-employment check is only necessary on those two or three final candidates the firm desires to know more about.

Suggested Documentation. Firms should review all hiring information after it has been gathered and accept or reject each candidate. The candidates that will be extended an offer should be contacted by telephone. After the candidate accepts the verbal offer, a written offer should be prepared that includes the following information:

- a. The job title.
- b. Whether the job is considered full or part-time.

- c. Whether the job is exempt or nonexempt from minimum wage and overtime pay regulations.
- d. Starting salary or wage.
- e. Starting date.
- f. Benefits the employee may initially qualify for.
- g. Any special terms of employment.
- h. Employment at will policy.

The firm should send two copies of the offer to the candidate: one to sign and return to the firm indicating acceptance of the offer and another for the candidate's files.

Best practices are to maintain a job file for each position that is recruited. The file should contain the following:

- a. Copies of job advertisements.
- b. All resumes and employment applications received.
- c. All interview evaluation forms completed.
- d. Documentation of all information gathered through references and former employers.
- e. Copies of letters sent to unsuccessful candidates.
- f. Copy of the letter sent to the successful candidate (The original letter, and any other information received or gathered on the successful candidate, also should be placed in that individual's personnel file.)

Since employment laws vary by state, the firm should contact an employment law attorney to see how long the job file should be kept before it is destroyed.

Rejecting a Candidate. One of the firm's most difficult tasks when hiring is telling certain applicants that they are not being hired. Not only is the task unpleasant, it may open the firm to discrimination claims from rejected applicants. Consequently, the firm should treat rejected applicants professionally and courteously, while protecting the firm's interests. The firm should do the following:

- *Document the Reasons the Firm Chose the Successful Candidate.* The firm should not document the reasons on the application or resume, but the documentation can be filed with those documents.
- *Document Separately the Business Reasons Why Each Applicant Considered Ineligible for Hire Was So Labeled.* The firm should not document the reasons on the application or resume, but the documentation may be filed with those documents.
- *Promptly Tell Rejected Applicants and Candidates When the Job Has Been Filled.* The firm may use letters or telephone calls to inform the rejected individuals.
- *Avoid Talking about the Applicant's Weaknesses.* If pressed, the firm should state the successful candidate appeared to be a better match to the job requirements.
- *Be Courteous and Professional.* Most people will respond similarly.

Training and Professional Development of Staff

A CPA firm must have properly trained staff to provide efficient write-up services to clients. Most of the training received by the write-up staff is on-the-job training. The amount of formal continuing professional education (CPE) provided to non-CPA write-up staff varies with each firm.

Quality Control Requirements. SQCS No. 7 indicates that continuing professional development has a significant impact on the ongoing competence of the firm's personnel because it facilitates maintaining their knowledge and capabilities. Effective policies and procedures emphasize the need for all levels of firm personnel to participate in general and industry-specific CPE and other professional development activities that enable them to fulfill their assigned responsibilities, such as passing the Uniform CPA Examination. In addition, such training will satisfy applicable CPE requirements of the AICPA and regulatory agencies.

The firm may provide the necessary training resources and assistance to facilitate the development and maintenance of firm personnel's required capabilities and competence. The firm may use an external source that is suitably qualified for that purpose if the firm lacks the technical expertise, or training resources, or for any other reason.

CPE Requirements. Members of the AICPA are subject to minimum CPE requirements. The requirements, which are described in Section 2.3.3 of the AICPA's Bylaws (BL 230.01 and 230R), state that all AICPA members must complete 120 hours of CPE over a three-year reporting period.

Firms applying for membership in the AICPA Division for CPA Firms agree to a certain level of CPE as a condition of membership. A basic membership requirement of the AICPA Division of CPA Firms is that every professional employed by a member firm must obtain 120 hours of qualifying CPE every three years.

State Boards of Accountancy and State CPA Societies. Most state boards of accountancy also have some form of CPE requirements for licensing. Most state CPA societies also have some form of CPE requirement for their members. Although many state requirements are similar to those of the AICPA, they do vary from state to state. For instance, for licensing, some states require that the individual must complete a stated number of CPE hours in accounting and auditing per reporting period. In addition, some state boards specify the maximum number of CPE hours that can be obtained in a particular delivery mode such as self-study, and some state boards do not allow any credit for certain delivery modes (for example, articles and publications). Some states require a stated number of CPE hours in ethics on a recurring basis and may stipulate that the ethics courses taken be approved by the state board of accountancy. Compliance with a state board's requirements will satisfy the AICPA requirement if certain conditions are met. However, the reverse is not necessarily true. Paragraph IB of the AICPA's *Policies for CPE Membership Requirement* (CPE Section 10 of the AICPA *Professional Standards*) cautions that AICPA standards may not necessarily be sufficient to meet requirements for continued state licensing or certification or for state society membership. Firms should contact their state boards and societies for specific requirements.

Are Write-up Staff Subject to CPE Requirements? All states require CPAs in public practice to meet minimum CPE requirements. Thus, all CPAs on the write-up staff (regardless of whether they are members of the AICPA) must obtain CPE.

Determining whether non-CPAs on the write-up staff must obtain formal CPE is more difficult. Because state CPE requirements extend only to those licensed to practice public accounting, state CPE requirements do not apply to non-CPAs. In addition, the AICPA's CPE requirement applies only to AICPA members. However, a requirement for membership in the AICPA Division of CPA Firms is that all *professionals* employed by a member firm meet certain CPE requirements. Thus, whether non-CPAs must obtain formal CPE depends on (a) whether the firm is a member of the AICPA Division of CPA Firms and (b) whether non-CPAs are classified as professionals.

The following literature addresses the issue of whether non-CPAs are considered professionals:

- a. The AICPA's CPE requirement applies only to AICPA members. The AICPA's *Statement on Standards for Continuing Professional Education Programs* applies to CPAs, which it defines in footnote 1 as "all persons who are licensed and/or regulated by boards of accountancy."
- b. *Government Auditing Standards* (the Yellow Book) states that CPE requirements apply to specialists who perform as members of the audit team, even if they are not CPAs.

In addition, SQCS No. 7 requires assigned personnel to have the necessary capabilities, competence, and time to perform engagements in accordance with professional standards and regulatory and legal requirements and to ensure that the firm issues reports that are appropriate in the circumstances. Accordingly, the firm's personnel are

required to have a sufficient level of continuing professional development to maintain their knowledge and capabilities. The standard states that the firm's policies should emphasize that all levels of firm personnel participate in general and industry-specific continuing professional education and other professional development activities that enable them to fulfill responsibilities assigned and to satisfy applicable continuing professional education requirements of the AICPA and regulatory agencies.

Planning the Firm's Professional Development Activities. At least once a year, the person responsible for professional development needs to assess the firm's professional development needs and plan the professional development program. In smaller firms, a partner (or even the managing partner) may be responsible for professional development in the firm. However, as the firm grows, this responsibility is often assigned to another individual because someone else can perform the duties if given proper training, supervision, and authority to implement the plans. Regardless of who is responsible, a thorough knowledge of the various CPE requirements affecting the firm, as well as a thorough understanding of the special needs of the firm to appropriately serve its clients, is essential. Planning the firm's professional development program is important if the firm is to accomplish the following:

- *Provide Quality Professional Services.* Competent staff who stay abreast of the technical guidance necessary to perform their engagements are essential to a firm's ability to provide quality professional services. A properly planned professional development program helps the staff maintain such ability.
- *Identify Individual Staff Training Needs.* Staff who have specific training deficiencies need to be identified and training techniques designed to remediate those deficiencies (i.e., a staff member who lacks good documentation techniques may be assigned to work under a supervisor who is experienced in this area).
- *Specific Industry Training Needs.* When firms add a new client with unique industry accounting requirements, even if a partner in the firm is familiar with the industry, staff often will not be. Accordingly, staff may need industry training to help develop the capabilities and competencies for the specific industry.
- *Control CPE Costs.* The CPE needs of the staff can be assessed and met more cost-effectively through planning. Such planning can also help achieve a proper mix of in-house and outside programs that best meet the needs of the firm and its personnel.
- *Develop Specialists or Experts.* Consider the firm's needs for specialists or experts. Identify special courses or reference materials that are needed and steps to fulfill those needs. Some firms may have a need for managers, partners, and experienced staff with professional certifications in addition to the CPA certification.

Create a Professional Development Plan for Each Professional in the Firm. Planning for a firm's CPE and professional development activities means more than having a policy that requires all professionals to earn 40 hours of CPE each year. To be effective, planning should include developing a professional development (PD) plan for each individual in the firm. The *Statement on Standards for Continuing Professional Education Programs* suggests, but does not require, that CPAs develop a learning plan. The Statement's glossary defines a *learning plan* as "structured processes that help CPAs guide their professional development" and further states that learning plans include the following:

- A self-assessment of the gap between current and needed knowledge, skills, and abilities.
- A set of learning objectives arising from this assessment.
- Learning activities to be undertaken to fulfill the learning plan.

Other factors to be considered when planning an individual's PD needs to include the following:

- The individual's personal PD desires, i.e., what CPE courses or seminars the individual wants to attend, what skills the individual would like to develop, any specialized industry areas that the individual would like to focus on, etc.
- The firm's assessment of both the individual's PD needs and the firm's particular needs to stay technically current in a special accounting area or to expand into a new service area.

- The CPE requirements of the AICPA, state boards of accountancy, the GAO, and other regulatory agencies. Those requirements pertain not only to obtaining the minimum CPE hours for each staff, but also ensuring that the professional development courses qualify for CPE credit.
- Encouraging personnel at each staff level to participate in PD activities such as completing external professional development programs, becoming members of professional organizations, serving on professional committees, writing for professional publications, and speaking to professional groups.

Planning the PD needs of each staff member is time consuming. Consequently, this type of planning may be viewed as an onerous and unnecessary task by sole practitioners and small firms, especially if CPE decisions in those firms have been made on an ad hoc basis. While establishing PD plans for each professional is time consuming, it represents the most effective method to ensure that staff members obtain the appropriate CPE to enable them to fulfill their assigned responsibilities and to satisfy applicable CPE requirements of the AICPA, state boards of accountancy, and other regulatory agencies. It is in the firm's best interest to oversee each staff members' PD program following firm guidelines and in subjects that are relevant to each individual's responsibilities. Additionally, as previously mentioned, coordination of CPE activities at the firm level can greatly reduce total CPE costs. Firms may choose to develop the PD plan for new staff and then discuss the plan with them, using the opportunity as a means to teach new staff how to develop their PD plan in subsequent years. Even when staff is preparing the PD plan, firm management needs to review and discuss the PD plan as necessary and give final approval.

Document the Professional Development Plan. Some firms elect to document the professional development planning process in a memo or minutes to a partners' meeting. Normally, partner meeting minutes would indicate in general terms that PD planning has occurred. This documentation approach can be effective for sole practitioners or small firms with only a few professional staff members. When larger firms, however, do not have evidence of a written PD plan for each professional in the firm, peer reviewers will normally ask how the firm went about determining CPE needs for each professional. Such a process may require the peer reviewer to interview each staff member in the firm to discuss how that individual's CPE needs were determined and met.

An alternative documentation approach is the preparation of an annual CPE planning worksheet for each individual in the firm. Staff may prepare their individual CPE plan and submit the form to management for discussion and approval. This approach has the advantage of allowing the person responsible for overall CPE planning to formally document the overall PD plan and to fine tune the plan for cost savings or other purposes.

Assessing Professional Capabilities and Competencies. SQCS No. 7 expands a firm's responsibility for the assessment of capabilities and competencies, making it a significant aspect of the firm's quality control. It defines *capabilities and competencies* as "the knowledge, skills, and abilities that qualify personnel to perform an engagement." SQCS No. 7 refers to several ways in which an individual's unique capabilities and competence are developed, which include—

- Professional education.
- Continuing professional development, including training.
- Work experience.
- Mentoring relationships with more experienced staff members.

SQCS No. 7 also states that "a firm's quality control policies and procedures should provide reasonable assurance that an engagement partner possesses the competencies necessary to fulfill his or her engagement responsibilities." Generally, an engagement partner gains the necessary competencies through the methods listed previously, but particularly through relevant and appropriate experience in engagements performed in the accounting and auditing practice.

The AICPA has developed an online tool for CPAs to assess their professional competency by identifying an individual's strengths, learning opportunities, and areas where growth is needed. Competency models are available for various specialty areas and each model assesses the individual's level of proficiency in the particular

functional specialty, broad business perspective, leadership qualities, and personal attributes. New competency models are added regularly to ensure that the tool remains up-to-date. The AICPA Competency Self-Assessment Tool (CAT) is available free of charge to AICPA members. This tool can be accessed at www.cpa2biz.com/CPEConferences/CAT.htm. Firms should consider having all professional staff utilize this tool to assist in identifying individual training opportunities.

A complete discussion of how individuals, including engagement partners, develop capabilities and competencies is beyond the scope of this course. However, a comprehensive discussion, including illustrations of general competencies for the competency categories of the CAT, can be found in *PPC's Guide to Quality Control*.

Evaluating Staff Performance

SQCS No. 7 (QC 10.55) states that a firm's quality control policies and procedures should provide that personnel selected for advancement have the qualifications necessary to fulfill the responsibilities they will be expected to assume.

Through the use of performance evaluation, compensation, and advancement procedures, the firm gives due recognition and reward to the development and maintenance of competence and commitment to ethical principles. To develop and maintain employee competence and commitment to ethical principles (including a commitment to quality), firms may take the following steps:

- Ensure that the firm's expectations regarding performance and ethical principles are clearly communicated to personnel.
- Provide personnel with performance evaluations and counseling specific to their individual progress and career development.
- Ensure that personnel understand—
 - The quality of an individual's performance and adherence to ethical principles directly affects compensation and advancement to positions of greater responsibility.
 - An individual's failure to comply with the firm's policies and procedures may result in disciplinary action.

Write-up staff should receive performance evaluations periodically. Performance evaluations also serve several other purposes. They—

- Inform employee of strengths and weaknesses noted during past job performances.
- Set goals for future job performance.
- Establish a basis for periodic salary adjustments.
- Allow feedback about employee concerns and morale.
- Provide the firm with a defense against employment discrimination claims.

Frequency of Evaluations. Write-up staff provide bookkeeping and other related services to assigned clients on a continuous basis throughout the year. Thus, it may not be practical to conduct formal performance evaluations after each engagement. Instead, it may be more productive to conduct evaluations at regular intervals throughout the year, such as quarterly, semi-annually, or annually.

Firms should not wait until the next scheduled performance evaluation to point out exceptional or unacceptable performances, however. Such instances should be discussed with the staff member when they occur to provide encouragement or to correct the deficiencies noted. Immediate feedback is also important for employee morale since staff members are always interested in knowing how they are doing. Generally, the feedback is communi-

cated verbally, although in some instances it may be preferable to also document the communication in writing by placing a memo in the staff member's personnel file. Firms should take special care to document conversations involving employee performance weaknesses, deficiencies, or repeat problems. A lack of adequate documentation of those conversations can potentially put firms at risk if an employee discharge is necessary in the future.

Input from Supervisors and Clients. Before conducting formal performance evaluations with staff members, the evaluator should obtain information about staff performances from supervisors that are familiar with the staff members' work. The information can be obtained verbally or through written evaluations completed by the supervisor.

The evaluator may also receive information about the write-up staff from clients. Information received from clients usually is more informal than that received from supervisors. Generally, client feedback is received verbally over the telephone or during informal meetings. Verbal feedback from clients should be summarized in a memo for inclusion in the staff member's personnel file.

Documenting the Performance Evaluation. Prior to conducting the performance evaluation, the evaluator should prepare a written evaluation of each staff member based on information obtained from supervisors and clients. The written evaluation should then be discussed with the appropriate staff member during the performance evaluation. Generally, the written evaluation should document the staff member's strengths and weaknesses. The evaluation should not dwell on the weaknesses noted but, instead, use them as a means of offering suggestions for improving future performance. At the conclusion of the evaluation, the evaluator should document the staff member's comments and reactions to the review.

Retaining Staff

The public accounting profession is constantly changing, and the need for experienced, highly technical staff is more critical than ever. Years ago, a common practice was to hire new inexperienced staff, train them, get a few years of hard work from them, and then expect them to leave. Today, most firms cannot afford that strategy. It is too expensive to hire and train staff only to lose them in a few years. In 2005, a consultant to the accounting industry stated the cost of losing a professional young staff person is \$75,000, including the cost of executive search fees for the replacement, re-training, and the loss of morale. Also, with the increased use of computer technology, there is less lower-level staff work to do. More work is now of a technical or analytical nature, requiring experienced and knowledgeable personnel. Retention of quality staff, therefore, is vital to a firm's success.

In today's environment, lifestyle choices and job satisfaction are major factors that employees consider when deciding whether or not to stay with a firm. Adequate compensation and benefits are obviously important and necessary, but the firm's culture is often just as important to an employee. The firm's culture significantly impacts an employee's overall perception of the firm and, in the long term, can often be the reason an employee chooses to stay with the firm or to go elsewhere.

The firm's culture should communicate the message to employees that they are valuable and deserving of respect. While definitely not all-inclusive, some of the cultural benefits a firm can provide are:

- *Positive Work Environment.* Overall working conditions may be the single most significant factor that contributes to an employee's level of job satisfaction. Few people enjoy being in a negative or oppressive work environment. Firms should strive to establish a work environment that encourages employees to want to perform to their potential. Firms should particularly work to maintain a positive environment during busy season as deadlines approach and tensions mount. If the firm management style promotes employee insecurity, hostility, or intimidation, employee morale will probably always be low, even if employees are well compensated.
- *Emphasis on Personal Development.* If the firm seeks to retain high-quality staff, it should develop those individuals and provide opportunities for their continued professional growth throughout their careers. Since professional staff are required to receive a certain number of CPE hours each year, the firm should ensure that those CPE hours are meaningful and relevant to the extent possible. Taking CPE just to satisfy the hour requirement wastes the firm's opportunity to increase both staff quality and job satisfaction. The firm should attempt to provide staff with courses that improve their individual skills, such as developing an

industry expertise, increasing knowledge in a particular area, or providing management or other skills as appropriate.

- *Recognition of Performance.* One of the most positive things a firm can do to increase staff job satisfaction is to recognize individuals for outstanding performance. Recognition does not have to be public, nor does it have to be expensive. A partner giving an employee a “pat on the back,” a simple thank-you for a job well done, can have a tremendous impact on that employee’s attitude and loyalty to the firm. All too often, accountants forget to reward positive performance; the old philosophy that “no news is good news” prevails. Firm partners should take every opportunity to reinforce positive performance. The benefits to the firm can be great. Regular and frequent feedback is particularly important to the latest generation of young professionals.
- *Emphasis on the Individual as Part of a Team.* All staff members should first be treated respectfully as individuals. They should also be treated as part of the group, as members of a team that works together to achieve a common goal. Employees need to feel that they are a part of things, that their efforts make a positive contribution to the firm as a whole. If the firm recognizes staff retention as a strategy for developing future partner candidates, promoting the team concept can be very effective. Some firms are now adopting a formal team approach to serve certain industries or specialties. Other firms are informally utilizing the team concept to motivate staff and management to communicate and work together better.
- *Open Communication.* In order to maintain job satisfaction for any length of time, employees must feel free to communicate with management. It takes little effort to promote the firm as having an open door policy, but it does require effort and sometimes patience to genuinely practice the policy. Employees need to be able to communicate their needs and problems openly and without fear of repercussions. Some firms are now soliciting staff input on an ongoing basis to improve client service and firm administration. Other firms designate a mentor for each new staff member who helps facilitate communication with management. For open communication to truly exist in a firm, partners must be willing to hear the truth. The truth may not always be pleasant, but hearing and accepting the truth will often make the firm stronger.
- *Information about the Firm.* From a staff perspective, some firms appear to operate under a veil of secrecy. Many firms do not disseminate financial information to the staff, or even provide more general information such as firm goals and plans for the future. Since communication is one of the top reasons that employees leave a firm, not communicating with all employees should be reconsidered. While it is necessary to maintain confidentiality in areas such as partner compensation, certain other firm information can and should be communicated to the staff. The staff will perceive it as a demonstration of trust. Just as a firm invests in its staff, its staff members also invest in the firm’s future by working to achieve firm profitability and to eventually become partners. The staff wants to know what is going on and how it will impact their jobs. As a result, those staff members deserve to be told basic information that will allow them to have some degree of security about the firm’s financial stability. Firms should share as much financial and other information with the staff as possible. At a minimum, the staff should be told whether the firm is profitable and whether there are opportunities for growth in the future. Additionally, the staff should know about the firm’s strategic plan and how each individual contributes to the firm’s plan. The firm’s most talented staff will usually choose to leave the firm at some point if a career path is not apparent.

The issue of staff retention is extremely important for firms today. Understanding the motivations and lifestyle objectives of those staff can help the firm position itself to retain the talent it has spent a significant amount of time and money cultivating. Firms can obtain further information about dealing with staff in the workplace and receive a free one-page monthly newsletter on related issues from www.rainmakerthinking.com. Additional guidance on staff retention may also be found in *PPC's Guide to Managing an Accounting Practice*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Recruiting qualified staff is best described as:
 - a. Selective, since there is an abundance of qualified candidates.
 - b. Just as important as marketing.
 - c. Interviewing and making offers.
 - d. Difficult since college students are not interested in the accounting profession.
8. Select from the following choices the best definition of *discrimination*.
 - a. Using a skills test to determine whether an employee or potential employee possesses the necessary skill and knowledge to perform the job.
 - b. Requesting information from former employers concerning a job-candidate's work ethic
 - c. Making a hiring judgment.
 - d. Using a basis other than individual merit to make a difference in treatment.
9. Lori is the HR director of a local write-up services firm. She has been reviewing the jobs that have signed engagement letters and anticipating the other engagements from previous years that have not been confirmed yet, to make sure the firm will have enough staff to cover the workload during their "busy" season and decide if any new hires need to be made. She considers her current staff stable and competent. In her staffing assessment, what factor is Lori concerning herself with?
 - a. Predicting staffing expected to cover growth of the firm.
 - b. Predicting the staff's workload during a particular time period.
 - c. Accommodating the schedule for expected turnover in the firm.
 - d. Making sure the firm will be able to assist all of their clients.
10. Which of the following is correct regarding the application process?
 - a. An application should be filled out when an employee completes the interview process and only if the employer is serious about hiring them.
 - b. Information on the application can be verified by the prospective employer with the consent of the applicant.
 - c. The application should assert that its completion is not a guarantee of employment.
11. Documentation is part of the hiring process and must be taken seriously by the firm. In which of the following scenarios has the manager used documentation properly in the hiring process.
 - a. Frank has made a decision on a candidate to fill the open position at the firm. He calls and extends an offer to the candidate, he accepts and Frank tells him when his first day of work will be.
 - b. Kim, the HR director creates a job file for each open position in the firm, and keeps all of the paperwork accumulated on the candidates considered for the position.
 - c. The documentation that was sent to Karen, a new hire of Bank and Brooks, contained the information on the job, including the starting date, job title and benefits, but the starting salary was not included.

12. When rejecting a job candidate, a firm should do which one of the following?
- Inform a rejected applicant the job was filled after the chosen candidate has been on the job for 90 days.
 - Inform the rejected applicant what job requirements he was lacking.
 - Document separately the business reasons why ineligible applicants were so labeled.
13. Martin, a relatively new CPA in the firm of Peavy, Pacey and Egerton, has been asked to perform a self—assessment of the gap between current and needed knowledge, skills, and abilities. This request is an indication that the firm is attempting to do which of the following?
- Evaluate Martin's performance as a staff member.
 - Provide the firm with a defense against employment discrimination claims.
 - Create a professional development plan for Martin.
 - Inform Martin of his strengths and weaknesses noted during past job performances.
14. Which of the following is **not** included in SQCS No. 7 as a method in which an individual's competency can be developed?
- Professional education.
 - Training and continuing professional development.
 - Creating a positive work environment.
 - Work experience.
15. What is one of the most positive things a firm can do to increase job satisfaction among staff?
- Recognize individuals for outstanding performance.
 - Share the firm's financial information.
 - Provide professional development opportunities.
 - Adopt the team approach.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

7. Recruiting qualified staff is best described as: **(Page 144)**
- a. Selective, since there is an abundance of qualified candidates. [This answer is incorrect. There is a shortage of qualified professionals.]
 - b. Just as important as marketing. [This answer is correct. Qualified professionals are difficult to find and attract because of competition among employers, therefore, as much attention should be focused on recruiting as on marketing.]**
 - c. Interviewing and making offers. [This answer is incorrect. Recruiting is much more than interviewing and making offers. It should encompass an ongoing plan to attract and hire qualified individuals.]
 - d. Difficult since college students are not interested in the accounting profession. [This answer is incorrect. A career in accounting has become prestigious and alluring to a higher percentage of college students.]
8. Select from the following choices the best definition of *discrimination*. **(Page 148)**
- a. Using a skills test to determine whether an employee or potential employee possesses the necessary skill and knowledge to perform the job. [This answer is incorrect. This is the definition of pre-employment testing. It allows a firm to determine whether an applicant possesses the necessary skills to perform the job. Care should be given to ensure all tests are relevant and specific to the job so that they are nondiscriminatory.]
 - b. Requesting information from former employers concerning a job-candidate's work ethic. [This answer is incorrect. This is the definition of checking personal references. The same questions should be asked for all candidates that references are confirmed to keep the process fair.]
 - c. Making a hiring judgment. [This answer is incorrect. Making a hiring judgment is part of the candidate evaluation process and is not discrimination. Every firm with a position to fill must select the candidate that possesses the attributes the firm is seeking.]
 - d. Using a basis other than individual merit to make a difference in treatment. [This answer is correct. Many groups are protected from discrimination under federal law. Firm leaders cannot make statements that could be construed as discriminatory concerning individuals in any protected category.]**
9. Lori is the HR director of a local write-up services firm. She has been reviewing the jobs that have signed engagement letters and anticipating the other engagements from previous years that have not been confirmed yet, to make sure the firm will have enough staff to cover the workload during their "busy" season and decide if any new hires need to be made. She considers her current staff stable and competent. In her staffing assessment, what factor is Lori concerning herself with? **(Page 148)**
- a. Predicting staffing expected to cover growth of the firm. [This answer is incorrect. When a firm is trying to pursue and promote growth of its client base and make sure they have enough staff to cover this growth, they are predicting staffing for growth. Lori is trying to make sure she has staff for confirmed work, not new work.]
 - b. Predicting the staff's workload during a particular time period. [This answer is correct. When a firm is concerning themselves with the staffing needs during a particular time period, they are anticipating their staffing workload to make sure they have enough staff to handle the client's needs. Various alternatives exist to handling the changing workload demands, including (1) working planned overtime hours during the busy season and (2) hiring part-time or contract personnel. The**

approach and philosophy for handling busy season workloads has a major impact on hiring decisions.]

- c. Accommodating the schedule for expected turnover in the firm. [This answer is incorrect. When assessing staffing needs, turnover is a consideration to ensure there will be enough staff to cover the work, but Lori is working on the current workload using the current staff that she feels is stable, so this is not the assessment that Lori is trying to complete.]
 - d. Making sure the firm will be able to assist all of their clients. [This answer is incorrect. Firms should also assess the ability of its staff to provide quality services to its existing clients. Lori is already considers her current staff stable and competent, so that is not her concern when assessing her current needs.]
10. Which of the following is correct regarding the application process? **(Page 153)**
- a. An application should be filled out when an employee completes the interview process and only if the employer is serious about hiring them. [This answer is incorrect. An employment application should be completed before any interviewing takes place. Information that is pertinent to the interview process is contained in the application and would help an interviewer have a more complete interview with the candidate.]
 - b. Information on the application can be verified by the prospective employer with the consent of the applicant. [This answer is incorrect. An important feature of the employment application is that it provides the employer with the consent to verify the information provided in the application. The prospective employer cannot confirm the information without the prospective employee's consent since it violates the applicant's privacy.]
 - c. **The application should assert that its completion is not a guarantee of employment. [This answer is correct. Applications should include a statement that conveys to the applicant that the completion of the application does not guarantee employment with the prospective company. This statement will ensure that there is no misunderstanding between the prospective employer and applicant about the status of the position with the company.]**
11. Documentation is part of the hiring process and must be taken seriously by the firm. In which of the following scenarios has the manager used documentation properly in the hiring process. **(Page 155)**
- a. Frank has made a decision on a candidate to fill the open position at the firm. He calls and extends an offer to the candidate, he accepts and Frank tells him when his first day of work will be. [This answer is incorrect. While Frank started the process correctly by calling and extending the offer verbally, he should follow up with a written offer for the candidate so that there will not be any misunderstanding between the hiring manager and the candidate.]
 - b. **Kim, the HR director creates a job file for each open position in the firm, and keeps all of the paperwork accumulated on the candidates considered for the position. [This answer is correct. Best practices indicate that a job file for each recruited position should be maintained. Paperwork should be kept on successful and unsuccessful candidates for legal purposes. Employment laws vary by state, so a firm should contact an employment law attorney to see how long the job files should be kept before they are destroyed.]**
 - c. The documentation that was sent to Karen, a new hire of Bank and Brooks, contained the information on the job, including the starting date, job title and benefits, but the starting salary was not included. [This answer is incorrect. The documentation should include the starting salary or wage so that there is no confusion on the part of the newly hired employee.]

12. When rejecting a job candidate, a firm should do which one of the following? **(Page 156)**
- a. Inform a rejected applicant the job was filled after the chosen candidate has been on the job for 90 days. [This answer is incorrect. A rejected applicant should be notified promptly once a candidate has been selected so that the applicant is not left wondering about a response from the firm.]
 - b. Inform the rejected applicant what job requirements he was lacking. [This answer is incorrect. The firm should avoid talking about the applicant's weaknesses because it could put the firm in a compromising position with the applicant. If necessary, the firm should state the successful candidate was a better match to the job requirements.]
 - c. Document separately the business reasons why ineligible applicants were so labeled. [This answer is correct. The reasons for not hiring an applicant should be documented but should not appear on the application or resume. Documenting reasons on applications could inadvertently create a discrimination situation.]**
13. Martin, a relatively new CPA in the firm of Peavy, Pacey and Egerton, has been asked to perform a self-assessment of the gap between current and needed knowledge, skills, and abilities. This request is an indication that the firm is attempting to do which of the following? **(Page 158)**
- a. Evaluate Martin's performance as a staff member. [This answer is incorrect. Evaluation of performance indicates an assessment on tasks already performed. The question refers to current and needed knowledge which emphasizes future needs rather than what has already been accomplished.]
 - b. Provide the firm with a defense against employment discrimination claims. [This answer is incorrect. This would be accomplished by a performance evaluation. The question is describing a learning plan.]
 - c. Create a professional development plan for Martin. [This answer is correct. One step in creating a professional development plan can be a learning plan. According to the *Statement on Standards for Continuing Professional Education Programs*, learning plans include the type of self-assessment described in this scenario.]**
 - d. Inform Martin of his strengths and weaknesses noted during past job performances. [This answer is incorrect. The question is emphasizing an assessment of knowledge needs that would help Martin perform in the future and this answer choice clearly states past job performance.]
14. Which of the following is **not** included in SQCS No. 7 as a method in which an individual's competency can be developed? **(Page 159)**
- a. Professional education. [This answer is incorrect. Professional education is mentioned in SQCS No. 7 as a method for developing competency.]
 - b. Training and continuing professional development. [This answer is incorrect. Continuing professional development, including training is mentioned in SQCS No. 7 as a method for developing competency.]
 - c. Creating a positive work environment. [This answer is correct. A positive work environment will contribute to an employee's level of job satisfaction but it is not included in SQCS No. 7 as a method for developing an individual's competency.]**
 - d. Work experience. [This answer is incorrect. Work experience is mentioned in SQCS No. 7 as a method for developing competency.]

15. What is one of the most positive things a firm can do to increase job satisfaction among staff? **(Page 161)**
- a. **Recognize individuals for outstanding performance. [This answer is correct. Personal recognition of a job well done can have tremendous impact on the employee's attitude and loyalty to the firm.]**
 - b. Share the firm's financial information. [This answer is incorrect. Although being informed of the company's financial condition is important, this is not the most compelling method of increasing job satisfaction. Not sharing information is due mainly to confidentiality issues.]
 - c. Provide professional development opportunities. [This answer is incorrect. This is important to employees and helps in retention of staff, but it does not have the biggest impact on job satisfaction because the majority of employees would rank other factors higher.]
 - d. Adopt the team approach. [This answer is incorrect. Staff members should first be respected as individuals and then treated as part of a group working to achieve a common goal. Employees need to feel that they are part of things, but they need to know that their contributions are noted.]

ACCEPTING AND CONTINUING AN ENGAGEMENT

An element common to all engagements is the decision to accept a new client or to continue to serve an existing client. One of the most important considerations in such a decision is the firm's desire to avoid association with a client that has a poor or questionable reputation for honesty or business ethics. A firm should not accept work from clients that would be detrimental to the firm's image.

SQCS No. 7 requires CPA firms to establish policies and procedures for the acceptance and continuance of client relationships and specific engagements. According to SQCS No. 7 (QC 10.27–.28), the policies and procedures should be “designed to provide the firm with reasonable assurance that it will undertake or continue relationships and engagements only where the firm:

- a. Has considered the integrity of the client, including the identity and business reputation of the client's principal owners, key management, related parties and those charged with its governance, and the risks associated with providing professional services in the particular circumstances;
- b. Is competent to perform the engagement and has the capabilities and resources to do so; and
- c. Can comply with legal and ethical requirements.”

Continuation Factors

Firms should review a list of write-up engagements at least annually to determine whether such engagements and/or client relationships should be continued. The following are some of the factors firms should consider when evaluating whether to continue to provide services to an existing write-up engagement:

- a. Timely payment of fees.
- b. The firm's relationship with the client's management or owners.
- c. Significant changes in one or more of the following:
 - (1) Independence relationships.
 - (2) Perceived integrity of management.
 - (3) Directors or key management.
 - (4) Legal counsel.
 - (5) Financial condition.
 - (6) Litigation.
 - (7) Nature of business.
 - (8) Nature or scope of engagement.
 - (9) Risk associated with a particular engagement.
 - (10) The firm's professional competence (expertise).

Terminating Services

Both objective and subjective reasons exist for terminating services to a client. In some instances, a client's actions provide specific reasons for no longer continuing the relationship. In other instances, the decision is based on more

subjective factors. Each firm must determine its own continuation policies. The following factors may cause firms to consider terminating services to a write-up client:

- a. Committing illegal acts or unethical practices.
- b. Failing to pay fees when due.
- c. Consistently not following advice.
- d. Being uncooperative with firm personnel, including:
 - (1) Failing to return phone calls.
 - (2) Being rude to staff.
- e. Continuing financial difficulties.
- f. Misleading firm personnel.
- g. Not providing complete data.
- h. Intentionally providing false tax return information.
- i. Failing to pay taxes when due—especially payroll taxes.
- j. Constantly complaining about fees and service.
- k. Changes in the perceived integrity of the client.
- l. Dramatically decreasing the scope of the engagement.

When a firm decides to end a relationship with a client, the actual firing should be handled tactfully. If not, bridges may be burned and hopes of a future relationship could be lost. The client should be notified in writing. In addition, the following steps are generally recommended:

- *Do Not Sue the Former Client.* One of the more common causes of litigation against accountants is fee disputes. Accordingly, malpractice insurance underwriters strongly recommend against suing a client over unpaid fees.
- *Do Not Withhold Any of the Client's Records.* Any workpapers, journals, ledgers, checkbooks, canceled checks, or similar items that belong to the client should be returned upon termination. It is a violation of professional ethics (and in some jurisdictions, a violation of law) to withhold those items.

WHAT TO CONSIDER IN AN ENGAGEMENT

Determining the Client's Needs

Accountants may provide bookkeeping, payroll, or financial statement preparation services during a write-up engagement. They may not provide all of those services for each write-up client, however. The size of the client, its stage of development, the sophistication of its accounting system, the needs of banks and creditors, and many other factors provide indications of the types of services that may be appropriate. Generally, the accountants can obtain information to tailor the write-up engagement to meet the client's needs by discussing each service with the client. Because as clients grow their needs change, accountants should periodically evaluate the write-up services provided.

Meeting clients' needs is one of the most important attributes of a successful practice. Accountants should be alert for opportunities to provide other services in addition to write-up services. Accordingly, accountants should view

write-up services as part of an overall engagement to provide a complete package of services for their clients. Those that view write-up services as a separate engagement often let opportunities such as financial planning slip away.

Considering the Intended Use of the Financial Statements

Introduction. Statement on Standards for Accounting and Review Services (SSARS) No. 19, *Compilation and Review Engagements*, allows accountants to provide management-use-only financial statements *without issuing a compilation report*, if the statements are *not reasonably expected to be used by third parties*. The compilation performance standards are the same for management-use-only financial statements as they are for third party financial statements. A complete discussion of the submission of financial statements as defined by SSARS No. 1, as amended, is beyond the scope of this course.

Accountants who elect to submit management-use-only financial statements without issuing a compilation report will also have to determine the clients for which they may provide such services. Factors such as the definition of management and third parties, the adequacy of management's knowledge, and the intended use of the financial statements will affect the accountants' ability to submit management-use-only financial statements without a report in specific client situations.

Third-party-use versus Management-use-only Financial Statements. If the financial statements are, or can reasonably be expected to be used by a *third party*, management-use-only financial statements are not appropriate for the client. The SSARS considers *third parties* to be all persons, including those charged with governance, who are not members of management.

Who Is Management? SSARS No. 19 (AR 60.04) defines *management* as—

The person(s) with executive responsibility for the conduct of the entity's operations. For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).

SSARS No. 19 (AR 60.04) defines *those charged with governance* as—

The person(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance are specifically excluded from management, unless they perform the management functions as defined above.

Consequently, boards of directors who are not members of management are considered to be *third parties*. Management-use-only financial statements may only be issued if all intended users are members of management. Management-use-only financial statements are not appropriate for *internal use only* (that is, for use by all individuals within an organization).

Intended Use of the Financial Statements. Accountants should consider the reasons for which the client intends to use the financial statements. This might be done based on the accountants' knowledge of and past experience with the client, as well as based on discussions with the client as to how they intend to use the financial statements. SSARS No. 19 requires a client representation that management-use-only financial statements are not intended for third-party use. Best practices indicate that, absent any contradictory information that comes to their attention, accountants may rely on those representations without performing any further procedures.

Accountants should not, however, ignore information that would suggest that the financial statements might be used by third parties. For example, if accountants have compiled financial statements for the client in years past to meet certain provisions in a loan agreement, they might question whether such requirements are still in effect before agreeing to submit management-use-only financial statements. Accountants might also question the need for third-party-use financial statements if the client has entered into a new lending relationship during the current year. If obvious facts suggest that the financial statements might be used by third parties (despite management's representation to the contrary), accountants should compile and report on the statements in accordance with SSARS No. 19.

Accountants' Responsibilities When Management-use-only Financial Statements Are Distributed to Third Parties. SSARS No. 19 (AR 80.24) states that accountants who become aware that management-use-only financial statements have been distributed to third parties should—

- Discuss the situation with the client and consider requesting that the financial statements be returned.
- If the accountant requests that the financial statements be returned and the client does not comply with that request within a reasonable period of time, the accountant should notify known third parties that the financial statements are not intended for third-party use, preferably in consultation with his or her attorney.

As discussed in the preceding paragraph, SSARS No. 19 places a responsibility on accountants who discover that management-use-only financial statements have been distributed to (and, presumably, are being used by) third parties. Distributing management-use-only financial statements to third parties is a violation of the terms of the engagement. However, the illustrative engagement letter in Compilation Exhibit A of SSARS No. 19 (AR 80.63) does not explicitly impose on management a restriction on distribution; rather, it addresses only management's intended use of the financial statements. For that reason, accountants can add additional language in the engagement letter to clarify that management also agrees not to distribute the financial statements to third-party users.

Because unauthorized distribution is a contractual problem, accountants first discuss with their attorneys what action, if any, to take when they discover that management-use-only financial statements have been distributed to third parties. Factors or alternatives that might be discussed with an attorney include (but are not limited to) the following:

- a. An evaluation, if possible, of any damages that might have been, or may be, incurred because of the use by a third party.
- b. Whether to notify the client that the accounting firm is aware of unauthorized distribution of the statements.
- c. Whether to notify third parties that received the statements that the distribution was unauthorized.
- d. Whether to continue to provide services to the client.

Engagement Letters

SSARS No. 19 requires an engagement letter for all compilation engagements.

Even if financial statements are not prepared (for example the write-up engagement involves preparation of a general ledger only), following the guidance in SSARS No. 19, AR 80.02 can be beneficial. Obtaining an engagement letter for all write-up engagements is recommended. Engagement letters are advantageous to both the client and the accountants because they:

- a. *Help Avoid Client Misunderstandings.* In today's environment, an engagement letter is needed for both existing and new clients. To avoid misunderstandings, the engagement letter describes in detail the services to be rendered, the fee, and the other terms and conditions of the engagement. Oral agreements may result in differences of recollection or understanding between the accountants and the client.
- b. *Help Avoid Staff Misunderstandings.* Placing a copy of the engagement letter in the workpapers provides the staff of the accounting firm with an authoritative reference to supplement their oral instructions. That eliminates confusion and misunderstandings about the type of engagement to be performed, the date and period covered by financial statements, and the nature of the report expected to be rendered.
- c. *Reduce Potential Legal Liability.* Many adverse consequences may result from failing to obtain a written engagement letter (in addition to noncompliance with SSARS No. 19). In the case of services that are new to the client, it is particularly important to obtain engagement letters as protection against misunderstandings and the lawsuits that may result.
- d. *Improve Practice Management.* Ordinarily, the engagement partner should review the engagement letter before it is presented to the client. A timely review may be the vehicle that permits the partner to amend

the terms of the engagement, approve the proposed fee and payment schedule, and set up guidelines to minimize possible collection problems.

- e. *Clarify Contractual Obligations.* Engagement letters are evidence that a contract is created when an accountant agrees to render services and a client agrees to pay for them. The engagement letter should contain a clear-cut delineation of the duties and responsibilities of the client and of the accountants.

Most accountants recognize the merits of using engagement letters, but some find that their clients resist them. The following steps can be employed to overcome client resistance and avoid damage to client relations:

- a. Explain that engagement letters are required by professional standards for all compilation engagements; the client should not think this engagement is unique.
- b. Explain the reasons for an engagement letter and that it also benefits management.
- c. Review the letter with the client personally. Explain that the engagement letter is intended to help the client fully understand exactly what the accountant is doing. It lists any limitations of the accountant's services so that the client will not allow important functions to fall between the cracks.

Understanding with the Entity for Compiled Financial Statements. SSARS No. 19 (AR 80.02) requires the accountant to establish an understanding with management regarding the services to be performed for compilation engagements and to document that understanding through a written communication with management. The understanding with management regarding a compilation of financial statements should include the following (AR 80.03):

- The objective of a compilation is to assist management in presenting financial information in the form of financial statements.
- The accountant uses information that is the representation of management without undertaking to obtain or provide any assurance that there are no material modifications that should be made to the financial statements in order for them to be in conformity with the applicable financial reporting framework (i.e., GAAP or OCBOA).
- Management is responsible for—
 - the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework.
 - designing, implementing, and maintaining internal control relevant to the preparation and fair presentation of the financial statements.
 - preventing and detecting fraud.
 - identifying and ensuring that the entity complies with the laws and regulations applicable to its activities.
 - making all financial records and related information available to the accountant.
- The accountant is responsible for conducting the compilation engagement in accordance with SSARS issued by the AICPA.
- A compilation differs significantly from a review or audit of financial statements. A compilation does not contemplate performing inquiry, analytical procedures, or other procedures performed in a review. Additionally, a compilation does not contemplate obtaining an understanding of the entity's internal control; assessing fraud risk; testing accounting records by obtaining sufficient appropriate audit evidence through inspection, observation, confirmation, or the examination of source documents; or other procedures ordinarily performed in an audit. Accordingly, the accountant will not express an opinion or provide any assurance regarding the financial statements.

- The compilation engagement cannot be relied upon to disclose errors, fraud, or illegal acts.
- The accountant will inform the appropriate level of management of any material errors and of any evidence or information that comes to the accountant's attention during the performance of the compilation procedures that fraud or an illegal act may have occurred (unless the illegal acts are clearly inconsequential).
- The effect of any independence impairments on the expected form of the accountant's report, if applicable.

Engagement letters can be used to document the understanding with the entity.

Understanding with the Entity When the Financial Statements Are for Management-use-only. When the financial statements are intended for management-use-only, SSARS No. 19 (AR 80.05) also requires the following communications to be made in the engagement letter, if applicable:

- a. A statement that material departures from GAAP or OCBOA may exist and the effects of those departures, if any, on the financial statements may not be disclosed.
- b. A statement that substantially all disclosures (and the statement of comprehensive income and cash flows, if applicable) required by GAAP or an OCBOA may be omitted.
- c. A reference to the supplementary information submitted with the financial statements.

Additional Matters to Include in the Letter. The following list provides additional matters accountants may wish to consider including in an engagement letter when financial statements are intended for management-use-only.

- a. *Notification of Need for Third-party-use Financial Statements.* Some accountants may wish to include in the letter a statement that management should notify the CPA if there is a need to provide the financial statements to a third party. Such a statement serves two functions. First, it reinforces the fact that the management-use-only financial statements are not appropriate for third-party use. Second, it informs the client that the accountant can provide a SSARS No. 19 report on the financial statements, which would allow them to be used by third parties.
- b. *Appropriateness of Financial Statements for Intended Use.* Some accountants believe they have no responsibility to determine whether the management-use-only financial statements are appropriate for management's intended use. Therefore, the engagement letter can contain optional language to clarify that point.
- c. *Restriction on Distribution.* If accountants discover that management-use-only financial statements have been distributed to (and, thus, are being used by) third parties, SSARS No. 19 requires that accountants discuss the issue with the client and ask that they have the statements returned. Despite that requirement, the illustrative engagement letter in SSARS No. 19 (Compilation Exhibit A) does not explicitly impose on management a restriction on distribution; rather, it addresses only management's intended use of the financial statements. For that reason, accountants may want to add additional language in the engagement letter to clarify that management also agrees to not distribute the financial statements to third-party users.

Risk of One-way Communication. Although SSARS No. 19 does not require management's signature on the engagement letter, there could be risks with issuing a one-way communication. The engagement letter is the written contract between the accountant and the client regarding the services to be performed. Furthermore, engagement letters are an excellent tool for educating clients about their own responsibilities and those of the accountant. Thus a communication that does not require a management signature may be less effective.

Period Covered by the Engagement Letter. When accountants document their understanding with the client via an engagement letter, do they need to obtain a new letter every year? Although the standard does not address that issue specifically, many accountants meet with their clients and update their engagement understandings at least annually. Doing so and documenting the understanding in an engagement letter ensures that it (a) reflects the scope of services the accountants are currently providing and (b) contains all legal protection clauses available to the accountants.

Other accountants have adopted the practice of issuing one engagement letter to cover the current engagement as well as any subsequently performed for a client. Those accountants obtain an engagement letter in the year in which they are first engaged to provide services for the client; however, they do not require a new letter in each subsequent year unless circumstances change.

SSARS No. 19 also does not address whether one engagement letter can be used to describe all of the services the accountants will provide to a client. However, it is possible for one engagement letter to cover multiple services. For instance, obtaining an engagement letter for each monthly financial statement that a firm compiles or reviews is probably unnecessary. An engagement letter for monthly, quarterly, or annual engagements could be used. It should list the services available, provide a place to indicate the frequency of each service (monthly, quarterly, annually, or as requested), and cover the other items required by SSARS No. 19.

Obtaining Knowledge of the Client and Its Industry

SSARS No. 19 requires accountants that issue compilation reports to possess a level of knowledge of the accounting principles and practices of the industry in which the entity operates. A "Client Information Form" can be used to document compliance with that requirement.

Enhancing the Engagement's Efficiency

The repetitive nature of most write-up engagements provides opportunities for the firm to provide write-up services more efficiently. Best practices indicate the following for improving a write-up engagement's efficiency:

- *Develop a Work Program.* Many firms develop or purchase work programs or checklists that can be used to document the procedures performed on write-up engagements. The programs list the steps that most firms would want their accountants to follow in completing the bookkeeping function, preparing the trial balance, and/or drafting the financial statements. The type of program that should be used depends on the accounting or tax services to be provided. For example, if an engagement involves only bookkeeping services followed by the preparation of a trial balance (i.e., no financial statements are generated) the accountant might use a checklist such as a "Data Processing Checklist." If compiled financial statements are prepared, a "Financial Reporting and Disclosure Checklists" might be used.
- *Plan the Engagement for the Entire Year.* It is generally more efficient to plan a monthly write-up engagement as a single, year-long engagement rather than as twelve separate engagements. In other words, plan the engagement once instead of twelve different times. Determine and document the checklists, services, and forms that should be completed throughout the engagement for the entire year.
- *Develop a Due Date Calendar for Each Engagement.* Due dates are important for write-up engagements, particularly in the area of taxes. To help monitor due dates and determine staff scheduling requirements, many firms maintain a calendar listing an engagement's due dates for tax returns, tax deposits, or other matters. Further discussion of due date monitoring systems appears later in this lesson.
- *Determine What Information and Documents Will Be Needed Each Month.* It is important to convey to the client what information and documents will be needed each month. Some accountants provide transmittal forms to be returned with their clients' information. The forms serve as memory joggers for their clients to help ensure that all information is provided. It can be very inefficient for the accountant if clients fail to provide the necessary monthly information.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. According to the text, what is the most important consideration when making a decision about continuing a relationship with a client
 - a. The amount of fees collected from the client.
 - b. The firm's desire to avoid association with a client of questionable reputation.
 - c. The client's ability to understand the information produced by the firm.
17. Which of the following actions should **not** be taken when terminating a client?
 - a. Notify the client in writing.
 - b. Return the client's records.
 - c. Sue the client for unpaid fees.
18. Define *those charged with governance*.
 - a. Person(s) with executive responsibility for conducting an entity's operations.
 - b. Person(s) responsible for overseeing an entity's strategic direction and obligations the entity is accountable for.
 - c. Person(s) who are not members of management, but part of the board of directors of the entity.
 - d. All individuals on the accounting staff of an entity.
19. Jean, a CPA, is engaged by the Style Depot to produce management-use-only financial statements. Management of the Style Depot's makes a representation that the statements are not intended for third-party use. Later, however, Jean discovers that the business is involved in a loan agreement that requires use of the financial statements by the lender. What should Jean do?
 - a. Withdraw from the engagement immediately.
 - b. Provide the management-use-only financial statements, as requested.
 - c. Compile and report on the statements in accordance with SSARS No. 19.
 - d. Notify the lender that the financial statements are not intended for its use.
20. Tom's client refuses to sign an engagement letter. Which step should Tom take to help him overcome his client's resistance?
 - a. Tell the client that the engagement letter is merely a formality with little importance.
 - b. Tell the client he is unique and that an engagement letter is necessary in this situation.
 - c. Review the letter with the client personally.
 - d. Assign the client to another accountant within the firm.

21. Which of the following statements is most accurate in regards to enhancing an engagement's efficiency?
- a. Purchase of a work program will enable the firm to keep track of any engagement.
 - b. It is best to plan monthly write-up services as twelve separate engagements.
 - c. Maintain a calendar listing an engagement's due dates.
 - d. Contact the client for missing information.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

16. According to the text, what is the most important consideration when making a decision about continuing a relationship with a client? **(Page 169)**
- a. The amount of fees collected from the client. [This answer is incorrect. Although the timely payment of fees was mentioned as a factor in deciding whether to terminate a client, the amount of fees paid was not and it is not the most important consideration.]
 - b. The firm's desire to avoid association with a client of questionable reputation. [This answer is correct. A firm should not accept work from clients that would be detrimental to the firm's image or call into question its business ethics.]**
 - c. The client's ability to understand the information produced by the firm. [This answer is incorrect. Although the client should understand the information provided, not understanding is not a reason for terminating the relationship. The firm could work with the client and educate them on the information.]
17. Which of the following actions should **not** be taken when terminating a client? **(Page 171)**
- a. Notify the client in writing. [This answer is incorrect. A client should be sent a termination letter for legal purposes.]
 - b. Return the client's records. [This answer is incorrect. The client's records should not be withheld and failure to return them is a violation of professional ethics.]
 - c. Sue the client for unpaid fees. [This answer is correct. One of the more common causes of litigation is fee disputes. Accordingly, malpractice insurance underwriters strongly recommend against suing a client over unpaid fees, since it could lead to more involved legal matters.]**
18. Define *those charged with governance*. **(Page 171)**
- a. Person(s) with executive responsibility for conducting an entity's operations. [This answer is incorrect. According to SSARS No. 19, this is the definition of *management*. *Those charged with governance* have different responsibilities. However, according to SSARS No. 19, For some entities, management includes some or all of those charged with governance (for example, executive members of a governance board or an owner-manager).]
 - b. Person(s) responsible for overseeing an entity's strategic direction and obligations the entity is accountable for. [This answer is correct. According to SSARS No. 19, this is the definition of *those charged with governance*. One task of this group is overseeing the entity's financial reporting process. Those charged with governance are specifically excluded from management, unless they perform the management functions defined in SSARS No. 19's definition of *management*.]**
 - c. Person(s) who are not members of management, but part of the board of directors of the entity. [This answer is incorrect. According to SSARS No. 19, this is the definition of *third parties*. Those charged with governance can be third parties, but that is not the official definition of the term.]
 - d. All individuals on the accounting staff of an entity. [This answer is incorrect. This definition does not apply to *those charged with governance*. That term is defined by SSARS No. 19, and a limited subset of those associated with an entity are encompassed by the term. While some of the accounting staff would be charged with governance, it would only include the individuals responsible for overseeing the financial reporting process.]

19. Jean, a CPA, is engaged by the Style Depot to produce management-use-only financial statements. Management of the Style Depot's makes a representation that the statements are not intended for third-party use. Later, however, Jean discovers that the business is involved in a loan agreement that requires use of the financial statements by the lender. What should Jean do? **(Page 171)**
- a. Withdraw from the engagement immediately. [This answer is incorrect. Jean does not have to withdraw from the engagement under these circumstances. If the Style Depot does provide the management-use-only financial statements to a third party in the future, Jean should consult with her attorney about whether to continue to provide services to the company; however, the business has not violated its contract yet, so Jean does not have to take such drastic measures.]
 - b. Provide the management-use-only financial statements, as requested. [This answer is incorrect. Best practices indicate that, absent any contradictory information that comes to their attention, accountants may rely, without performing any further procedures, on clients' representations that management-use-only financial statements are not intended for third-party use. Accountants should not, however, ignore information that would suggest the financial statements might be used by third parties. Therefore, Jean cannot simply go on with the engagement as planned once this information comes to light.]
 - c. **Compile and report on the statements in accordance with SSARS No. 19. [This answer is correct. If obvious facts suggest that the financial statements might be used by third parties (despite management's representation to the contrary), accountants should compile and report on the statements in accordance with SSARS No. 19.]**
 - d. Notify the lender that the financial statements are not intended for its use. [This answer is incorrect. If the Style Depot actually shares the management-use-only financial statements with third parties, this might be a course of action Jean should pursue. However, as the business has not taken that action yet, Jean does not have to make that notification at this time.]
20. Tom's client refuses to sign an engagement letter. Which step should Tom take to help him overcome his client's resistance? **(Page 173)**
- a. Tell the client that the engagement letter is merely a formality with little importance. [This answer is incorrect. This information would not be true, so Tom should not say this to his client, even to convince the client to sign the engagement letter. Instead, Tom explain the reasons engagement letters are used and how it also benefits management.]
 - b. Tell the client he is unique and that an engagement letter is necessary in this situation. [This answer is incorrect. Explain that engagement letters are required by professional standards for all compilation engagements and that his engagement is not unique.]
 - c. **Review the letter with the client personally. [This answer is correct. Explain that the engagement letter is intended to help the client fully understand exactly what the accountant is doing.]**
 - d. Assign the client to another accountant within the firm. [This answer is incorrect. Assigning the client to another accountant within the firm would be the correct action if the client has a major dislike of the accountant. However a reassignment is no guarantee that the client will sign the engagement letter. There is a better answer choice.]
21. Which of the following statements is most accurate in regards to enhancing an engagement's efficiency? **(Page 175)**
- a. Purchase of a work program will enable the firm to keep track of any engagement. [This answer is incorrect. No one program will cover all engagements.]
 - b. It is best to plan monthly write-up services as twelve separate engagements. [This answer is incorrect. It is more efficient to plan a monthly write-up engagement as a single, year-long engagement.]

- c. Maintain a calendar listing an engagement's due dates. [This answer is correct. Listing due dates, particularly for taxes, on a calendar is the best way to monitor due dates so that no important due dates are missed.]**
- d. Contact the client for missing information. [This answer is incorrect. It is best to send the client a transmittal letter up front requesting all information and reviewing it upon receipt so that an understanding of expectations is established between the client and the firm.]

PROCESSING REPORTS, TAX RETURNS, AND CORRESPONDENCE

Often, the only physical evidence of the long hours and hard work that a firm spends providing its professional services are the reports (for example, accountant's report attached to compiled financial statements), tax returns, and correspondence that it issues. Consequently, care should be taken to ensure that those products project the firm's professional image. For example, each report, letter, and other document should be proofread to ensure that it contains no "typos" or other errors. (Word processing software such as Microsoft's Word has spelling and grammar tools that can be helpful in identifying those types of errors in documents. However, such tools are not 100% accurate.) It also should be prepared using a high quality paper, attractive typestyle, and, if appropriate, bound in the firm's report cover.

This portion of the lesson presents considerations for preparing the firm's reports, tax returns, and correspondence. It discusses producing the reports, obtaining the necessary signatures, and delivering the finished product. It does not discuss the quality control procedures that the firm should follow to ensure the appropriateness of the reporting format or the accuracy of the firm's conclusions.

Producing Reports, Tax Returns, and Correspondence

Developing the Firm's Style. Authoritative literature provides little guidance on matters of form or style. Thus, in practice, many approaches are used, most of which are no more right or wrong than others. Typically, a firm's style evolves over time by addressing questions as they arise. As a result, inconsistencies develop, making the training of new administrative staff and staff accountants time-consuming and expensive.

Developing a style guide that documents specific, standardized style policies for all correspondence and reports is recommended. The style guide should address topics such as salutations, closings, margins, spacing, indentation, continuing page headings, capitalization, punctuation, format for numbers and dates, underscoring, words used, unique spellings, etc. Doing so provides the following advantages:

- It frees up the time previously needed to resolve format questions. Since disputes often must be resolved by individuals with higher billing rates, cost savings and added efficiency usually result.
- It provides a reference for new administrative personnel, thus reducing the amount of training time (including supervisory time).
- It promotes more efficient use of a firm's talents by enabling the professionals who draft and review the financial statements and other documents to concentrate on content and to leave the detailed format considerations to the word processing staff.
- It helps ensure that all documents consistently convey the same pleasing, professional appearance.

Style and form considerations are a matter of firm preference. The firm should focus on developing a style that is logical, consistent, easy to apply, attractive, and, most importantly, does not distract from the material being presented. Firms may use standardized correspondence and reporting templates that conform to the firm's style preferences to increase consistency in the appearance of documents.

Producing the Documents. The firm also should consider developing specific procedures for producing reports and tax returns. Doing so helps ensure that the firm's standards are met when the documents are processed, proofed, reproduced, and bound. For most firms, producing the report or tax return at the end of an engagement includes the following steps:

- *Submitting the Initial Draft of the Document for Word Processing.* The initial draft of the document is typically prepared by a member of the firm's professional staff and then submitted electronically for word processing. Simply providing the document to the administrative staff and asking them to return the draft and typed document upon completion may be sufficient for many small to medium-sized firms. However, larger firms that produce a high volume of documents may need more formal procedures. Such firms may find it necessary to require employees to sign a report control log when documents are submitted and

returned so that the word processing staff has a record of each document and its status. In addition, many firms use a "Report Control Form" to keep track of who processes, proofreads, corrects, reviews, and signs each report.

- *Processing the Document.* The firm should make its word processing staff aware that the documents they create convey the firm's image. Staff members should make sure that each document follows the firm's style policies (even if the original draft did not). They should also make sure that the overall format of typed documents is attractive (that is, pages are well balanced, columns are appropriately aligned, pages do not break awkwardly, etc.). Finally, they should understand that finished documents must contain no errors. Documents that do not meet the firm's standards should be corrected until they do. In today's computerized environment, a lot of the actual input, formatting, and typing has been greatly reduced. Tax preparation and trial balance software packages often have report writing capabilities, or the packages generate output that often can be imported directly to the word processing package being used to generate the report.
- *Proofreading and Footing the Document.* Someone should proofread the hardcopy document and recompute any calculations it may contain. All corrections should be clearly marked on the hardcopy document. Errors or unusual items noted in the original draft should be brought to the attention of the preparer and, if necessary, corrected on the hardcopy draft.
- *Correcting the Document.* The hardcopy document should be returned to the word processing staff for the correction of any errors noted while proofreading and footing the document (or to make any other revisions considered necessary). As mentioned previously, finished documents should contain no errors.
- *Obtaining the Necessary Signatures.* The firm should adopt a policy describing who may sign reports, tax returns, and other correspondence. Generally, only a partner may sign accountants' reports, and the partner signs them using the firm's name rather than his or her own. Tax returns should be signed by the preparer using his or her name, as required by the Internal Revenue Service. (The firm's name should also appear in the signature block of the return.) Correspondence may be signed by any member of the firm, although many firms allow only managers and partners to sign documents presented on the firm's letterhead.
- *Assembling the Document.* Assembling the document involves making the appropriate number of copies, binding the document(s) if necessary, and preparing envelopes.

Many firms document each step of the production process by attaching a routing slip or report control form to the folder containing the report drafts and requiring the appropriate individuals to sign it as each step is performed. A firm may also monitor the progress of documents through the production process by maintaining a production control log. The log, which should be kept by the firm's word processing staff (or word processing department), records the status of each project from the time it is submitted for processing until it is delivered to the client.

Delivering the Finished Product

Generally, tax returns and reports should be delivered to the appropriate client personnel in person by the engagement partner, manager, or primary client contact. However, most firms allow exceptions to that practice for recurring engagements such as monthly write-up engagements or routine tax return preparation services. Many firms also deliver the final bill with each report to shorten the collection cycle and improve cash flow. If a client has been slow in paying its bills in the past, however, the firm might even consider holding off delivering its report until the client pays the final bill. This is because once the client has the report in hand, the firm loses a certain amount of collection leverage.

Presenting the final work product is an important element of the overall engagement. To enhance the presentation, many firms give their clients reporting packages, of which the actual work products (such as the financial statements and tax return) are only a part. For example, a reporting package may include summarized financial information in the form of graphs or tables, key financial ratios, or an executive summary highlighting the information most important to the client. A small gesture such as presenting an understandable, visually appealing reporting package can often strengthen the firm's position as a business advisor in the client's eyes.

Establishing Correspondence Guidelines

Like the manner in which the firm answers the telephone, how the firm communicates in its written correspondence reflects the image of the firm. Forms of written correspondence include formal and informal letters, emails, faxes, and memos. The firm should establish correspondence guidelines that set a standard for the firm's written communications and provide guidance on the forms of correspondence to be used in specific situations.

Technology has had a major impact on the way in which firms communicate. The immediate nature of email, instant messaging, and faxing creates an opportunity for poorly written or inaccurate communications to be misunderstood by the reader and to reach people other than those to whom they are intended. It is important that the firm understand the dangers posed by email correspondence.

The firm's correspondence policy should address formats and formalities, give guidance on the appropriate medium based upon the circumstances of the correspondence, and define filing and retention requirements. It should also address the use of standard forms such as the firm's letterhead, fax cover sheets, and email templates. The firm should also establish guidelines for approvals of and signatures for correspondence.

Formal Correspondence. Even though technology has significantly reduced the volume of formal correspondence, formal letters remain very important for communicating with business organizations, clients, and other external parties. Some guidelines for formal letters include:

- Always use the firm's letterhead.
- Use formal letters for:
 - Any communications in which the firm or its employees express professional opinions.
 - Proposals.
 - Engagement letters and any other correspondence that confirms or clarifies services, business issues, and relationships.
 - Transmittal letters for reports and other client material.
 - Offers or changes to terms of employment.
 - Legal correspondence of any nature.
- Always use the recipients' full names, titles, and credentials.
- Require that a partner or manager review all formal correspondence.
- Establish a signature policy, e.g., requiring all formal correspondence to be signed by a partner or senior manager.
- Establish a standard format for the basic elements of the letter including margin size, font style and size, indentation, spacing, headings for second pages, etc.
- Use printed second sheets, preferably with a firm watermark.
- Establish a filing and retention policy for formal correspondence.

Informal Correspondence. Informal correspondence includes informal letters, email, memoranda, and faxes used for communications among familiar individuals or of an informal nature. Notes and memoranda often contain important documentation of issues, opinions, or other matters that require some kind of attention. Some guidelines for informal correspondence include:

- Use the firm's letterhead, personal stationery, or plain paper for informal letters. Partners and persons in key administrative positions often have their own personal stationery.
- Do not require the use of the recipients' titles, surnames, or credentials in informal communications.
- Establish a policy for who may sign informal firm communications.
- When faxing, always include a fax cover sheet with the firm's name, address, fax number, telephone number, the sender's name and title, the subject of the fax, and the number of pages. The fax cover sheet should also include a confidentiality disclosure. Applicable rules for formal correspondence should be followed when faxing formal letters.
- Establish a policy for obtaining and maintaining fax confirmations and fax sending and receiving logs.
- Establish a filing and retention policy for informal correspondence.

Establishing an Email Policy

Email, like letters, can be formal or informal; when in doubt, it is safer to be more formal, especially because email is vulnerable to interception. It is important that all members of the firm use caution when writing emails because it is so easy to send a hastily, poorly written email that does not appropriately communicate the intended message. Email creates an electronic document that is stored on the firm's, the recipient's, and, in some cases, the internet service provider's network. It is possible for deleted email messages to be restored, which further increases the possibility that the message could reach unintended recipients. Both the firm and the sender could be held liable for damages resulting from unlawful or harmful email. Accordingly, guidelines for writing and retaining emails are important.

Firms should use caution when responding to client email inquiries. The informality of email as a communication medium does not make the information contained in emails informal conversation. The same quality control procedures the firm follows for written responses to technical inquiries should also be followed for similar email responses. For instance, assume that a client emails a staff member for guidance on the proper accounting treatment of a transaction in accordance with a newly issued accounting standard. Before the advent of email, the staff member would research the issue and draft a response that provides guidance, complete with support from the professional standards. The response would typically be reviewed and approved by the engagement partner and appropriate disclaimer language would be added to the correspondence. A copy of the formal communication would be maintained in the client correspondence file. None of those steps should be excluded simply because the communication is made electronically. Email documentation is still documentation, and the client has a permanent record of what the firm has advised it to do.

All incoming and outgoing emails normally should be deleted as soon as any necessary action has been taken. When incoming or outgoing emails must be preserved, they should be transferred to the firm's electronic document management system where they can be labeled and indexed. The copy in the email system should then be deleted. Best practices are that in no event should emails remain in the firm's email system more than 30 days.

Some guidelines for email usage include:

- Establish a firm email policy.
- Include email etiquette tips in your email policy.
- Write emails as if they are going to be read by unknown or unintended recipients.
- Establish policies that set forth authorized users and uses as well as prohibited purposes and uses.
- Define the firm's monitoring policy and its rights to inspect and disclose the contents of employee emails.
- Do not include confidential or sensitive information without using encryption or other controls that prevent unauthorized access to the information.

- Establish a filing and retention policy.
- Keep on eye on technology and review the policy at least quarterly.
- Obtain employees' signatures on the policy or include it in their employment contract. Include a copy of the policy in the employee handbook.
- Require that a confidentiality statement be included on every email.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. A firm that has **not** developed a style guide for use in producing documents will experience:
- a. A consistent professional appearance in all correspondence.
 - b. Less time spent training new administrative staff.
 - c. Staff members meeting to resolve format disputes.
23. Which of the following describes the best approach in delivering the finished product to the client?
- a. Send the bill separately.
 - b. Hand deliver all finished products to the client's office.
 - c. Present the client with an understandable reporting package.
24. Holly, a new staff person, is drafting an email to a client. The email includes confidential information. What step should Holly take?
- a. Encrypt the message to the client.
 - b. Use the recipient's title in the communication.
 - c. Delete the email as soon as it is sent without retaining any documentation of the information.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

22. A firm that has **not** developed a style guide for use in producing documents will experience: **(Page 182)**
- a. A consistent professional appearance in all correspondence. [This answer is incorrect. Without a style guide that dictates specific, standard style policy, documents produced by the firm will be inconsistent and potentially unprofessional.]
 - b. Less time spent training new administrative staff. [This answer is incorrect. Having a style guide provides a reference for new administrative personnel and makes it easier for new personnel to learn the system.]
 - c. **Staff members meeting to resolve format disputes. [This answer is correct. Without style standards, time is wasted determining how documents should be formatted.]**
23. Which of the following describes the best approach in delivering the finished product to the client? **(Page 183)**
- a. Send the bill separately. [This answer is incorrect. It is better to deliver the bill along with the report to shorten the collection cycle.]
 - b. Hand deliver all finished products to the client's office. [This answer is incorrect. Generally, tax returns and reports should be delivered by the engagement partner, manager, or primary client contact, however, most firms allow exceptions for monthly write-up engagements.]
 - c. **Present the client with an understandable reporting package. [This answer is correct. A report that includes summarized financial information in the form of graphs, key financial ratios, or an executive summary provides the client with data that is more understandable, and therefore more useful.]**
24. Holly, a new staff person, is drafting an email to a client. The email includes confidential information. What step should Holly take? **(Page 185)**
- a. **Encrypt the message to the client. [This answer is correct. The firm's email policy should require encryption to prevent unauthorized access to the information sent by email.]**
 - b. Use the recipient's title in the communication. [This answer is incorrect. An email can be formal or informal; thus, a title is not always required.]
 - c. Delete the email as soon as it is sent without retaining any documentation of the information. [This answer is incorrect. Since the email includes sensitive information, it should be transferred to the firm's electronic document management system for preservation. Then, the copy in the email system should be deleted.]

IMPLEMENTING A DUE DATE MONITORING SYSTEM

Monitoring Due Dates

Due dates are extremely important in the accounting profession, especially in the area of taxes (including payroll taxes). Filing deadlines, payment and deposit deadlines, and even planning deadlines (for instance, to guarantee implementation by year end) present firms with many scheduling challenges each year. The consequences of not complying with a tax deadline can be severe. The resulting late filing penalties and missed opportunities (especially relating to the filing of important elections) can cause clients to lose confidence in the firm. They may even increase the firm's malpractice exposure. An effective system for monitoring due dates is critical to minimizing the risks associated with missed deadlines.

Although a due date monitoring system is generally used more for tax deadlines, it can also be used for accounting and other deadlines. For example, if a firm does several different compilation engagements regularly (such as quarterly compilations for 20 different clients), a due date tracking system can help monitor the compilations each quarter to ensure that the firm completes them on time.

The form of a due date monitoring system can vary from a very simple, manually prepared due date calendar to a much more complex computerized system.

Adequate Lead Time

Most firms have developed their own unique systems for monitoring due dates. However, whatever form the system takes, it is imperative that it identifies due dates far enough in advance so that the firm has adequate lead time to perform the engagement before the deadline. A system that prints a report on April 1 identifying tax returns with April 15 due dates or compilation engagements with April 10 due dates will not be very useful if there is not enough time between the report date and the due date to complete the engagements. The amount of lead time needed will vary with the type of engagement. However, at least two months before the due date is usually sufficient for tax engagements and at least four months before the due date is usually sufficient for accounting engagements.

Normally, computerized monitoring systems track items through the 15th of each month, since this corresponds with most tax deadlines. However, there are returns and other engagements with odd due dates (such as payroll tax, state income tax, and inheritance tax returns), and it is imperative that the system adequately alerts professionals to these deadlines in addition to the mid-month deadlines. It may be helpful to establish a system that has three separate reports. The first report could list all items that are due from the date of the report through the 15th of the upcoming month. The second report could list the items that are due from the date of the report through the 15th of the following month and establish the two-month lead time. The third report could list all of the items that are currently past due. The firm should print and distribute the reports as soon after the 15th of each month as possible.

To illustrate the approach discussed in the preceding paragraph, a firm that uses such a system would generate the following three reports on February 16, 20X1:

- a. A report that would list all past due items that were required to be filed on or before February 15, 20X1.
- b. A report that would list the items that should be filed from February 16, 20X1, through March 15, 20X1.
- c. A report that would list items due from February 16, 20X1, through April 15, 20X1.

Depending on the firm's monitoring system, the system may be able to generate separate reports for tax engagements and accounting engagements. This can be beneficial since a longer lead time is usually necessary for accounting engagements. Therefore, if the system generates separate reports for accounting engagements, the system would generate the reports listed above only for tax engagements. In addition, the system would also generate the following three reports on February 16, 20X1, for accounting engagements:

- a. A report that would list all past due items that were required to be completed on or before February 15, 20X1.

- b. A report that would list the items that should be completed from February 16, 20X1, through March 15, 20X1.
- c. A report that would list items that should be completed from February 16, 20X1, through June 15, 20X1.

The information included on the tax and accounting due date reports will usually show, at a minimum, the client name, the type of service being performed, and the due date of the service. The ability to sort the due date reports by due date, client name, staff person, or other component will depend on the monitoring system that the firm uses.

Maintaining the Integrity of the Monitoring System

The firm can maintain the integrity of its monitoring system only if it has established adequate procedures for maintaining the system. The first step in establishing adequate procedures is to give one person in the firm the responsibility for keeping the due date monitoring system up-to-date (such as a due date administrator). The due date administrator will also be responsible for generating and distributing the due date listings to the appropriate professionals. After designating a due date administrator, a firm should establish procedures to correctly enter the following events into the monitoring system:

- a. Adding new clients or engagements.
- b. Clearing completed jobs.
- c. Purging former clients or engagements.

Adding New Clients or Engagements. One way to ensure that new clients are properly entered into the due date data base is to include a step in the new client setup process that prompts the firm to record and input engagements and corresponding due dates into the system. This forces personnel to input due dates into the monitoring system at the time the firm accepts the job. This can be accomplished through completion of a due date monitoring system input form. The firm can also put new engagements (recurring or nonrecurring) for *existing* clients into the system by using this form. The firm should require that personnel that set up new engagements for existing clients or new clients complete these forms, have them approved by the engagement manager or partner, and then forward them to the due date administrator who will enter them into the due date monitoring system.

Clearing Completed Jobs. It is not enough to ensure that new engagements are properly set up in the firm's due date monitoring system. The due date administrator must also tell the system when the firm completes projects, so that the reports do not show completed projects as past due. The following are two ways to update the due date monitoring system to reflect completed projects:

- The person who mails or delivers the finished product to the client can route a copy of the transmittal letter that accompanies the return or report to the due date administrator.
- The person who mails or delivers the finished product to the client can prepare the due date monitoring system input form, have it approved by the engagement manager or partner, and route it to the due date administrator.

Purging Former Clients and Engagements. The firm needs to establish procedures to purge former clients from the due date monitoring system. This will also be necessary for engagements of continuing clients that will no longer be done. For example, at some point the firm might stop performing monthly compilations for a particular client even though the firm will continue to prepare the company's corporate tax return. The firm can use the due date monitoring system input form to purge former clients or engagements from the system. This completed form should be approved by the manager or partner assigned to the former client or engagement and should be routed to the due date administrator.

Engagements with No Due Date

Certain engagements, such as tax planning engagements and some compilation engagements, do not have required or statutory due dates. Just because there are no required deadlines for these engagements, however,

does not mean that they should not be set up in the client's due date monitoring system. In fact, the firm can assign all engagements a due date and set them up in the system. Whenever the firm accepts a new engagement, the partner or manager who will be responsible for the engagement should discuss the engagement completion date with the client. The firm should put the target completion date into the monitoring system and schedule the work accordingly. Assigning a due date to all engagements helps the firm focus on the importance of its engagements, facilitates their timely completion, and increases client satisfaction.

Automated Systems

Every firm should have some sort of system to track upcoming due dates and monitor the firm's compliance with them. In very small firms, a formal tracking system may not be necessary. Instead, engagement partners and managers may keep up with their own clients' deadlines. For other firms, it is likely that using due date monitoring software is more efficient and reliable. With automated due date monitoring systems, recurring services can be entered once and automatically recur in the due date list on an annual, semiannual, quarterly, bimonthly, or monthly basis (as specified by the user) without further effort. Firms that use due date monitoring software can usually update status reports with little effort. During busy season, when time and personnel resources are scarce, an automated system can be an efficient way to generate detailed reports at frequent intervals. There are several commercial software packages that are available to monitor due dates. In addition, some tax return preparation software packages have due date tracking capabilities.

Due date monitoring applications typically include several standard reports with multiple types of due date lists. Some monitoring packages even include options allowing a firm to print customized reports. Besides various due date listings, some of these monitoring systems can generate assignment reports by staff level or by individual staff assignments.

BILLING AND COLLECTING

Billing Philosophies

Generally, accountants bill write-up services based on one (or both) of the following methods:

- a. *Fixed Fee for Each Engagement.* This arrangement may be advantageous because it enables accountants and clients to forecast the exact fee that will be billed each period. It has several disadvantages, however. For example:
 - (1) The fixed fee is likely to be too high or too low.
 - (2) Fixed fees may be difficult to increase to reflect rising costs. Even if the fee is increased, there is often a considerable time lag between when the additional costs are incurred and when the fee is raised.
 - (3) If costs have been underestimated, accountants may be tempted to cut corners, which results in substandard work.
 - (4) Misunderstandings about the exact services covered by the fixed fee may arise.
- b. *Hourly Rates.* The time needed to perform write-up services may vary each period. For example, more work may be necessary if the client's volume of business increases or if payroll tax returns must be prepared at the end of a calendar quarter. This method allows accountants to be compensated for additional work that may be needed during certain periods without requiring extensive revisions of fee estimates or engagement letters. (Even if this method is used, however, accountants must still perform the services efficiently and at reasonable rates to remain competitive.)

Regardless of the billing method used, the fee for write-up services should consider the time spent performing the services, standard billing rates for performing the services, and subjective factors such as the following:

- a. Skill and experience of the staff.

- b. Value of the services to the client.
- c. Difficulty of the engagement.
- d. Fees charged by other accountants for similar services.
- e. Ability to collect the fee.
- f. Fees that may be collected by performing other services.

Assigning Responsibility for Billing and Collecting

The responsibility for billing and collecting should be clearly defined. In many firms, the overall responsibility for billing and collecting is assigned to the client-service partner, and in other firms it is assigned to partners or staff that perform the service (for example, the tax partner bills and collects for tax services and another partner or staff accountant bills and collects for write-up services). The best practices indicate that the engagement staff be involved in the billing process and that responsibility for reviewing and collecting the bills be assigned to the client-service partner. That approach allows individuals that are closest to the engagement (and thus more familiar with client personnel, the work performed, and any problems encountered) to have significant input into the billing process. In addition, assigning overall responsibility to the client-service partner helps foster a full-service firm image, and clients generally prefer dealing with a firm rather than a collection of individuals.

Improving Collections

A key ingredient in improving fee collections is the careful consideration before the engagement is accepted of the client's ability to pay the fee. The following practices also can contribute significantly to improving fee collections:

- *Clearly Communicate Fees and Billing Policies.* Best practices are to send each new client a letter that explains the firm's fee structure and billing policies. (This is in addition to the engagement letter previously discussed.) The letter is intended to help avoid future disagreements and complaints about fees and to inform the client about when payment is expected. The letter should be sent to the client upon acceptance.
- *Bill Frequently.* A firm can reduce its exposure to nonpayment by billing the client monthly and following up on collecting the bill. A small bill is easier to pay than a large one.
- *Work Efficiently.* Stress the importance of a logical and systematic approach for obtaining information from the client. Ask for it once, complete the work with it, and return it promptly. That helps prevent a seemingly casual or uncoordinated approach that could destroy a client's confidence.
- *Make Progress Reports.* Keep the client updated on the progress of the engagement when delays are encountered, and inform the client immediately when they are responsible for delays that will require additional time or billing.
- *Use Clear Descriptions on Bills.* Bills should be as descriptive as possible to avoid confusion about the services performed and the services billed. Ideally, the wording used in the engagement letter to describe the services to be rendered should also be used on the actual billings.
- *Identify Slow-paying Clients.* Aged accounts receivable reports should be prepared to help identify slow-paying clients. To speed collection from slow-paying clients, accountants should consider (a) telephoning clients that have past due accounts, (b) charging interest on past due accounts, and (c) writing personal notes on accounts receivable statements. If the client is a habitually slow payer, the firm should also consider requiring payment in advance of providing services.
- *Consider Discontinuing Service.* If the bill is not paid after notifying the client that it is past due, the firm should discontinue providing any services until payment is received. (Accountants should not withhold client records, however, to obtain payment of fees.)

- *Consider Obtaining a Note Receivable from a Client That Is Experiencing Cash Flow Problems.* When clients experience cash flow problems, accountants are usually the last creditors to be paid. In those instances, accountants should ask the client to sign a note receivable covering the unpaid fees. If collection proceedings are necessary, the accountants may have a better chance collecting a note receivable than an open account.

FTC's "Red Flags" Rule

The "Red Flags" rule, which was released November 9, 2007, was mandated by the Fair and Accurate Credit Transactions Act of 2003 (FACTA) and requires financial institutions and creditors to implement programs to identify, detect, prevent and mitigate identify theft. Enforcement of the rule has been postponed several times since the original November 1, 2008, effective date, and was recently postponed until December 31, 2010. The FTC delayed enforcement of the rule in response to requests from Congress, who was encouraged to pursue the delay by numerous organizations, including the AICPA and many state CPA societies.

According to the FTC website, the definition of *creditor* in the rule is broad and includes businesses or organizations that regularly provide goods or services first and allow customers to pay later. As examples, the FTC lists accountants and other professionals. The AICPA is concerned with the broad application of the "Red Flags" rule and its impact on the accounting profession. Therefore, in August 2009, the AICPA sent a letter to the FTC asking that CPAs be exempt from certain provisions of its "Red Flags" rule to prevent identity theft. "We are concerned with the potentially broad application of the Red Flags Rule to the accounting profession, and do not believe that there is any reasonably foreseeable risk of identity theft when CPA clients are billed for services rendered," wrote AICPA CEO, Barry Melancon. Many state CPA societies are also sending letters to their members of Congress and the FTC urging exemption. The FTC's "Red Flags" website, www.ftc.gov/redflagsrule, offers resources to help entities determine if they are covered and, if they are, how to comply with the Rule. Practitioners should be alert for any actions the FTC takes related to CPAs and enforcement of the "Red Flags" rule.

INFORMING CLIENTS OF OUTSOURCING ARRANGEMENTS

In most instances, it will be rare for accounting firms to outsource portions of compilation or review engagements. However, firms often will outsource other services which might be covered by their compilation or review engagement letter, such as tax services. Ethics Ruling 112 (ET 191.224-.225) under Rule 102, *Integrity and Objectivity*, requires that clients be informed, preferably in writing, if the practitioner's firm will outsource professional services to third-party service providers. If the practitioner intends to use third-party service providers (that is, entities not controlled or employed by the accounting firm), the client must be informed before confidential client information is shared with the service provider. Also, revised Ethics Ruling No. 1 (ET 391.001-.002) under Rule 301, *Confidential Client Information*, states that if the accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party (a) to maintain the confidentiality of the client's information and (b) to have procedures in place to prevent unauthorized release of confidential information, the accounting firm must obtain the client's consent to disclose the client's confidential information to the third-party service provider.

In cases where the practitioner chooses to provide written disclosure that a third-party service provider will be used, the following paragraph may be included in the engagement letter.

We may from time to time, and depending on the circumstances, use certain third-party service providers in serving your account. We may share confidential information about you with these service providers, but remain committed to maintaining the confidentiality and security of your information. Accordingly, we maintain internal policies, procedures, and safeguards to protect the confidentiality of your personal information. In addition, we will secure confidentiality agreements with all service providers to maintain the confidentiality of your information and we will take reasonable precautions to determine that they have appropriate procedures in place to prevent the unauthorized release of your confidential information to others. In the event that we are unable to secure an appropriate confidentiality agreement, you will be asked to provide your consent prior to the sharing of your confidential information with the third-party service provider. Furthermore, we will remain responsible for the work provided by any such third-party service providers.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. A due date monitoring system is important because:
- a. It minimizes the risks associated with missed deadlines.
 - b. It eliminates the need for lead time.
 - c. It produces one monthly reminder report.
 - d. It frees up staff time.
26. Assigning a due date to all engagements does all **except** which of the following?
- a. Helps the firm focus on the importance of its engagements.
 - b. Facilitates timely completion of engagements.
 - c. Monitors the progress of the engagement.
 - d. Increases client satisfaction.
27. Which of the following is appropriate regarding a due date monitoring system?
- a. When jobs are done, an administrator should close the job on the due date monitoring system.
 - b. It is the system administrator's responsibility to ask the partner on the engagement when projects are completed.
 - c. Engagements with no due date cannot be kept on a due date monitoring system.
 - d. Automated due date monitoring software is the only way to insure that due dates are monitored and complied with for a firm.
28. What is an advantage of using the fixed fee method of billing?
- a. It removes misunderstanding about the services covered.
 - b. The client can count on the amount to pay.
 - c. The fee is easily adjusted.
 - d. Substandard work is avoided.
29. What is the key ingredient in collecting fees due?
- a. Bill frequently.
 - b. Clear communication with the client.
 - c. The client's ability to pay.
 - d. Provide detailed description on billing statements.

30. Fortuitous, Franklin and Faith, P.C. (FFF) is moving forward with their outsourcing decision. They are reviewing a contract with a potential third-party service provider. Correctly match the options FFF has with the Ethics Rulings governing the use of third-party service providers.

Ethics Rulings:

1. Rule 102, *Integrity and Objectivity*
2. Rule 301, *Confidential Client Information*

Options:

- i. Inform the client, preferably in writing, if the practitioner's firm will outsource professional services to third-party service providers.
 - ii. If an accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party to (1) maintain the confidentiality of the client's information and (2) to have procedures in place to prevent unauthorized release of confidential information, then the firm must obtain the client's consent to disclose confidential client information to the third-party service provider.
-
- a. 1 and i.
 - b. 1 and ii.
 - c. 1 and i; 2 and ii.
 - d. 1 and ii; 2 and i.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. A due date monitoring system is important because: **(Page 189)**
- a. **It minimizes the risks associated with missed deadlines. [This answer is correct. The consequences of not complying with a tax deadline can be severe, costing the client money in penalties and lost opportunities for not taking certain tax elections.]**
 - b. It eliminates the need for lead time. [This answer is incorrect. Although a monitoring system alerts the accountant to due dates, it cannot eliminate the amount of lead time required to meet deadlines.]
 - c. It produces one monthly reminder report. [This answer is incorrect. A more effective due date monitoring system should produce more than a monthly report since many tax deadlines occur mid-month.]
 - d. It frees up staff time. [This answer is incorrect. The work to meet due dates will not be reduced by using a due date monitoring system since it only alerts the staff of deadlines and does not complete any work.]
26. Assigning a due date to all engagements does all **except** which of the following? **(Page 190)**
- a. Helps the firm focus on the importance of its engagements. [This answer is incorrect. Assignment of a due date focuses the firm to complete an engagement in a timely fashion.]
 - b. Facilitates timely completion of engagements. [This answer is incorrect. Establishing the target completion date allows the firm to schedule work accordingly.]
 - c. **Monitors the progress of the engagement. [This answer is correct. Having a due date does not ensure progress is monitored without setting up a work schedule. Monitoring the progress could help a firm achieve a due date if they are consistent and work towards it.]**
 - d. Increases client satisfaction. [This answer is incorrect. Clients expect the firm to protect them from missing deadlines and paying penalties and by doing so, it will increase the client's confidence in the firm.]
27. Which of the following is appropriate regarding a due date monitoring system? **(Page 190)**
- a. **When jobs are done, an administrator should close the job on the due date monitoring system. [This answer is correct. When a job is completed, the due date administrator needs to tell the system that the firm completed the project so that the completed projects do not appear past due.]**
 - b. It is the system administrator's responsibility to ask the partner on the engagement when projects are completed. [This answer is incorrect. The person who mails or delivers the finished product to the client can route a copy of the transmittal letter to the due date administrator to inform them that the project is complete.]
 - c. Engagements with no due date cannot be kept on a due date monitoring system. [This answer is incorrect. Although there are no required deadlines for some engagements, it does not mean that they should not be set up in the client's due date monitoring system. The firm can assign a date to the engagement, even if it is not required or has statutory due dates so that the firm can schedule accordingly.]
 - d. Automated due date monitoring software is the only way to insure that due dates are monitored and complied with for a firm. [This answer is incorrect. In larger firms, using a due date monitoring software is the most efficient and reliable system of keeping up with due date, but in a smaller firm, a formal tracking system may not be necessary. Instead, engagement partners and managers may keep up with their own clients' deadlines.]

28. What is an advantage of using the fixed fee method of billing? **(Page 191)**
- a. It removes misunderstanding about the services covered. [This answer is incorrect. Misunderstandings can arise when using this method if the client is unclear as to the exact services covered by the fixed fee.]
 - b. The client can count on the amount to pay. [This answer is correct. Since the amount is stated, the client knows exactly how much to budget and the firm knows how much it will collect.]**
 - c. The fee is easily adjusted. [This answer is incorrect. Fixed fees may be difficult to increase if costs rise because clients are accustomed to the fee. Even if the fee is increased, there can be considerable time lags between higher costs and higher fees.]
 - d. Substandard work is avoided. [This answer is incorrect. If costs have been underestimated, accountants may be tempted to cut corners, which results in substandard work.]
29. What is the key ingredient in collecting fees due? **(Page 192)**
- a. Bill frequently. [This answer is incorrect. Although frequent billing can reduce a firm's exposure to nonpayment, this is not the determining factor for whether or not a client will pay the bill.]
 - b. Clear communication with the client. [This answer is incorrect. A letter detailing the firm's fee structure and billing policies can be helpful in avoiding future disagreements. However, there is one more important ingredient in collecting fees that are due.]
 - c. The client's ability to pay. [This answer is correct. Careful consideration should be given to the client's ability to pay prior to accepting the engagement. This is key because, although the client may have the desire to pay, he will not do so if he is unable to pay.]**
 - d. Provide detailed description on billing statements. [This answer is incorrect. Descriptive bills can diminish confusion but cannot ensure the client will pay the bill when it is presented.]
30. Fortuitous, Franklin and Faith, P.C. (FFF) is moving forward with their outsourcing decision. They are reviewing a contract with a potential third-party service provider. Correctly match the options FFF has with the Ethics Rulings governing the use of third-party service providers. **(Page 193)**

Ethics Rulings:

1. Rule 102, *Integrity and Objectivity*
2. Rule 301, *Confidential Client Information*

Options:

- i. Inform the client, preferably in writing, if the practitioner's firm will outsource professional services to third-party service providers.
 - ii. If an accounting firm does not enter into a contractual agreement with the third-party service provider requiring the party to (1) maintain the confidentiality of the client's information and (2) to have procedures in place to prevent unauthorized release of confidential information, then the firm must obtain the client's consent to disclose confidential client information to the third-party service provider.
- a. 1 and i. [This answer is incorrect. This answer choice does not match both ethics rulings with an action item.]
 - b. 1 and ii. [This answer is incorrect. This answer choice does not match both action items with the correct ruling.]

- c. **1 and i; 2 and ii. [This answer is correct. Ethics Rule 102 does require that clients be informed prior to the accountant outsourcing professional services. Also, Ethics Rule 301 does require certain actions that help accountants ensure client information is kept confidential when third-party service providers are used.]**
- d. 1 and ii; 2 and i. [This answer is incorrect. The ethics rulings are not appropriately matched with the action items.]

EXAMINATION FOR CPE CREDIT**Lesson 1 (WUSTG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

1. TKM, Inc. is regarded as the leading write-up-service firm in the city. It has achieved this status through high ethics and meeting all of its clients' needs. What characteristic is TKM, Inc. relying on for the success of their firm?
 - a. Philosophy of the level of work the firm would like to engage.
 - b. Reputation of the firm within the community.
 - c. Leadership of the firm by the partners.
 - d. Commitment of the firm's staff to produce quality work.
2. In the comprehensive planning system, Carrie has been charged with obtaining commitment to achieve the firm's goals. Which task has been assigned to her?
 - a. Strategic planning.
 - b. Budgeting.
 - c. Individual performance planning.
 - d. Plan review.
3. The _____ should be brief, reflect on a firm's business focus, and provide motivation for partners and staff, as well as direction for the firm as a whole.
 - a. Mission statement.
 - b. Action plan.
 - c. Executive summary.
 - d. Strategic plan.
4. Which factor included in the SWOT analysis would a firm have little control over influencing and could adversely affect the firm's profitability?
 - a. Threats.
 - b. Strengths.
 - c. Weaknesses.
 - d. Opportunities.
5. Which of the following is the most accurate description of objectives and strategies?
 - a. Objectives and strategies should be written separately.
 - b. Strategies indicate a firm's chosen direction.
 - c. The accomplishment of the strategy should not be too simple.
 - d. Objectives spell out the details of expected results.

6. The step of the marketing plan in which a firm can define a potential niche is:
- Evaluating the firm's capabilities.
 - Analyzing the competition.
 - Developing a marketing strategy.
 - Identifying the target market.
7. The supply of new and experienced accounting staff is:
- Plentiful due to the downsizing of accounting firms.
 - Plentiful due to more accounting professionals available in the market.
 - Tight due to increased competition for employees.
 - Do not select this answer choice.
8. Kathy is a single mom with two school-age children. She is a CPA with 10 years of experience in public accounting. Which of the following should Cunningham & Associates offer to improve Kathy's work-life balance?
- A hiring bonus.
 - Flextime.
 - A life insurance plan.
 - Incentive pay.
9. Complete the following sentence from SQCS No. 7 (paragraph 37). "A firm should establish policies and procedures over the human resource quality control (QC) element designed to provide reasonable assurance that the firm has sufficient personnel with the capabilities, competence, and commitment to _____ principles necessary to (a) assure engagements are performed in accordance with professional standards and regulatory and legal requirements and (b) enable the firm to issue appropriate reports."
- Ethical.
 - Accounting.
 - Management.
 - Marketing.
10. What is the first step in preparing a staffing plan?
- The firm first evaluates its current and anticipated future staffing needs.
 - The firm first looks for qualified candidates.
 - The firm first evaluates personnel turnover.
 - The firm first evaluates the adequacy of its retirement plans.

11. Which of the following is an alternative to hiring full-time professional staff?
- Flextime.
 - Paraprofessionals.
 - Telecommuting.
 - Outsourcing administrative functions.
12. With regard to the hiring process, which of the following statements is most accurate?
- Candidates for a write-up staff position should be asked different questions because no two people are alike.
 - All questions asked during the interview process should be job-related.
 - Personal references and former employers normally will provide the most objective source of information about a candidate for a write-up staff position.
 - Pre-employment tests should never be given to candidates for a write-up staff position.
13. The managing partner of Peavy, Pacey and Egerton is seeking to control CPE costs. Name one program the firm could implement to help with these costs.
- Intern Program.
 - Employee Retention Program.
 - Professional Development Program.
 - Employee Recruitment Program.
14. Which of the following would help accountants assess the level of proficiency in a particular functional specialty and broaden their business perspective?
- A performance evaluation.
 - Completing the required CPE requirements.
 - A professional development program.
 - AICPA Competency Self-Assessment Tool.
15. Which of the following is **not** considered a reason for periodically providing write-up staff with performance evaluations?
- To inform the employee of strengths and weaknesses noted during past job performances.
 - To set goals for future job performance.
 - To obtain feedback about employee concerns and morale.
 - To provide on-the-job training.

16. Name one business culture benefit a firm can provide to enhance employee retention.
- Correspondence policies.
 - Engagement continuance policies.
 - Personnel policies.
 - Open communication.
17. The managing partner of the Lawton CPA firm is surprised to learn that members of the new management of a long-term client are related to a new hire of Lawton. During the client continuance evaluation, what factor should the firm consider?
- The determination of the client's needs.
 - Any significant changes in key management.
 - Independence issues.
 - Do not select this answer choice.
18. In which of the following situations should a firm terminate service to a client instead of considering the factors for continuing the engagement?
- The CFO of the client has been indicted of fraud since the previous engagement.
 - The client has been slow to pay any fees due to the firm, after the work was performed.
 - The company has done a public offering since the last engagement and the firm does not have experience auditing public companies.
 - The daughter of the president of the company was recently hired by the firm as a new staff auditor.
19. A firm should periodically evaluate the write-up services provided to a client because:
- As clients grow, their needs change.
 - The fees should be increased.
 - They may no longer be profitable.
 - Do not select this answer choice.
20. Breakwater Inc. would like to limit its financial statements to internal use only. Is it appropriate for Breakwater to have management-use-only financial statements produced under these circumstances?
- Yes.
 - No.
 - Do not select this answer choice.
 - Do not select this answer choice.

21. In relation to management-use-only financial statements and the distribution to a third party, which of the following is true?
- Management is allowed to distribute them, since they paid the firm for the financials.
 - Accountants are protected as long as they have a standard engagement letter.
 - The accountant should request that the financial statements be returned.
 - The accountant should continue to provide a service to the client so that they will know if the financials are correct.
22. Which of the following is **not** an advantage of using engagement letters?
- Assist in avoiding client and staff misunderstandings.
 - Enhances practice management.
 - Prevents all potential legal liability.
 - Explains contractual obligations to the client.
23. In which of the following scenarios does the CPA's engagement letter comply with the requirements of SSARS No. 19 for a compilation engagement?
- Anna's engagement letter states that she is responsible for detecting and preventing fraud.
 - Bob's engagement letter states that he will perform inquiry and analytical procedures.
 - Cleo's engagement letter states that she is responsible for conducting the engagement in accordance with SSARS issued by the AICPA.
 - Don's engagement letter states that he is responsible for preparation of the financial statements.
24. Greta, a CPA, is preparing an engagement letter for a client who needs management-use-only financial statements. Which of the following communications is Greta required to make by SSARS No. 19?
- A statement to clarify the accountant's responsibility for determining if the financial statements are appropriate for how management will use them.
 - A statement that management will not provide the statements to any third-party users.
 - A statement that management must sign and return the engagement letter.
 - A statement that substantially all disclosures required by GAAP or an OCBOA may be omitted.
25. An advantage of using a style guide for use in producing a firm's documents is:
- It involves higher level professionals in the process.
 - It ensures professional looking documents.
 - It eliminates training time.
 - It allows staff flexibility in producing correspondence.

26. Denise supervises the word processing staff of a major accounting firm. Her job is to do all **except**:
- Make sure each document follows the firm's style policies.
 - Make sure the format is attractive.
 - Make sure the content is accurate.
 - Make sure the document contains no grammatical errors.
27. In adopting a policy for obtaining signatures on documents, which of the following is the most accurate?
- Only a partner can sign accountants' reports.
 - Tax returns are signed using the firm's name.
 - Accountants' reports are signed using the partner's name.
 - Correspondence is always signed by firm managers.
28. What type of correspondence is described by the following attributes? The correspondence is on the firm's letterhead, includes the recipient's full name, title and credentials.
- Formal.
 - Informal.
 - Email.
 - Do not select this answer choice.
29. Which of the following can be a disadvantage of a due date monitoring system?
- The confidence a client would have in the firm.
 - The ability to deal with scheduling challenges in the firm.
 - The complexity of setting up the system.
 - The compliance with project deadlines.
30. Joyce is entering due dates into the firm's monitoring system. How much lead time should she allow for tax and accounting engagements?
- 30 days for tax and 30 days for accounting.
 - 45 days for tax and 60 days for accounting.
 - 2 months for tax and 4 months for accounting.
 - 4 months for tax and 4 months for accounting.
31. The job of the due date administrator includes all of the following **except**:
- Adding new clients or engagements.
 - Determining appropriate due dates.
 - Clearing completed jobs.
 - Purging former clients or engagements.

32. Penny Pincher is a habitually late-paying client. Name one item her accountant can do to remedy this problem.
- Require payment in advance of providing services.
 - Transfer Penny's account to a new accountant, thus lowering the cost of the services provided.
 - Withhold Penny's records until payment is received.
 - Use clearer descriptions on the bills to help Penny process the payment.
33. Tom needs to outsource a portion of the accounting services he performs for his client. Which of the following would keep Tom in compliance with the accounting standards?
- Tom will need to enter into a contractual agreement with the third-party service provider and require them to keep the client's information confidential and have procedures in place to prevent any unauthorized release of confidential information.
 - Since Tom has an engagement letter with his client, he is able to complete the service without informing his client that he is going to outsource a portion of the accounting services.
 - Tom is using a third-party provider that he has used numerous times in the past, so he does not feel he needs a contract with the provider. He will inform his client that he plans to employ the third-party provider.
 - Do not select this answer choice.

Lesson 2: Quality Control Standards, Disaster Recovery and Succession Planning

INTRODUCTION

The AICPA and the state societies of CPAs attempt to maintain self-regulation of firm quality and professionalism through various committees, such as ethic committees and practice review committees. The AICPA's Quality Control Standards, Peer Review Program, and Code of Professional Conduct, are discussed in the following paragraphs.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the quality control standards that contribute to a successful write-up engagement process.
- Determine the risks and responsibilities in an engagement.
- Identify the features of a disaster recovery plan and a succession plan for the firm.

Quality Control Standards

Statement on Quality Control Standard No. 7, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's responsibilities for its system of quality control for its accounting and auditing practice. In October 2010, the Auditing Standards Board (ASB) issued SQCS No. 8, *A Firm's System of Quality Control (redrafted)*, that will supersede SQCS No. 7, *A Firm's System of Quality Control*. SQCS No. 8 redrafts SQCS No. 7 to apply the ASB's clarity drafting conventions and to converge with International Standards on Quality Control (ISQS) No. 1, *Quality Control For Firms That Perform Audits and Reviews Of Financial Statements, and Other Assurance and Related Services Engagements*. SQCS No. 8 does not change or expand SQCS No. 7 in any significant respect. SQCS No. 8 is applicable to a firm's system of quality control for its accounting and auditing practice as of January 1, 2012.

Paragraph 3 of SQCS No. 7 (QC 10.03) states that the firm "must establish a system of quality control designed to provide the firm with reasonable assurance that the firm and its personnel comply with professional standards and applicable regulatory and legal requirements," and that the firm or engagement partners issue reports that are appropriate in the circumstances. The firm's quality control system consists of policies and procedures.

The purpose of a quality control system is to promote quality in performing accounting and auditing engagements. As the QC standards indicate, a firm's system of quality control is a system designed to provide the firm with reasonable assurance that the firm is (a) complying with professional standards and legal and regulatory requirements, and (b) issuing reports that are appropriate in the circumstances. In developing and maintaining its quality control system, a firm establishes policies designed to achieve the objectives associated with obtaining reasonable assurance and procedures required to implement and monitor compliance with the policies. *Reasonable assurance* is defined as a "high, but not absolute, level of assurance" (SQCS No. 7, QC 10.05).

The nature of the policies and procedures the firm develops to obtain reasonable assurance and comply with the requirements of SQCS No. 7 will depend on various factors, such as the following:

- The size of the firm.
- The operating characteristics of the firm, for example—
 - Types of services provided.
 - Types of industries served.
 - Number of partners.
 - Number of professional personnel.

Major Provisions of SQCS No. 7. SQCS No. 7 was issued to improve the quality of engagement performance. Some of the most important changes to quality control requirements as a result of SQCS No. 7 are as follows:

- The firm must establish a system of quality control designed to provide reasonable assurance that the firm complies with professional standards and issues reports appropriate in the circumstances.
- The firm should document and communicate its quality control policies and procedures.
- The firm's system of quality control encompasses six QC elements, rather than the previous five.
- The firm should promote a quality-oriented internal culture and firm leadership should assume ultimate responsibility for the firm's system of quality control, including assigning responsibilities so that commercial considerations do not override the objective of the system of quality control.
- The firm is required to establish criteria to determine which engagements (if any) are subject to an engagement quality control review.
- The firm should follow specific requirements related to dealing with and resolving differences of opinion.
- The firm should establish policies and procedures for dealing with complaints and allegations of noncompliance with professional standards or with the firm's system of quality control.

Professional Requirements. SQCS No. 7 establishes requirements regarding the firm's degree of responsibility it has in complying with the requirements of the standard. The firm's professional requirements as defined in the standard are designated into two categories:

- *Unconditional Requirements.* Unconditional requirements are those the firm must follow in all cases if the circumstances apply to the requirement. These requirements use the words *must* or *is required*.
- *Presumptively Mandatory Requirements.* Firms are also expected to comply with presumptively mandatory requirements if the circumstances apply to the requirement; however, in rare situations, a departure from the requirement is allowed if the firm documents the justification and how alternative procedures that were performed were sufficient to achieve the objectives of the requirement. Presumptively mandatory requirements are identified by the word *should*. If the SQCS uses the words *should consider* for a procedure, the consideration of the procedure is presumptively required.

Elements of a Quality Control System. QC 10.14 states that the firm's system of quality control should incorporate policies and procedures that address each of the following QC elements:

- *Leadership responsibilities for quality within the firm (tone at the top).* The firm has policies and procedures to promote an internal culture recognizing that quality is essential in performing engagements.
- *Relevant ethical requirements.* The firm and its personnel comply with relevant ethical requirements.
- *Acceptance and continuance of client relationships and specific engagements.* The firm undertakes or continues only client relationships and engagements in which the firm (a) considers the client's integrity and the risks associated with performing the client engagement; (b) determines the firm has the competence, capabilities, and resources to perform the engagement; and (c) determines the firm can comply with legal and ethical requirements.
- *Human resources.* The firm has sufficient personnel with the capabilities, competence, and commitment to ethical principles to (a) perform engagements in accordance with professional standards and legal and regulatory requirements, and (b) enable the firm to issue reports that are appropriate in the circumstances.
- *Engagement performance.* Work performed by engagement personnel consistently complies with applicable professional standards and regulatory requirements, and that the firm issues reports that are appropriate in the circumstances.

- *Monitoring.* The policies and procedures established by the firm for the other elements of quality control are (a) relevant and adequate, (b) consistently complied with, and (c) operating effectively.

Documentation and Communication of the Firm's QC Policies and Procedures. QC 10.12 states that the firm should document its QC policies and procedures. However, matters such as the nature of the firm's practice, its size, and its structure may be considered in determining the extent of documentation of the firm's QC policies and procedures. Documentation of the policies and procedures of a single-office firm with a small number of partners and staff might not be expected to be as extensive as those of a large, multi-office firm.

SQCS No. 7 does not require the firm to have a formal quality control policies and procedures *document*; instead, the standard indicates only that the firm's QC policies and procedures be *documented*. SQCS No. 7 allows the firm to have flexibility and latitude in determining the documentation method that best suits their individual practice and circumstances.

In addition to documenting the firm's QC policies and procedures, QC 10.13 states that the firm should communicate its QC policies and procedures to firm personnel. That communication is not required to be in writing, although written communication is preferable. An effective firm communication of its QC policies and procedures, as described in paragraph 13 of SQCS No. 7, incorporates the following:

- A description of the policies and procedures and the objectives they achieve.
- A message that each person is responsible for maintaining quality, as well as being familiar with the policies and procedures and complying with them.
- Comments stressing the importance of receiving feedback on how the QC system is operating and encouraging staff to communicate their concerns on quality control issues.

This practice monitoring requirement is applicable to firms that have a compilation and review practice, as well as firms that have an accounting and auditing practice, and requires those firms to undergo a peer review at least once every three years. As a result, such firms must have in place a quality control system that will withstand such a review or risk termination of firm membership in the program, individual memberships in the AICPA, and, in some states, loss of their licenses to practice.

Quality Control Materials. Quality control materials (QCM) consist of programs, checklists, sample confirmation letters, and other practice aids. When designing the firm's quality control policies and procedures, the firm should indicate the QCM that are being used, or make reference to the firm's accounting manuals that contain the firm's QCM. QCM are an integral part of a firm's QC system is a system of engagement checklists and practice aids that helps ensure compliance with both authoritative literature and peer review standards. Exhibit 2-1 lists quality control materials recommended for compilation engagements.

Exhibit 2-1

Quality Control Materials Recommended for Compilation of Historical Financial Statements

ENGAGEMENT PERFORMANCE QUALITY CONTROL STEPS	Person or Group Responsible for Completing Step		Is Step Required? ^a	Description of QCM
	Primary Responsibility	Secondary Responsibility		
1. Evaluate whether to accept/continue the engagement, considering the client's integrity and the firm's capabilities.	Partner (P)	Engagement Team (ET)	Yes	Engagement Acceptance Form/Step on Checklist
2. Communicate the partner's identity and role to the client.	P	ET	Yes	Engagement Letter
3. Obtain an engagement letter. ^b	P	ET	Yes	Engagement Letter
4. Assign staff based on capabilities, competence, and availability.	P	ET	Yes	Step on Checklist
5. Plan the work and obtain background information about the entity, officers, accounting practices, etc.	ET	P	Yes	Step on Checklist
6. Consider potential fraud implications.	ET	P	Yes	Step on Checklist
7. Prepare an engagement plan.	ET	P	Yes	Checklist
8. Develop a time estimate.	ET	P	Opt	Budget Form
9. Obtain partner approval of engagement plan and staff assignments, and, if applicable, time estimates.	P	ET	Opt	Step on Checklist
10. Perform and document the procedures.	ET	P	Yes	Checklist
11. Supervise procedures (including work of other accountants).	ET	P	Yes	Checklist
12. Evaluate the propriety of a step down to a lower level of service.	ET	P	Yes	Step-down Checklist/ Step on Checklist
13. Draft (or assist in drafting) the financial statements.	ET	P	Yes	Numerous illustrations
14. Perform analytical procedures.	ET	P	No	Step on Checklist
15. Complete a presentation and disclosure checklist and read the financial statements.	ET	P	Yes	Disclosure Checklist
16. Obtain a management representation letter.	ET	P	Opt	Representation Letter
17. Draft the report.	ET	P	Yes	Numerous illustrations
18. Review the workpapers.	P & ET	—	Yes	Step on Checklist
19. Determine that all review points and open items have been cleared.	ET	P	Yes	Step on Checklist
20. Document significant, unusual matters, including disposition.	P	ET	Yes	Step on Checklist
21. Obtain an engagement quality control review, if required by firm policy.	P	ET	Yes	Technical Reviewer Checklist/ Step on Checklist
22. Obtain consultation when appropriate and document and implement conclusions.	P	ET	Yes	Step on Checklist
23. Resolve any differences of opinion and document and implement conclusions.	P	ET	Yes	Step on Checklist
24. Have the partner sign the report or transmittal letter.	P	ET	Yes	Step on Checklist
25. Evaluate the staff's performance.	ET	P	Opt	Evaluation Form
26. Maintain the confidentiality, safe custody, integrity, accessibility, and retrievability of the workpapers.	ET	P	Yes	Step on Checklist
27. Assemble and retain the workpapers for a sufficient period of time (subject to monitoring review).	ET	P	Yes	Filing Examples

Notes:

^a Certain steps listed are more than the minimum required by professional standards. The steps listed are required in the PPC quality control system because best practices indicate they are the most cost-effective means of providing quality services and minimizing engagement risks.

^b SSARS No. 19, *Compilation and Review Engagements*, which supersedes AR sections 20, 50, and 100, and is effective for compilations and reviews of financial statements for periods ending on or after December 15, 2010, requires that an understanding be established with the entity and be documented by using a written, signed engagement letter.

* * *

Reference Materials. The AICPA Practice Aid, *Establishing and Maintaining a System of Quality Control for a CPA Firm's Accounting and Auditing Practice*, provides illustrative examples of various types of policies and procedures a firm should consider when developing its system of quality control under the guidelines of SQCS No. 7. Illustrative examples of quality control documents are provided for four hypothetical firms varying in size, as follows:

- Firm with multiple offices.
- Single office firm.
- Sole practitioner.
- An alternative practice structure.

The AICPA Practice Aid is not authoritative and only presents the recommendations of the AICPA Quality Control Standards Task Force on the applicability of SQCS No. 7. Even so, the AICPA Practice Aid may be a good resource for use by a firm when drafting its QC policies and procedures. The AICPA Practice Aid can be purchased from the AICPA store at www.cpa2biz.com.

In addition, *PPC's Guide to Quality Control—Compilation and Review* can assist firms in this task. It illustrates suggested policies and procedures that address the elements of quality control listed in SQCS No. 7. It is updated annually to keep firms aware of recent developments relating to quality control issues and peer reviews.

Establishing Criteria for Engagement Quality Control Reviews (EQCR). Firms are required to establish criteria as part of their QC policies and procedures for determining when an EQCR should be performed. In establishing criteria for performance of an EQCR, the structure and nature of the firm's practice are important. Such criteria may include considerations such as the following:

- The nature of the engagement, including whether it involves a matter of public interest.
- Whether unusual circumstances or risks have been identified relating to the engagement, engagement service type, or industry.
- Whether laws or regulations require an engagement quality control review to be performed.

If no engagements meet the criteria established by the firm for review, no EQCRs are required to be performed.

The structure and nature of the firm's practice are important factors in establishing criteria to consider when determining which engagements are to be subject to an EQCR. Accordingly, the firm should begin the process of developing EQCR policies and procedures by considering its unique structure and nature. Firm structure includes the size of the firm, whether the firm is a single-office firm or part of a multi-office practice, the number of partners in the firm, etc. The nature of the firm includes the types of services the firm performs and how those services make up the total engagements of the firm. For example, does the firm provide an extensive line of services including reviews, compilations, and attest engagements?

Firms define engagement quality control review criteria based upon the firm's unique circumstances (that is, structure and nature). Accordingly, some firms may establish criteria that result in more EQCRs being performed than other firms. For example, a compilation and review firm with a larger tax practice and a smaller accounting practice may designate that all reviews exceeding an 80-hour time budget have an EQCR performed. For that particular firm, since the firm offers a variety of services overseen by multiple partners, some of whom perform both review and tax services, there may be a more pressing need to have EQCRs performed on a larger number of review engagements. Alternatively, a firm that performs a significant number of reviews may feel more confident in its ability to follow established review guidance because all of its partners routinely perform reviews as a matter of course. Thus, that firm may designate only review engagements that it considers to be high-risk (as defined by the firm) for EQCR. The preceding discussion indicates that different firms may treat the same engagement differently for purposes of establishing engagement quality control review criteria. The key point is that EQCR criteria are as unique as the firm.

For each type of service provided, the firm may consider a different set of EQCR criteria. In other words, the criteria established for review engagements may differ significantly from the criteria established for compilation engagements or the criteria established for other types of attest engagements. SQCS No. 7 suggests that when establishing criteria for EQCRs, firms may consider the nature of the engagement, unusual circumstances or risks of the engagement, and whether other laws or regulations impact EQCR requirements. The following list represents the types of situations that may be considered in establishing EQCR criteria:

- Third-party use of the report, such as by the client's lender for financing purposes.
- High profile clients, for example, well-known individuals or entities in the local community.
- Entities subject to governmental regulations.
- New types of service for the firm.
- New or complex specialized industries.
- Client entities without competent or experienced accounting personnel.
- Client entities with substantial fraud risk factors.
- Client entities with significant related party transactions.
- Clients that have experienced material misstatements during the current or previous engagements.
- First-time clients.
- New firm partners.

Any circumstance that creates an unusual or a higher level of engagement risk should be considered in establishing EQCR criteria. Whenever an engagement is subject to a heightened level of risk, the firm may consider it prudent to have a second pair of eyes review the engagement.

Since EQCR criteria is based upon each firm's unique circumstances, firms should consider whether their established EQCR criteria need to change when firm circumstances change. The firm's quality control system should be a dynamic system that changes as the firm changes.

Peer Reviews

Applicability of Peer Review Requirements. AICPA Bylaw Section 220-2.2, "Requirements for Admission to Membership," defines the criteria that persons must possess to qualify for membership in the AICPA. Bylaw Section 220-2.2.3 states:

With respect to those persons who are engaged in the practice of public accounting as an owner or as an employee who has been licensed as a CPA for more than two years, either they are practicing in a firm that is enrolled in an Institute-approved practice-monitoring program if the services performed by such a firm are within the scope of the AICPA's practice-monitoring standards and the firm issues reports purporting to be in accordance with AICPA professional standards, or if authorized by Council, are themselves enrolled in such a program.

Basically, that bylaw requires accountants who are AICPA members to enroll in a practice monitoring program when they (a) perform services covered by peer review and (b) issue reports in accordance with professional standards. AICPA Council-authorized bylaws allow individual CPAs who practice in a non-CPA owned firm (i.e., an alternative practice structure) to be enrolled in a practice-monitoring program. A Council resolution also allows these individual CPAs to perform SSARS compilations as long as the CPAs (a) sign their reports with their own name (rather than with the name of their non-CPA owned firm employer) and (b) undergo peer review of the compilations. Interpretation No. 3-2 of Peer Review Standards (PRPM Section 2000) states that the term *firm*, as it

appears in the Standards, applies to the individual CPAs practicing in a non-CPA owned firm who are enrolled in a practice-monitoring program.

Revisions to the Peer Review Standards. In May 2008, the AICPA Peer Review Board issued revised *Standards for Performing and Reporting on Peer Reviews* (Peer Review Standards) and Interpretations. The revised Peer Review Standards superseded all existing Peer Review Standards and Interpretations and are effective for peer reviews commencing on or after January 1, 2009. The new Peer Review Standards are more principles-based, with detailed guidance provided in the Interpretations. All peer review guidance has been reevaluated, reengineered, updated, and clarified. Some of the more significant changes include:

- Revamping the language of system and engagement review reports to make them shorter and more concise. The *standard*, *modified*, and *adverse* reports have been replaced with *pass*, *pass with deficiencies*, and *fail* reports.
- Incorporating SQCS No. 7 throughout the new Peer Review Standards and Interpretations.
- Folding report reviews into engagement reviews while maintaining several attributes of the report review process, and making other revisions to engagement reviews.
- Eliminating the letter of comments.
- Making various changes to the engagement review process and documentation.
- Allowing, under specified circumstances, the new Peer Review Standards to be used by certain approved administering entities to administer peer review of non-AICPA firms.
- Making changes to reviewer training and resume requirements.
- Adding the concept of a review team assessing its “capability” to perform a peer review.
- Clarifying the information to be included in the reviewed firm’s representation letter.
- Incorporating guidance for performing and reporting on peer reviews of QCM and CPE programs.

The revised Peer Review Standards and Interpretations are located in the AICPA Peer Review Program Manual at Sections 1000 and 2000, respectively.

Types of Reviews. The revised Peer Review Standards provide for two types of reviews: a system review and an engagement review. Firms that perform audit engagements under the SASs or *Government Auditing Standards*, examinations of prospective financial statements under the SSAEs, or audits of non-SEC issuers performed under the standards of the PCAOB are required to have a system review every three years. Firms that have an accounting and auditing practice, as defined by the Peer Review Standards, but do not perform the types of engagements that require a system review and instead perform only services under the SSARS or the SSAEs (excluding examinations of prospective financial statements), are required to have an engagement review every three years, but may elect to have a system review. Firms that do not perform any of these services are not required to undergo peer review.

Engagement Reviews. As discussed in the preceding paragraph, compilation and review firms generally undergo a peer review known as an engagement review. The Peer Review Standards (PR 100.102) state,

The objective of an engagement review is to evaluate whether engagements submitted for review are performed and reported on in conformity with applicable professional standards in all material respects. An engagement review consists of reading the financial statements or information submitted by the reviewed firm and the accountant’s report thereon, together with certain background information and representations and, except for compilation engagements performed under SSARS, the applicable documentation required by professional standards.

The peer reviewer does not attempt to evaluate the adequacy of the firm’s quality control system. As a result, an engagement review does not involve a review of engagement workpapers, administrative files or personnel files,

personnel interviews, or other procedures. Since an engagement review does not evaluate the firm's system of quality control, an engagement review report is very different from a system review report, which expresses an opinion on the firm's QC system. The engagement review report provides assurance only on the firm's engagements.

Performing Review Procedures. Under an engagement review, the following procedures are performed by the reviewer:

- a. Consideration of the financial statements or information and the related accountant's report on the compilation and review engagements performed under SSARS and engagements performed under SSAEs.
- b. Consideration of the documentation on the engagements performed via reviewing background and engagement profile information, representations made by the firm, and inquiries.
- c. For engagements other than compilation engagements performed under SSARS, review of all other documentation required by applicable professional standards on the engagements.
- d. The review captain may request to review other documentation on compilation engagements performed under SSARS (1) if the firm represented that the documentation is appropriate, but the review captain has cause to believe that such documentation may not have been prepared in accordance with applicable professional standards, or (2) to support presentation or measurement issues relating to the financial statements or information.

Applicability of Peer Review Requirements to Compilations of Management-use-only Financial Statements.

SSARS No. 19 allows CPAs to compile management-use-only financial statements without issuing a compilation report if the statements are not reasonably expected to be used by third parties. A related issue is whether peer review requirements apply to compilations of management-use-only financial statements. (As previously discussed, it is clear that CPAs who issue SSARS review or compilation reports must be in a firm that is enrolled in an AICPA-approved practice-monitoring program, or if the CPA is in a non-CPA owned firm and issue a compilation report, the CPA must individually be in a peer-review program.)

Interpretation No. 6-1 of the Peer Review Standards states that management-use-only financial statements issued under SSARS No. 19 do not include a report for purposes of Section 220-2.2.3 of the AICPA bylaws and, accordingly, will not require a firm to join a peer review program. The Interpretation also states, however, that compilations of management-use-only financial statements performed by firms that are already subject to peer review (because, for instance, they also perform one or more SSARS compilation engagements for third-party use) will be included within the scope of engagements to be reviewed by the peer reviewers. The Interpretation clarifies that such engagements are not required to be selected for review, but only that they are within the scope of the existing engagement selection process and, thus, might be selected.

If selected for review, Interpretation No. 6-3 states that if compilations of management-use-only financial statements are reviewed, the reviewer will only inquire about the engagement letter to determine that it documents the matters required and will review the financial statements only to determine that they include the required use restriction.

Furthermore, accountants should be aware that some state boards of accountancy might have peer review requirements that differ from those of the AICPA. In some cases, those state boards could require peer review of compilations of management-use-only financial statements when a report is not issued, even though the AICPA does not.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

31. Which of the following scenarios demonstrates the *human resource element* of a quality control system (QCS)?
 - a. The managing partner of the firm periodically tests the quality control policies and procedures established by the firm to determine if they are operating effectively.
 - b. The diversely educated and experienced staff of a firm includes a partner with 20 years of experience and sufficient educational background to qualify her to teach ethics to CPAs statewide.
 - c. The firm includes a Client Acceptance and Continuance Checklist as part of its QCS.
32. In preparing a compilation of historical financial statements, which of the following quality control steps is optional?
 - a. Obtain a management representation letter.
 - b. Consider potential fraud implications.
 - c. Obtain an engagement quality control review.
 - d. Evaluate the propriety of a step down to a lower level of service.
33. Connie is a CPA employed by a non-CPA owned firm and produces compilation reports for the firm's clients. Which of the following statements is accurate?
 - a. Connie is not subject to a peer-review program.
 - b. Connie should sign the compilation reports using the firm's name, not her own.
 - c. Connie is allowed to be enrolled in a practice-monitoring program.
 - d. The term *firm* is not considered to apply to Connie under the standards.
34. Jones Hart, LLC performs engagements under the Statements on Auditing Standards. The type of peer review required for this type of engagement is:
 - a. An engagement review.
 - b. An audit review.
 - c. A system review.
35. Which of the following should be completed when undergoing an engagement review?
 - a. A review of engagement workpapers.
 - b. A reading of the financial statements submitted by the reviewed firm.
 - c. Review of the administrative and personnel files of the firm.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

31. Which of the following scenarios demonstrates the *human resource element* of a quality control system (QCS)? **(Page 210)**
- a. The managing partner of the firm periodically tests the quality control policies and procedures established by the firm to determine if they are operating effectively. [This answer is incorrect. This answer choice demonstrates the *monitoring element* of a quality control system, not the *human resource element*.]
 - b. The diversely educated and experienced staff of a firm includes a partner with 20 years of experience and sufficient educational background to qualify her to teach ethics to CPAs statewide. [This answer is correct. The *human resource element* of a QCS is adequately demonstrated by the partner's level of experience and commitment to ethical principles and includes personnel with sufficient capabilities, competence, and commitment to perform engagements.]**
 - c. The firm includes a Client Acceptance and Continuance Checklist as part of its QCS. [This answer is incorrect. A Client Acceptance and Continuance Checklist is a highly recommended tool that demonstrates the firm's commitment to the QC element of *acceptance and continuance of client relationships and specific engagements*, not the *human resource element*.]
32. In preparing a compilation of historical financial statements, which of the following quality control steps is optional? **(Page 212)**
- a. Obtain a management representation letter. [This answer is correct. This QCS step is optional and not required by any authoritative literature.]**
 - b. Consider potential fraud implications. [This answer is incorrect. This is a required step for adequate quality control materials per the Step on Work Program.]
 - c. Obtain an engagement quality control review. [This answer is incorrect. This is a required step on a technical reviewer checklist.]
 - d. Evaluate the propriety of a step down to a lower level of service. [This answer is incorrect. This step is required on a step-down checklist or work program.]
33. Connie is a CPA employed by a non-CPA owned firm and produces compilation reports for the firm's clients. Which of the following statements is accurate? **(Page 214)**
- a. Connie is not subject to a peer-review program. [This answer is incorrect. If the CPA is in a non-CPA owned firm and issues compilation reports, the CPA must individually be in a peer-review program.]
 - b. Connie should sign the compilation reports using the firm's name, not her own. [This answer is incorrect. An individual CPA is allowed to perform SSARS compilations as long as the CPA signs her reports in her own name and not the name of her non-CPA owned firm employer.]
 - c. Connie is allowed to be enrolled in a practice-monitoring program. [This answer is correct. AICPA Council-authorized bylaws allow individual CPAs who practice in a non-CPA owned firm to be enrolled in a practice-monitoring program.]**
 - d. The term *firm* is not considered to apply to Connie under the standards. [This answer is incorrect. Interpretation No. 3-2 of Peer Review Standards states that the term *firm*, as it appears in the Standards, applies to the individual CPAs practicing in a non-CPA owned firm who are enrolled in a practice-monitoring program.]

34. Jones Hart, LLC performs engagements under the Statements on Auditing Standards. The type of peer review required for this type of engagement is: **(Page 215)**
- a. An engagement review. [This answer is incorrect. According to the Peer Review Standards, the engagement review is for firms that are not required to undergo a system review and perform only services under the SSARS or SSAEs.]
 - b. An audit review. [This answer is incorrect. There is no audit review category of peer reviews in the Peer Review Standards.]
 - c. **A system review. [This answer is correct. According to the Peer Review Standards, the system review is required for firms that perform engagements under SASs, Government Auditing Standards, examinations of prospective financial statements under the SSAEs, and/or audits of non-SEC issuers performed under the standards of the PCAOB.]**
35. Which of the following should be completed when undergoing an engagement review? **(Page 215)**
- a. A review of engagement workpapers. [This answer is incorrect. An engagement review does not include a review of the engagement workpapers when completing a peer review, since an engagement review is not concerned with the adequacy of the firm's quality control system.]
 - b. **A reading of the financial statements submitted by the reviewed firm. [This answer is correct. An engagement review consists of reading the financial statements or information submitted by the reviewed firm and the accountant's report thereon, to evaluate whether the engagement submitted for review was performed and reported on in conformity with applicable professional standards in all material respects.]**
 - c. Review of the administrative and personnel files of the firm. [This answer is incorrect. A peer review is not a review of how the firm runs its practice, but how it manages its engagements. An engagement review would not include review of administrative or personnel files of the firm.]

PRACTICE ISSUES IN WRITE-UP ENGAGEMENTS

Practicing a profession is generally a stimulating and intellectually rewarding undertaking; however, practice issues and the threat of legal liability can cast shadows on professional lives and ruin an otherwise successful professional career. This section addresses several practice issues accountants should consider while performing a write-up engagement.

Litigation Risks

Liability claims against CPA firms prior to 1970 were relatively rare events. Since 1970, however, such claims have increased dramatically and today, on average, they strike at the rate of one claim per year for approximately every 120 professionals. Not only has the frequency of such claims increased, the severity of claims against CPA firms has also escalated. It is not unusual for small CPA firms with no audit practice to be hit with claims seeking in excess of \$1 million. In fact, a CPA firm that does only tax, compilation, and review and other write-up work should never assume that their malpractice risk is immaterial. There are a large number of malpractice claims filed involving bookkeeping, compilations, and reviews. Because of the potentially disastrous effects of liability claims, every CPA firm needs to develop systems designed to avoid liability claims and to minimize their impact. Defensive measures CPA firms should consider using include—

- Quality control,
- Professional liability insurance,
- Loss prevention, and
- Engagement letters.

Quality Control. Statement on Quality Control Standard No. 7, *A Firm's System of Quality Control*, establishes standards and provides guidance for a CPA firm's system of quality control responsibilities for its accounting and auditing practice. SQCS No. 7 requires the firm to establish a system of quality control designed to provide reasonable assurance that the firm complies with professional standards and issues reports appropriate in the circumstances. The standard also requires the firm to document and communicate its quality control policies and procedures.

Traditionally, CPA firms have tried to employ quality control systems as their first line of defense on the assumption that a firm that practices according to the dictates of the profession makes itself invulnerable to liability claims. While quality control measures clearly decrease the possibility of substandard performance (and the chances of being sued), they are by no means a total answer. In fact, the changes that have been made to SSARS, ethics, and other professional standards over the past 30 years have, in some respects, increased the vulnerability of CPA firms to liability claims as practitioners struggle to keep up to date with the latest standards.

Professional Liability Insurance. The second line of defense of CPA firms has traditionally been professional liability insurance. Thus, when quality control measures prove inadequate, the CPA firm would nevertheless be protected by its liability insurance coverage. While liability insurance is essential for all professional firms, it too is no panacea. Even throughout the late 1990s when the cost of professional liability coverage was relatively inexpensive there was still a large percentage of CPA firms that practiced without insurance. Immediately following the September 11, 2001 disaster, the liability insurance market began to tighten. Today, some firms are unable to obtain malpractice insurance coverage and many medium size and large firms cannot obtain the limits of liability coverage they desire.

Notwithstanding the relatively competitive state of the current insurance market, it is not altogether clear that every insurer will provide coverage for all claims that may arise out of the wide variety of services now being offered by CPA firms. This is especially true of claims based on erroneous investment advice, as many insurers remain unwilling to cover such claims.

Loss Prevention. Because of the limitations in professional liability insurance and the inability of CPA firms to purchase sufficient insurance to cover their full risk exposure, CPA firms have had to turn to a third line of defense—loss prevention. Loss prevention consists of the following two important components:

- Risk avoidance.
- Damage control.

Risk Avoidance. Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts. Gone are the days when CPA firms made client acceptance decisions solely on the basis of whether the engagement could be performed profitably. Today, before accepting an engagement, CPA firms must not only examine the economics of servicing the client but also the potential liability risks posed by the engagement. (SQCS No. 7 requires firms to establish policies and procedures for client and engagement acceptance and continuance.)

Another aspect of risk avoidance is protecting the assets of the firm and its owners in the event that the firm's defenses against liability prove ineffective. This can be accomplished by organizing the firm's operating assets into separate legal entities. Under this asset protection strategy, a claimant seeking to recover damages inflicted by one element of the firm's operations may not recover from other elements of the firm's operations. In addition, all states now permit CPA firms to conduct their operations as limited liability entities. Thus, a CPA firm can operate as a professional corporation, a limited liability company, or a limited liability partnership. Under these types of structures, the personal assets of each owner are immune to liability claims against the firm unless the owner himself actually committed the acts that gave rise to the liability or supervised the individuals who committed the wrongful acts.

In addition to these structural protections, CPAs can protect their personal assets in a number of other ways, including placing assets in protected pension plans and holding property jointly with others with rights to survivorship. Moreover, personal assets may be protected by outright transfers of assets to others or by placing them in trust.

Damage Control. Another aspect of loss prevention is damage control, which considers ways of containing potential liability problems and thereby minimizing their impact. Damage control procedures focus on responding quickly to threatened and actual liability claims. With the aid of professional help, a CPA firm may usually take remedial actions that will mitigate the size of a pending or threatened claim.

Engagement Letters. Finally, as discussed in Lesson 1, SSARS No. 19 requires accountants to always utilize an engagement letter when performing write-up engagements. The form and content of the letters should be structured to help minimize legal liability.

Responsibility for Fraud and Illegal Acts

SSARS No. 19 sets forth the accountant's responsibilities for fraud and illegal acts in compilation engagements. The Statement (footnote to AR 80.03) defines *fraud* as "an intentional act that results in a misstatement in compiled financial statements" and defines *illegal acts* as "violations of laws or government regulations, excluding fraud."

Do SAS No. 99, *Consideration of Fraud in a Financial Statement Audit*, and SAS No. 54, *Illegal Acts by Clients*, apply to compilation engagements? The answer is no. SAS No. 99 and SAS No. 54 apply only to audits of financial statements conducted in accordance with generally accepted auditing standards. SSARS performance standards do not require accountants to document their assessment of fraud in a compilation engagement. Nor do SSARS performance requirements impose detection requirements for illegal acts. No expression of assurance is contemplated in a compilation. In addition, SSARS No. 1 obligates the accountant in compilation (AR 80.03) engagements to obtain additional or revised information when the accountant becomes aware of information that is incorrect, incomplete, or otherwise unsatisfactory.

Use of Engagement Letters to Clarify the Accountant's Responsibilities. Management is responsible for the prevention and detection of fraud and illegal acts, and the maintenance of internal control. However, many small business clients do not understand management's responsibility. They may have unrealistic expectations and may assume that the accountant is providing a higher level of assurance than he or she actually is, including detecting fraud, illegal acts, and internal control deficiencies. A written engagement letter is required by SSARS No. 19 (AR 30.02) and can be helpful in clarifying and documenting the understanding of the accountant's responsibility regarding fraud, illegal acts, and internal control deficiencies. This written understanding should provide, among

other things, (a) that the engagement cannot be relied upon to disclose errors, fraud, or illegal acts and (b) that the accountant will inform the appropriate level of management of any suspected fraud or material errors and any illegal acts, unless clearly inconsequential, that come to his or her attention.

Whether an act actually is fraudulent or illegal is a determination that is normally beyond the accountant's professional competence. Accountants—when reporting on financial statements—present themselves as being proficient in accounting and compilation and review services. The accountant's training, experience, and understanding of the client and its industry may cause him or her to recognize some client acts as fraudulent or illegal. However, the determination of whether a particular act is fraudulent or illegal should be based on the advice of an informed expert qualified to practice law or may have to await final determination by a court of law.

Communication of Suspected Fraud or Illegal Acts. SSARS No. 19 (AR 80.54), as amended by SSARS No. 12, addresses the question of what the accountant should do to communicate suspected fraud or illegal acts discovered during the performance of a compilation engagement. The Standard states that when the accountant suspects fraud or illegal acts may have occurred, the matter should be communicated to the appropriate level of management. The accountant need not report matters regarding illegal acts that are clearly inconsequential (e.g., misdemeanor traffic violation) and may reach agreement in advance with the entity on the nature of any such matters to be communicated. If the suspected fraud or illegal acts involve senior management, then the matter should be communicated at the highest level within the company. And, if the suspected fraud or illegal act involves the owner of the company, the accountant should consider resigning from the engagement and consulting legal counsel. Additional procedures are not required to substantiate whether fraud or illegal acts have, in fact, occurred. However, the accountant should request that management consider the effect of the matter on the financial statements. In addition, the accountant should consider the impact the suspected matters might have on the engagement. The accountant is required to document any communications, whether oral or written, regarding fraud or illegal acts.

The disclosure to third parties of any evidence or information that comes to the accountant's attention during the performance of the compilation procedures that indicate fraud or an illegal act may have occurred is not usually the accountant's responsibility. In fact, in most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality. There are certain instances, however, such as complying with legal and regulatory requirements, communicating with a successor accountant regarding acceptance of an engagement in accordance with SSARS No. 4, and responding to a subpoena, where an accountant has a duty to disclose matters related to fraud and illegal acts to parties outside of the entity.

Other Practice Issues

Bookkeeping Services. Accountants who perform compilation services for their clients often also perform bookkeeping services for those same clients. Bookkeeping engagements have usually been viewed as presenting minimal professional liability risk because the accountant provides no assurance and the work is relatively straightforward and without technical complexities. However, if a client company suffers a financial loss due to fraud or theft, the accountant is often viewed by the client as contributing to the loss. Consequently, there is a growing trend of lawsuits being filed against accountants who perform bookkeeping services when the accountant fails to detect fraud or theft.

The potential for fraud exists on all engagements. The accountant's responsibility to detect fraud is often different than the public's perception of the accountant's responsibility. See the earlier discussion of the accountant's responsibility for fraud in compilation engagements. When performing bookkeeping services, best practices indicate that the accountant should take special care in having an engagement letter that specifically details exactly what procedures the accountant will perform. This is especially important as it relates to any work being performed relative to the cash account. For example, if the accountant is performing a bank reconciliation, the engagement letter should specify exactly what procedures will (or will not) be performed with respect to the payee and endorsement of the cancelled checks. That is, the engagement letter should clearly communicate whether the accountant will look at cancelled checks to review for proper payees or endorsements.

Licensing Problems. State legislatures and the courts have determined that it is in the public interest to regulate professional services offered by CPAs. Accountancy laws governing the licensing of certified public accountants and prescribing entry requirements for those who wish to hold themselves out to the public to practice accounting have been enacted in all fifty states, District of Columbia, Puerto Rico, Guam and Virgin Islands.

CPAs should also consider applicable state board of accountancy licensing and registration requirements for the firm and its personnel. Some states require firms to be licensed while other states do not. A firm may also do business in states other than where it is domiciled. Those states may also require licenses. While licensing is not a QC standard, the failure of firms to have one or more required firm licenses has been an issue in certain states as to acceptance of the peer review report by the state board of accountancy. In addition, if a CPA is acting as an expert witness in a state in which he or she is not licensed, his or her testimony may be disallowed. Many other issues also arise due to improper licensing. Because the licensing rules vary significantly from state to state, the CPA firm should investigate a state's licensing requirements by contacting the applicable state board or consulting an attorney prior to doing business in that state.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

36. Cantwell & Associates, LLC is a growing accounting firm which carries professional liability insurance. In addition to providing tax services and investment advice, the firm is now offering auditing services. Should the partners feel assured that they are adequately covered now and in the future?
- a. Yes, because their staff only occasionally provides investment advice.
 - b. No, because they may not be able to obtain the amount of liability coverage they need as they grow.
37. In order to protect the personal assets of the owners against liability claims, an accounting firm should elect to organize under which form of business?
- a. A professional corporation.
 - b. A general partnership.
 - c. A general corporation.
38. Arnie's Gun Shop has hired an accounting firm to prepare the company's financial statements and taxes. Arnie expects the accounting firm to detect any fraud or internal control deficiencies in his business. What is the best action for the accountant to take?
- a. The accountant should have a conversation with Arnie and tell him that fraud detection is beyond the scope of the engagement.
 - b. The accountant should tell Arnie to contact a lawyer if he suspects fraud.
 - c. The accountant should provide a written engagement letter clarifying the accountant's responsibilities.
39. Susan is performing a compilation engagement for her new client, Wilton Manufacturing. She discovers that Mr. Wilton, the owner, is committing fraud. What should Susan do?
- a. Resign and consult legal counsel.
 - b. Communicate her discovery to senior management.
 - c. Complete the engagement and consult with her client.
 - d. Disclose to third parties any evidence or information she has to substantiate the fraud.
40. CPAs operate under licensing laws. Which of the following statements is accurate?
- a. Not all states require CPAs to be licensed.
 - b. All states require accounting firms to be licensed.
 - c. A firm cannot do business in any state other than where it is domiciled.
 - d. A CPA's expert witness testimony may be disallowed if the CPA is not licensed in that state.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

36. Cantwell & Associates, LLC is a growing accounting firm which carries professional liability insurance. In addition to offering tax services and investment advice, the firm is now offering auditing services. Should the partners feel assured that they are adequately covered now and in the future? **(Page 220)**
- Yes, because their staff only occasionally provides investment advice. [This answer is incorrect. Professional liability risk is greater for those offering investment advice, no matter how infrequently. The firm may not have adequate coverage to cover this risk and the cost could be prohibitive.]
 - No, because they may not be able to obtain the amount of liability coverage they need as they grow. [This answer is correct. The liability insurance market has tightened since 9/11/2001, which has made some firms unable to obtain malpractice insurance coverage and many medium and large size firms cannot obtain the limits of liability coverage they desire.]**
37. In order to protect the personal assets of the owners against liability claims, an accounting firm should elect to organize under which form of business? **(Page 221)**
- A professional corporation. [This answer is correct. A professional corporation operates as a limited liability entity which protects the individual owners from liability. Other choices for a CPA firm would be limited liability company and a limited liability partnership.]**
 - A general partnership. [This answer is incorrect. A general partnership does not protect the individual owners' assets.]
 - A general corporation. [This answer is incorrect. The general corporation's assets are at risk but the individual owner's can be held liable as well.]
38. Arnie's Gun Shop has hired an accounting firm to prepare the company's financial statements and taxes. Arnie expects the accounting firm to detect any fraud or internal control deficiencies in his business. What is the best action for the accountant to take? **(Page 221)**
- The accountant should have a conversation with Arnie and tell him that fraud detection is beyond the scope of the engagement. [This answer is incorrect. While it is accurate that the client should be informed, it is best to have this communicated in writing.]
 - The accountant should tell Arnie to contact a lawyer if Arnie suspects fraud. [This answer is incorrect. While an accountant may suspect fraud, the determination of whether an act is fraudulent should be based on the advice of an informed expert qualified to practice law. However, unless the client is certain fraud has occurred, it would be in the client's best interest for the accountant to confirm if fraud is suspected before suggesting the client hire an attorney.]
 - The accountant should provide a written engagement letter clarifying the accountant's responsibilities. [This answer is correct. A written engagement letter can clarify and document the understanding of the accountant's responsibility regarding fraud, illegal acts, and internal control deficiencies. Written engagement letters are required by SSARS No. 19.]**
39. Susan is performing a compilation engagement for her new client, Wilton Manufacturing. She discovers that Mr. Wilton, the owner, is committing fraud. What should Susan do? **(Page 222)**
- Resign and consult legal counsel. [This answer is correct. Since the owner is involved, there is no higher level Susan can report the fraud to. So, her best action is to remove herself from the engagement immediately.]**

- b. Communicate her discovery to senior management. [This answer is incorrect. This would be the correct action if the owner was not involved and she could communicate to a higher level.]
 - c. Complete the engagement and consult with her client. [This answer is incorrect. She does not want to become further involved in any fraudulent acts of the client. Waiting until the engagement is concluded and then speaking to the client is not in her best interests as an accountant.]
 - d. Disclose to third parties any evidence or information she has to substantiate the fraud. [This answer is incorrect. Disclosure to third parties is not the accountant's responsibility. In most instances, the accountant is precluded from communicating such matters to third parties by ethical and legal obligations of confidentiality.]
40. CPAs operate under licensing laws. Which of the following statements is accurate? **(Page 223)**
- a. Not all states require CPAs to be licensed. [This answer is incorrect. State legislatures have determined that it is in the public interest to regulate professional services offered by CPAs so that accountants will be held to laws governing the licensing requirements.]
 - b. All states require accounting firms to be licensed. [This answer is incorrect. Some states require firms to be licensed while other states do not.]
 - c. A firm cannot do business in any state other than where it is domiciled. [This answer is incorrect. A firm may also do business in states other than where it is located, but the firm may need to obtain the appropriate license to do business in that state, dependent on the state's requirements.]
 - d. **A CPA's expert witness testimony may be disallowed if the CPA is not licensed in that state. [This answer is correct. Without a license to practice in the state, a CPA may be barred from providing expert witness testimony per the rules of the state licensing board.]**

DISASTER RECOVERY PLANNING

In recent years, many firms have had to recover from unexpected damages to their offices, equipment, and files. In some instances, the damages were caused by natural disasters. In other cases, man-made disasters, such as fire, theft, terrorism, or vandalism, have caused firms to close—sometimes for good. Even less catastrophic events, such as a power failure or an inadvertent liquid spill on a computer, have prevented firms from conducting business as usual and, consequently, have caused them to lose time and money.

Although it is virtually impossible to plan for every conceivable disaster, firms can anticipate and plan for those that are more likely to occur. All firms need to have some type of disaster recovery plan in place. The plan should provide for items such as the following:

- Continuing to handle the firm's activities with as little interruption as possible.
- Communicating with clients, employees, vendors, and others if the firm must vacate its offices.
- Relocating the office if the firm's current space is damaged or destroyed.
- Replacing equipment, such as computers, servers, network infrastructure, fax machines, scanners, copiers, and the telephone system.
- Reinstalling all system and accounting applications, current version updates, and restoring all client data into a usable format.
- Replacing furniture and office supplies.
- Reconstructing lost or damaged paper files and computer records.
- Shifting work assignments if key employees are unable to report to work.
- Obtaining financial assistance, if necessary, to pay the firm's obligations while business is interrupted.
- Response to the media.

Simply put, a disaster recovery plan is a list of procedures and activities that allow normal operations to continue (or resume quickly) if disaster strikes. The plan should provide for many items; however, protecting the firm's hardware and software and protecting files and records are the most critical of those items.

Protecting the Computer System

Many firms rely heavily on their computer systems. Consequently, a firm has much to lose if equipment or files are destroyed, lost, or stolen. In such cases, the firm must not only replace physical assets, but also reconstruct important data that may have been lost.

Firms should carefully evaluate computer system security controls, which fall into three basic categories:

- *Physical Access.* Physical security limits the physical access to equipment, reducing the risk of theft or hardware destruction. Because PCs, servers, workstations, and printers are relatively small, this equipment is often placed near employees' work areas, making physical isolation difficult.
- *User Access.* User access controls protect against physical damage and access to computing systems and data files by unauthorized users, whether physically located in the firm's facility or remotely through some form of communications link. Those measures include items such as passwords, user identification codes, and audit trails. Passwords should be at least eight characters with a mix of numbers, letters, and punctuation characters, and users should be required to change their passwords regularly.
- *Data Access.* The best defense against loss of data files is to regularly and systematically copy (or back up) data files.

Protecting Files and Records

Because firms rely on data, their client and firm files are important assets. Some records, such as current workpaper files, may be impossible to replace if they are destroyed. Other records, such as permanent files and certain firm records, may be reconstructed if they are lost, but only at considerable cost. To protect their files, firms should consider adopting some or all of the following procedures:

- *Store Important Papers in Fire-proof File Cabinets.* Although more expensive than conventional filing cabinets, insulated, fire-proof cabinets may be the most practical method of protecting the firm's physical files. When purchasing a fire-proof cabinet, make sure that its internal temperature rating is sufficient to protect the types of materials (e.g., paper files or electronic media) that will be stored inside.
- *Keep File Cabinet Drawers Closed.* Even uninsulated file cabinets offer some protection from fire and water damage, but no file cabinet (including a fire-proof cabinet) will protect its contents if its drawers are left open. Closing and locking file cabinet drawers can reduce the supply of oxygen inside the file cabinet and, thus, help protect files from fire damage.
- *Return Files to File Cabinets at the End of Each Day.* Files left in the open on the top of file cabinets, desks, or the floor have no protection from fire or water damage. By adopting a policy of returning files to file cabinets at the end of each day, the firm not only reduces its risk of losing files in a fire, but it reduces its risk of losing or misplacing files as well.
- *Destroy Old Files.* Old unnecessary files can be expensive to store and, in some cases, may become a fire hazard. Consider adopting a record retention policy and destroy files whose retention periods have expired.
- *Maintain Duplicate Copies of Certain Irreplaceable Files at an Off-site Location.* Certain records, such as client lists and the firm's internal accounting records in paper format, are extremely important to the firm's continuing operations and would be difficult to reconstruct if they were lost or destroyed. Consider making copies of such records and storing them in an off-site location or scanning them into a digital format on the network where they can be backed up and stored off-site.
- *Restrict Access to Files.* Files are less likely to be lost if only authorized employees have access to them. If possible, store files in a separate file room or in locked cabinets and allow only those who need the files to have access to them.
- *Store Permanent Files in Digital Format.* It should be noted that as firms transition to a "less-paper" environment and acquire scanners and document management systems, they are storing files primarily in a digital format, particularly those that are on a permanent retention cycle, which also serves to protect the files because digital files, when properly stored, are generally more secure than paper files. Firms should only scan those documents deemed permanent, however, unless the cost of labor to scan them is less than the storage costs would be.

SUCCESSION PLANNING FOR THE TRANSFER OF OWNERSHIP

There are two important aspects to succession planning: (a) planning for the transfer of the firm to new owners and (b) protecting the firm from potential damage caused by the loss of critical firm partners, managers, and employees. The succession planning process as it relates to protecting the firm from the loss of critical partners, managers, and employees on an ongoing basis is discussed in Lesson 1. This lesson discusses succession planning as it relates to the transfer of ownership.

In the not too distant past, say 10–15 years ago, CPA firm owners and partners did not have to spend a lot of their time considering succession planning until perhaps the last few years of their career. The accounting industry had an ample supply of eager practitioners striving to be chosen to take over as owner or partner of the firm they had worked in for years. Times have changed. For the past several years, the top two concerns of firm owners and partners have been staffing shortages and succession planning. These are related issues in that the lack of

qualified and committed *up-and-coming* CPA professionals has partially been the cause of the current succession planning crisis that is facing the accounting industry today. Another significant cause of the succession planning crisis is the aging accounting firm owner population.

Determining what the owner wants to do with the firm when he or she retires is the first step in succession planning. The options available include:

- Do nothing and close the doors for good one day (the worst-case scenario if the owner desires any funded retirement).
- Groom an individual within the firm to buy out the practice.
- Locate and hire a practitioner from outside the firm who could be groomed as an internal candidate for future ownership.
- Merge the practice with another public accounting firm.

After the decision is made as to which succession alternative best suits the owner's needs, another choice remains to be made. Succession planning can be performed in one of two ways:

- a. In crisis mode, when the firm faces a sudden death, disability, or withdrawal, or when retirement is just a short time away.
- b. In proactive mode, by performing specific planning steps in a logical order, giving careful consideration to issues raised and conclusions reached.

Obviously, the latter approach provides the most effective way of ensuring long-term firm success and survival. The owner makes a conscious decision how to perform succession planning for the firm. If the owner does not give succession planning the priority it requires, then in effect, he or she has chosen the crisis mode option since a sudden death or disability can occur without warning.

While having a viable succession plan is important for every firm, for sole proprietor firms the consequences of not having a succession plan will generally be immediately disastrous. In a small firm, when the senior or managing partner becomes disabled or dies with little or no warning, the firm is likely to experience considerable turmoil, loss of clients, and potentially the risk of going out of business entirely if a succession plan or practice continuation agreement is not in place.

If done properly, succession planning lays out a game plan to effectively deal with the inevitable transfer of ownership from current owners to others. Most accounting firm owners want to receive the highest value possible for their investment in the firm they worked long and hard to create or perpetuate. The value of an accounting firm lies primarily in the value of the firm's client relationships and the firm's professional personnel. A succession plan serves to preserve both client and staff continuity and firm value.

A few of the goals of succession planning are to—

- Lay the groundwork for transferring authority and control.
- Maximize firm value for owners and their families by making the firm attractive to prospective successors.
- Provide continuity of service delivery to clients.
- Provide a reasonable and secure retirement income for retiring owners.
- Avoid crisis situations.

Although there are numerous factors to be considered, some of the keys to ensuring firm continuity through succession planning include the following:

- Developing and implementing the plan.
- Reviewing and revising the plan as needed.
- Requiring a two-year notification of retirement.
- Capping retirement payments to a level that will not hurt the firm's future financial viability.
- Creating a plan that is a "win-win" situation for both the continuing and retiring owners.

The Succession Planning Process

The succession planning process should be performed in a methodical, rational manner, with sufficient time to address all owner, firm, and client issues prior to the owner's retirement. Succession planning is not a process that can be performed well under pressure or time-constraints. The impact throughout the firm when a leading partner or owner retires should be carefully considered to develop a comprehensive succession plan. The plan should consider everybody who will be affected by the retiring partner's departure: clients, the successor, the firm and its staff, the remaining partners, and the retiring partner.

The succession planning process can be broken down into the following five steps:

- Choosing a Successor.* For a firm succession plan to work effectively, the firm must identify an individual to transfer ownership to and allow sufficient time to complete the needed transition steps by the time the exiting owner is ready to retire. In some cases, there may be a clear candidate for successor. However, many practitioners in recent years have indicated they are having difficulty retaining and grooming qualified staff to become owners. In those cases, the successor selection decision can be much more difficult. Additionally, the successor selection needs to include all roles that the retiring partner provides. Consider the hours and fees that must be replaced when the retiring partner retires. Often, practitioners in the senior years of their career have developed extensive client relationships and are well-known in the accounting and finance communities. Those relationships result in business coming to the firm and that community presence should be replaced. The retiring partner's administrative leadership roles also must be transitioned. The firm should consider whether administrative roles performed by the retiring partner are better transitioned to someone other than the successor partner. Some of the more common methods of identifying candidates for succession are to promote an employee from within the firm, bring in an individual from outside the firm, merge with another firm, or enter into a practice continuation agreement with another firm.
- Creating a Personal Technical Development Plan for the Successor.* Once the successor candidate has been identified, the firm should identify activities tailored to that individual's specific development needs as they relate to transitioning from high-level new-hire, manager, or entry-level partner into a key full-service partner in the firm. Activities may include taking post-graduate college courses, obtaining industry certifications, attending specialized industry or other targeted technical training courses, and going to accounting profession conferences (e.g., marketing and practice management conferences). It is important to provide a learning path that will optimize the successor candidate's ability to transition into his or her new role.
- Implementing a Leadership Development Program for the Successor.* Investing in a leadership development program is a critical component in extending a firm's lifecycle. In fact, it is the lifeblood of a firm's future. Firms without such a program eventually develop management problems that may lead to a forced merger for survival or dissolution, and the lack of a program certainly does not promote the advancement of the next generation of owners. Additionally, not having an effective leadership development program can have significant negative implications on recruitment and retention. Potential new recruits may choose a firm that has a formal leadership development program over a firm that does not. A firm's top performers will more easily be tempted to leave the firm if they cannot see that there is a process in place to develop them into a firm leader. However, having a leadership development program that outlines the firm's process for elevating people throughout the organization, evaluating staff strengths and weaknesses, and offering individualized development plans that address those strengths and weaknesses helps differentiate a firm from the competition.

- d. *Planning Succession within the Firm.* Transitioning the retiring owner's responsibilities to the successor begins as an internal firm process. Although clients and others outside the firm should not be informed until well into the transition, the transition plan and timeline should be fully communicated within the firm early in the process. It is important to communicate the upcoming transition to the staff early so they understand why the successor in-training is taking on more authority within the firm and assuming the retiring owner's responsibilities. Thus, the staff will appreciate why the successor warrants the same respect afforded the other owners. Additionally, eventually clients and others outside the firm will learn that an owner transition is taking place. It is helpful for the staff to be coached about the proper way to answer questions from individuals outside the firm to ensure that a consistent message is conveyed to the public.

- e. *Transitioning Leadership Roles.* One of the biggest mistakes a retiring owner can make is to refuse to relinquish authority. Firms should consider establishing a mandatory retirement age and, in conjunction with that event, set a time prior to retirement (such as three to five years) when the owner begins to transition his or her leadership and client service roles to the identified successor. If the transition is properly implemented, at retirement, the retiring owner should no longer have any leadership responsibility and very limited client service responsibilities.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

41. The most important reason an accounting firm should have a disaster recovery plan in place is:
 - a. To have a predetermined location to continue operations.
 - b. To provide the means for staff members to communicate with clients and each other.
 - c. To protect the firm's hardware and software and protect files and records.
 - d. To continue to handle the firm's activities with little interruption.
42. Regularly backing up data files falls into which category of computer system security controls:
 - a. User Access.
 - b. Data Access.
 - c. System Access.
 - d. Physical Access.
43. Mark is in charge of protecting the firm's files and records. Which of the following procedures should he **not** include on his checklist?
 - a. Make sure old files are stored appropriately.
 - b. Use only fire-proof file cabinets to store important papers.
 - c. Keep file cabinet drawers closed.
 - d. Put files away in file cabinets at the end of each day.
44. When selecting a successor to replace a retiring partner, which of the following statements is most accurate?
 - a. Firms should expect the successor to produce the same amount of fees as the retiring partner.
 - b. Firms should limit their search for a successor to an individual within the firm.
 - c. Firms should expect the successor to assume all of the retiring partner's administrative leadership roles.
 - d. Firms are having difficulty retaining and grooming qualified staff to become owners.
45. The Hartman Clark accounting firm has implemented a leadership development program. What is the most important effect this will have on the firm?
 - a. The firm will avoid management problems.
 - b. The firm will attract and retain top performers.
 - c. The firm will avoid discrimination in its selection of potential leaders.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

41. The most important reason an accounting firm should have a disaster recovery plan in place is: **(Page 228)**
- a. To have a predetermined location to continue operations. [This answer is incorrect. While selecting a site for operations in advance is important, it is not the most critical reason for a disaster recovery plan since it is not the most important resource of the firm.]
 - b. To provide the means for staff members to communicate with clients and each other. [This answer is incorrect. Staff will need the ability to communicate, but this is not the most critical element of the plan.]
 - c. **To protect the firm's hardware and software and protect files and records. [This answer is correct. Although the other items of a disaster recovery plan are important, the most critical are protecting the firm's hardware and software and protecting files and records since firms rely heavily on their computer systems.]**
 - d. To continue to handle the firm's activities with little interruption. [This answer is incorrect. This answer is not the most important; in fact, it will be a consequence of the most important reason.]
42. Regularly backing up data files falls into which category of computer system security controls: **(Page 228)**
- a. User Access. [This answer is incorrect. User access controls protect against physical damage and access to computing systems and data files by unauthorized users.]
 - b. **Data Access. [This answer is correct. Regularly and systematically copying data files is the best defense against loss of data files.]**
 - c. System Access. [This answer is incorrect. This is not a category of computer security controls.]
 - d. Physical Access. [This answer is incorrect. Physical security limits the physical access to equipment, reducing the risk of theft or hardware destruction.]
43. Mark is in charge of protecting the firm's files and records. Which of the following procedures should he **not** include on his checklist? **(Page 229)**
- a. **Make sure old files are stored appropriately. [This answer is correct. Old unnecessary files can be expensive to store and could become a fire hazard. They should be destroyed according to the firm's record retention policy.]**
 - b. Use only fire-proof file cabinets to store important papers. [This answer is incorrect. Fire-proof, insulated cabinets can be the most practical method of protecting the firm's files in case of a disaster.]
 - c. Keep file cabinet drawers closed. [This answer is incorrect. Even uninsulated file cabinets offer some protection from fire and water damage, but no file cabinet will protect its contents if the drawers are left open.]
 - d. Put files away in file cabinets at the end of each day. [This answer is incorrect. Adopting a policy of returning files to file cabinets at the end of each day will reduce the risk of losing files in a fire and the risk of losing or misplacing files as well.]

44. When selecting a successor to replace a retiring partner, which of the following statements is most accurate? **(Page 231)**
- a. Firms should expect the successor to produce the same amount of fees as the retiring partner. [This answer is incorrect. A retiring senior partner has developed extensive client relationships and is well-known in accounting and finance communities. It is unrealistic to expect a successor to begin producing the same level of fees.]
 - b. Firms should limit their search for a successor to an individual within the firm. [This answer is incorrect. There may not be a qualified candidate within the firm so consideration should be given to bringing in an individual from outside.]
 - c. Firms should expect the successor to assume all of the retiring /partner's administrative leadership roles. [This answer is incorrect. The firm should consider whether administrative roles are better transitioned to someone other than the successor partner.]
 - d. Firms are having difficulty retaining and grooming qualified staff to become owners. [This answer is correct. The overall shortage of qualified accounting professionals has made identifying successor owners very difficult.]**
45. The Hartman Clark accounting firm has implemented a leadership development program. What is the most important effect this will have on the firm? **(Page 231)**
- a. The firm will avoid management problems. [This answer is incorrect. Although having a leadership development program helps avoid management problems, this is not the most important effect.]
 - b. The firm will attract and retain top performers. [This answer is correct. Not having an effective leadership development program can have significant negative implications on recruitment and retention. Having a development plan exhibits the firm's commitment to developing leaders from within.]**
 - c. The firm will avoid discrimination in its selection of potential leaders. [This answer is incorrect. Having a formal plan that offers individualized development of potential leaders does not eliminate the potential of perceived discrimination.]

EXAMINATION FOR CPE CREDIT**Lesson 2 (WUSTG102)**

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet located in the back of this workbook or by logging onto the Online Grading System.

34. Which of the following statements accurately describes the Statement of Quality Control Standard No. 7, *A Firm's System of Quality Control* (SQCS No. 7)?
- a. SQCS No. 7 is effective for a firm's system of quality control for its tax practice.
 - b. SQCS No. 7 is effective for a firm's system of quality control for its accounting and auditing practice.
 - c. SQCS No. 7 is effective for a firm's system of quality control for its consulting practice.
 - d. Do not select this answer choice.
35. QC 10.14 requires that all firms consider the following quality control elements in establishing their QC systems, **except** for:
- a. Monitoring.
 - b. Human resources.
 - c. Security access.
 - d. Engagement performance.
36. Firms with employees who are members of the AICPA and engaged in the practice of public accounting must participate in an AICPA peer review. This independent review of the firm's quality control system must be conducted every _____ years.
- a. 2.
 - b. 3.
 - c. 4.
 - d. 5.
37. Which of the following statements is the most accurate regarding Interpretation No. 7 of the Peer Review Standards?
- a. Management-use-only financial statements issued under SSARS No. 1 do not include a report and will require a firm to join a peer group.
 - b. Compilations of management-use-only financial statements performed by firms already subject to peer review will not be included with the scope of engagements to be reviewed by peer reviewers.
 - c. The reviewer will check the engagement letter for inclusion of the matters required by SSARS No. 1, if compilations of management-use-only financial statements are reviewed.
 - d. If compilations of management-use-only financial statements are reviewed, the reviewer has no reason to review the financial statements.

38. Which of the following is true regarding liability claims against CPAs?
- a. A firm should cultivate a system to help avoid liability claims and diminish their impact.
 - b. CPA firms that do not engage in tax work will not have to worry about litigation claims.
 - c. The frequency of claims against CPAs has increased, but the severity has remained the same.
 - d. If a firm uses an engagement letter, it should negate any possible litigation problems.
39. What are the two components of loss prevention?
- a. Security systems and ethics training.
 - b. Restricted access and fireproof file cabinets.
 - c. Risk avoidance and damage control.
 - d. Liability insurance and regular compliance reviews.
40. Which statement most accurately describes SSARS and SAS rules regarding fraud and illegal acts?
- a. SSARS performance standards require accountants to document their assessment of fraud in a compilation engagement.
 - b. SSARS performance requirements impose detection requirements for illegal acts.
 - c. If the accountant becomes aware that information is incorrect in a compilation engagement, SSARS No. 1 compels the accountant to acquire additional information.
 - d. SAS No. 99 and SAS No. 54 apply to all financial statement audits.
41. Winston's client is worried that the bookkeeper has committed fraud. Winston's responsibility as the accountant is:
- a. To advise the client to seek legal counsel.
 - b. To assure the client he will determine whether fraud has been committed.
 - c. To ignore the situation because it is the client's responsibility.
 - d. Do not select this answer choice.
42. Which of the following statements is the most accurate regarding performance of bookkeeping services?
- a. The work is usually complex.
 - b. The accountant is responsible for detecting fraud.
 - c. Lawsuits are never filed against engagements for bookkeeping services.
 - d. Bookkeeping engagements have minimal liability risk.
43. Maintaining duplicate copies of files at an off-site location is an example of:
- a. Succession planning.
 - b. Strategic planning.
 - c. Marketing planning.
 - d. Disaster recovery planning.

44. Albert Klein, the senior partner and majority owner in the firm Klein and Korn, Inc., unexpectedly passed away over the weekend. Which of the following is true regarding the firm and its plans for the future?
- a. The firm should be able to continue on with everyone doing their job and will not have interruptions to the workflow.
 - b. Klein and Korn, Inc. has been placed into proactive mode with their succession planning.
 - c. The firm does not have to worry because there are so many qualified and committed up-and-coming CPAs in the marketplace today.
 - d. Klein and Korn, Inc. has been thrust into crisis mode in regards to their succession planning.
45. Arch & Associates has decided to develop a succession plan for the firm. Factors to be considered include all **except** which one of the following?
- a. Develop and implement the plan.
 - b. Cap retirement payments.
 - c. Determine who the successors should be.
 - d. Require a two-year notification of retirement.

GLOSSARY

Action plans: Action plans serve several basic purposes, including the following: Individual responsibilities are assigned. Tasks can be prioritized and sequenced so that conflicts and delays will be minimized. Some tasks may surface that affect the related cost/benefit analysis. Monitoring the progress of the project is easier because of the due dates that are established.

Budgeting: Budgeting can be described as the strategic plan put into numbers.

Damage control: Another aspect of loss prevention is damage control, which considers ways of containing potential liability problems and thereby minimizing their impact.

Disaster recovery plan: The plan should provide for items such as the following: Continuing to handle the firm's activities with as little interruption as possible. Communicating with clients, employees, vendors, and others if the firm must vacate its offices. Relocating the office if the firm's current space is damaged or destroyed. Replacing equipment, such as computers, fax machines, scanners, copiers, and the telephone system. Replacing furniture and office supplies. Reconstructing lost or damaged paper files and computer records. Shifting work assignments if key employees are unable to report to work. Obtaining financial assistance, if necessary, to pay the firm's obligations while business is interrupted. Response to the media.

Due date monitoring system: Although a due date monitoring system is generally used more for tax deadlines, it can also be used for accounting and other deadlines. The form of a due date monitoring system can vary from a very simple, manually prepared due date calendar to a much more complex computerized system.

Engagement letter: A document to help prevent any type of misunderstanding with the client, the accountant should document in writing his or her understanding with the client regarding the following—Objectives of the engagement (i.e., the nonattest services), Services to be performed, Client's acceptance of its responsibilities, Accountant's responsibilities.

Executive summary: A reporting package may include summarized financial information in the form of graphs or tables, key financial ratios, or an executive summary highlighting the information most important to the client.

Government Auditing Standards (GAS): When performing an audit in accordance with the GAO's *Government Auditing Standards*, (the Yellow Book), an auditor is required to adhere to the Yellow Book's independence standards.

Management-use-only financial statements: Factors such as the definition of management and third parties, the adequacy of management's knowledge, and the intended use of the financial statements will affect the accountants' ability to submit management-use-only financial statements without a report in specific client situations.

Marketing plan: Generally, a marketing plan includes the following steps: Evaluate the firm's capabilities, Analyze the competition, Identify the target market, Develop a marketing strategy, Select specific marketing methods.

Mission statement: The mission statement answers three very important questions that a firm must address early in the planning process. Those questions are as follows: What business are we in? What business do we want to be in? What do we want to achieve?

Objectives: When part of a SWOT Analysis, objectives represent the general or high-level goals for improving the firm.

Peer review: The AICPA's peer review programs evaluate compliance with the QC standards. The AICPA Standards for Performing and Reporting on Peer Reviews recognize the needs of firms with different scopes of practice by providing for three types of peer reviews—a system review, an engagement review and a report review.

Risk avoidance: Risk avoidance includes a variety of loss prevention techniques that focus on limiting the types of clients and engagements the firm accepts.

Strategic planning: The development of a firms' goals.

Strategies: A strategic plan can be described as a road map of where a firm wants to go during the next three to five years. In developing such a plan, the firm defines its current status and where the firm plans to go in the future. The firm then develops strategies and a detailed action plan that will help it achieve its long-term goals.

Succession planning: Determining what the owner wants to do with the firm when he or she retires is the first step in succession planning.

SWOT analysis: Once the firm has developed its mission statement, the next planning step is to thoroughly analyze its current operating conditions. This process is commonly called a SWOT analysis. SWOT is an acronym for strengths, weaknesses, opportunities, and threats.

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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Write-Up Services—Course 1— Payroll and Payroll Tax Services (WUSTG101)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

ONLINE GRADING. Log onto our Online Grading Center at cl.thomsonreuters.com to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

PRINT GRADING. If you prefer, you may mail or fax your completed answer sheet to the address or number below. In the print product, the answer sheets are bound with the course materials. Answer sheets may be printed from electronic products. The answer sheets are identified with the course acronym. Please ensure you use the correct answer sheet. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number.

Send your completed **Examination for CPE Credit Answer Sheet, Course Evaluation**, and payment to:

**Thomson Reuters
Tax & Accounting—R&G
WUSTG101 Self-study CPE
36786 Treasury Center
Chicago, IL 60694-6700**

You may fax your completed **Examination for CPE Credit Answer Sheet** and **Course Evaluation** to the Tax & Accounting business of Thomson Reuters at **(817) 252-4021**, along with your credit card information.

Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

2. If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.
3. Copies of the answer sheet are acceptable. However, each answer sheet must be accompanied by a payment of \$79. Discounts apply for 3 or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is \$225 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is \$284 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is \$336 (a 15% discount on all five courses or more).
4. To receive CPE credit, completed answer sheets must be postmarked by **November 30, 2011**. CPE credit will be given for examination scores of 70% or higher. An express grading service is available for an **additional \$24.95** per examination. Course results will be faxed to you by 5 p.m. CST of the business day following receipt of your examination for CPE Credit Answer Sheet.
5. Only the **Examination for CPE Credit Answer Sheet** should be submitted for grading. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS**. Be sure to keep a completed copy for your records.
6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC's Guide to Write-Up Services—Course 1—
Payroll and Payroll Tax Services (WUSTG101)

Price \$79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: Add \$24.95

Signature: _____

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ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙

- | a | b | c | d | a | b | c | d | a | b | c | d | a | b | c | d |
|-------|---|---|---|-------|---|---|---|-------|---|---|---|-------|---|---|---|
| 1. ○ | ○ | ○ | ○ | 11. ○ | ○ | ○ | ○ | 21. ○ | ○ | ○ | ○ | 31. ○ | ○ | ○ | ○ |
| 2. ○ | ○ | ○ | ○ | 12. ○ | ○ | ○ | ○ | 22. ○ | ○ | ○ | ○ | 32. ○ | ○ | ○ | ○ |
| 3. ○ | ○ | ○ | ○ | 13. ○ | ○ | ○ | ○ | 23. ○ | ○ | ○ | ○ | 33. ○ | ○ | ○ | ○ |
| 4. ○ | ○ | ○ | ○ | 14. ○ | ○ | ○ | ○ | 24. ○ | ○ | ○ | ○ | 34. ○ | ○ | ○ | ○ |
| 5. ○ | ○ | ○ | ○ | 15. ○ | ○ | ○ | ○ | 25. ○ | ○ | ○ | ○ | 35. ○ | ○ | ○ | ○ |
| 6. ○ | ○ | ○ | ○ | 16. ○ | ○ | ○ | ○ | 26. ○ | ○ | ○ | ○ | 36. ○ | ○ | ○ | ○ |
| 7. ○ | ○ | ○ | ○ | 17. ○ | ○ | ○ | ○ | 27. ○ | ○ | ○ | ○ | 37. ○ | ○ | ○ | ○ |
| 8. ○ | ○ | ○ | ○ | 18. ○ | ○ | ○ | ○ | 28. ○ | ○ | ○ | ○ | 38. ○ | ○ | ○ | ○ |
| 9. ○ | ○ | ○ | ○ | 19. ○ | ○ | ○ | ○ | 29. ○ | ○ | ○ | ○ | 39. ○ | ○ | ○ | ○ |
| 10. ○ | ○ | ○ | ○ | 20. ○ | ○ | ○ | ○ | 30. ○ | ○ | ○ | ○ | 40. ○ | ○ | ○ | ○ |

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Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Write-Up Services—Course 1—Payroll and Payroll Tax Services Course Acronym: WUSTG101

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
 Fill in like this not like this .

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
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TESTING INSTRUCTIONS FOR EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to Write-Up Services—Course 2— Managing a Write-up Practice (WUSTG102)

1. Following these instructions is information regarding the location of the **CPE CREDIT EXAMINATION QUESTIONS** and an **EXAMINATION FOR CPE CREDIT ANSWER SHEET**. You may use the answer sheet to complete the examination consisting of multiple choice questions.

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**Thomson Reuters
Tax & Accounting—R&G
WUSTG102 Self-study CPE
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Chicago, IL 60694-6700**

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Please allow a minimum of three weeks for grading.

Note: The answer sheet has four bubbles for each question. However, not every examination question has four valid answer choices. If there are only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

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6. Please direct any questions or comments to our Customer Service department at (800) 431-9025.

EXAMINATION FOR CPE CREDIT

To enhance your learning experience, examination questions are located immediately following each lesson. Each set of examination questions can be located on the page numbers listed below. The course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of each lesson, the participant then answers the examination questions and records answers to the examination questions on either the printed **EXAMINATION FOR CPE CREDIT ANSWER SHEET** or by logging onto the Online Grading System. The **EXAMINATION FOR CPE CREDIT ANSWER SHEET** and **SELF-STUDY COURSE EVALUATION FORM** for each course are located at the end of all course materials.

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EXAMINATION FOR CPE CREDIT ANSWER SHEET
Companion to PPC's Guide to Write-Up Services—Course 2—
Managing a Write-up Practice (WUSTG102)

Price \$79

First Name: _____

Last Name: _____

Firm Name: _____

Firm Address: _____

City: _____ State /ZIP: _____

Firm Phone: _____

Firm Fax No.: _____

Firm Email: _____

Express Grading Requested: Add \$24.95

Signature: _____

Credit Card Number: _____ Expiration Date: _____

Birth Month: _____ Licensing State: _____

ANSWERS:

Please indicate your answer by filling in the appropriate circle as shown: Fill in like this ● not like this ○ ⊗ ⊙ .

- | a | b | c | d | a | b | c | d | a | b | c | d | a | b | c | d |
|-------|---|---|---|-------|---|---|---|-------|---|---|---|-------|---|---|---|
| 1. ○ | ○ | ○ | ○ | 13. ○ | ○ | ○ | ○ | 24. ○ | ○ | ○ | ○ | 35. ○ | ○ | ○ | ○ |
| 2. ○ | ○ | ○ | ○ | 14. ○ | ○ | ○ | ○ | 25. ○ | ○ | ○ | ○ | 36. ○ | ○ | ○ | ○ |
| 3. ○ | ○ | ○ | ○ | 15. ○ | ○ | ○ | ○ | 26. ○ | ○ | ○ | ○ | 37. ○ | ○ | ○ | ○ |
| 4. ○ | ○ | ○ | ○ | 16. ○ | ○ | ○ | ○ | 27. ○ | ○ | ○ | ○ | 38. ○ | ○ | ○ | ○ |
| 5. ○ | ○ | ○ | ○ | 17. ○ | ○ | ○ | ○ | 28. ○ | ○ | ○ | ○ | 39. ○ | ○ | ○ | ○ |
| 6. ○ | ○ | ○ | ○ | 18. ○ | ○ | ○ | ○ | 29. ○ | ○ | ○ | ○ | 40. ○ | ○ | ○ | ○ |
| 7. ○ | ○ | ○ | ○ | 19. ○ | ○ | ○ | ○ | 30. ○ | ○ | ○ | ○ | 41. ○ | ○ | ○ | ○ |
| 8. ○ | ○ | ○ | ○ | 20. ○ | ○ | ○ | ○ | 31. ○ | ○ | ○ | ○ | 42. ○ | ○ | ○ | ○ |
| 9. ○ | ○ | ○ | ○ | 21. ○ | ○ | ○ | ○ | 32. ○ | ○ | ○ | ○ | 43. ○ | ○ | ○ | ○ |
| 10. ○ | ○ | ○ | ○ | 22. ○ | ○ | ○ | ○ | 33. ○ | ○ | ○ | ○ | 44. ○ | ○ | ○ | ○ |
| 11. ○ | ○ | ○ | ○ | 23. ○ | ○ | ○ | ○ | 34. ○ | ○ | ○ | ○ | 45. ○ | ○ | ○ | ○ |

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Expiration Date: November 30, 2011

Self-study Course Evaluation

Please Print Legibly—Thank you for your feedback!

Course Title: Companion to PPC's Guide to Write-Up Services—Course 2—Managing a Write-up Practice Course Acronym: WUSTG102

Your Name (optional): _____ Date: _____

Email: _____

Please indicate your answers by filling in the appropriate circle as shown:
 Fill in like this not like this .

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. Rate the appropriateness of the materials for your experience level:	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
2. How would you rate the examination related to the course material?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
3. Does the examination consist of clear and unambiguous questions and statements?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
4. Were the stated learning objectives met?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
5. Were the course materials accurate and useful?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
6. Were the course materials relevant and did they contribute to the achievement of the learning objectives?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
7. Was the time allotted to the learning activity appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
8. If applicable, was the technological equipment appropriate?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
9. If applicable, were handout or advance preparation materials and prerequisites satisfactory?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>
10. If applicable, how well did the audio/visuals contribute to the program?	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>	<input type="radio"/>

Please provide any constructive criticism you may have about the course materials, such as particularly difficult parts, hard to understand areas, unclear instructions, appropriateness of subjects, educational value, and ways to make it more fun. Please be as specific as you can.
 (Please print legibly):

Additional Comments:

1. What did you find **most** helpful? _____
2. What did you find **least** helpful? _____
3. What other courses or subject areas would you like for us to offer? _____
4. Do you work in a Corporate (C), Professional Accounting (PA), Legal (L), or Government (G) setting? _____
5. How many employees are in your company? _____
6. May we contact you for survey purposes (Y/N)? If yes, please fill out contact info at the top of the page. **Yes/No**

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