2022 WICPA ACCOUNTING & AUDITING CONFERENCE

YOUR SOURCE FOR KEY UPDATES & INSIGHTS ON TIMELY ISSUES

WEDNESDAY, NOV. 16

BROOKFIELD CONFERENCE CENTER
& WICPA CPE LIVESTREAM

CONFERENCE AT A GLANCE

WEDNESDAY, NOV. 16 | BROOKFIELD CONFERENCE CENTER | BROOKFIELD

7 – 8 a.m.
Registration & Networking
Celebration Atrium

8 – 8:10 a.m.
Welcome & Opening Remarks
Connect C1 & C2

8:10 – 9:10 a.m.
GENERAL SESSION
Economic & Financial Market Outlook: 2022-2028
Connect C1 & C2

9:10 – 9:25 a.m.
Networking Break
Celebration Atrium

9:25 – 10:15 a.m.
GENERAL SESSION
Testing IT Controls in Today's Environment
Connect C1 & C2

10:15 – 10:30 a.m.
Networking Break
Celebration Atrium

10:30 – 11:20 a.m.
GENERAL SESSION
GASB & FASB Update
Connect C1 & C2

11:20 a.m. – 12:05 p.m.
Networking Lunch
Collaborate

12:05 – 12:55 p.m.
GENERAL SESSION
Retention, Post-COVID-19, Company Culture & Labor Shortages
Connect C1 & C2

12:55 – 1:05 p.m.
Networking Break
Celebration Atrium

1:05 – 1:55 p.m.
GENERAL SESSION
ESG State of Play: An Introduction to ESG
Connect C1 & C2

1:55 – 2:05 p.m.
Networking Break
Celebration Atrium

2:05 – 3:35 p.m.
GENERAL SESSION
Crypto & Audit Implications: Trends & Applications for Accounting Practitioners
Connect C1 & C2

3:35 – 3:50 p.m.
Networking Break
Celebration Atrium

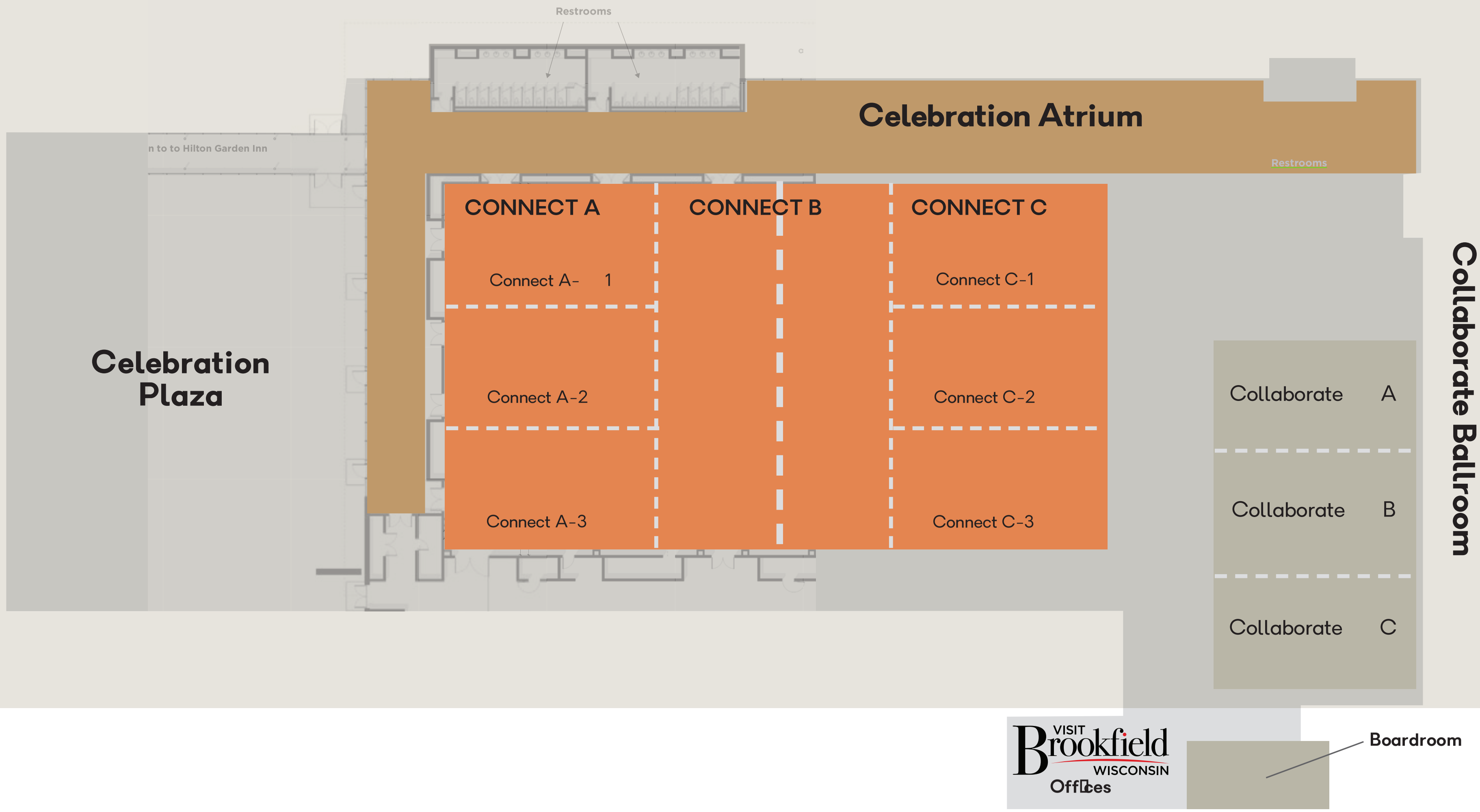
3:50 – 4:40 p.m.
GENERAL SESSION
Hot Tax Practice Procedure & Ethical Issues
Connect C1 & C2

4:40 p.m.
Closing Remarks & Raffle Drawings
Connect C1 & C2

BE SURE TO WATCH YOUR EMAIL FOR THE CONFERENCE EVALUATION TO LET US KNOW HOW THE CONFERENCE WAS!

BROOKFIELD CONFERENCE CENTER

FLOOR PLANS AND CAPACITY CHARTS



We're here to build local businesses because that's what commercial banking is all about.

Community is *Main Street.* Community is business parks. It's networking. It's referrals. It's growth. And Community is valuable partnerships. At Waukesha State Bank we know that local businesses help define a Community. From financing expansions to supporting everyday banking needs, our commercial banking platform is designed around you and the needs of your clients.

Waukesha State Bank

Find your business banking partner at WaukeshaBank.com.

Solutions for businesses of all shapes and sizes:

- *A wide range of lending capabilities from start-up loans to loans in excess of $20 million. SBA Preferred Lender since 1999.*
- *Completely local decision-making and support. Local = Fast.*
- *True Relationship Banking – No 1-800 number.*
- *Consistent, yet flexible, lending approach backed by a commercial banking team with more than 300 years of collective experience.*
- *A full suite of cash management products, payroll processing and wealth management services.*
- *14 full-service locations throughout Waukesha County.*
- *Reinvestment in the communities we serve, creating vibrant places to live and work.*

SPECTRUM℠
INVESTMENT ADVISORS

Partnering to cover the spectrum of financial needs.

Retirement Plans | **Wealth Management** | **Financial Wellness**

Our approach is collaborative and personal, with advice based on understanding the person, not just the situation.

Holistic Planning

Investment Consulting

Income Strategies

Fiduciary Status

Spectrum Investment Advisors
6329 West Mequon Road Mequon, WI 53092
262-238-4010 | www.spectruminvestor.com

CONNECT

A GREAT WAY FOR WICPA MEMBERS TO COLLABORATE

WICPA Connect is your exclusive members-only networking and knowledge base designed to connect you with WICPA members and resources.

- **Network with peers** and grow your contact list using the member directory of more than 7,000 members.
- **Post questions** to find out from fellow members who have the expertise or may have been in the same situation.
- **Personalize your profile** by adding your interests, education, experience, honors and even your photo.
- **Contribute and download resources** such as documents, whitepapers, articles, reports, guides and more.
- **Share your knowledge and expertise** by answering questions and offering your insights and ideas to fellow members.
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As a WICPA member, you already have a profile on WICPA Connect.
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Connect with thousands of fellow members now at **wicpa.org/connect**

8:10 – 9:10 a.m.

Economic & Financial Market Outlook: 2022-2028

Clare Zempel, CFA, CBE, *Principal, Zempel Strategic*

WICPA Accounting and Auditing Conference

The Economic and Market Outlook
2022 – 2028

Why So Much Confusion?
What Do “Best Indicators” Predict?
Has Recession Started?
Can Recession Be Averted? Limited?
How Will Sectors Perform?

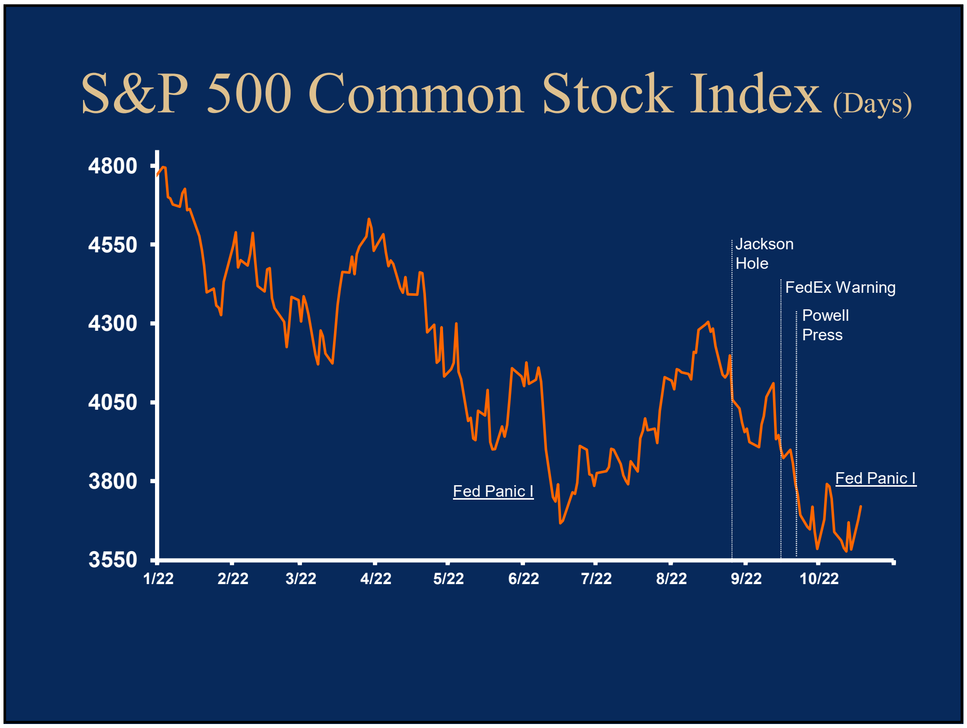
Clare Zempel
Economist and Investment Strategist

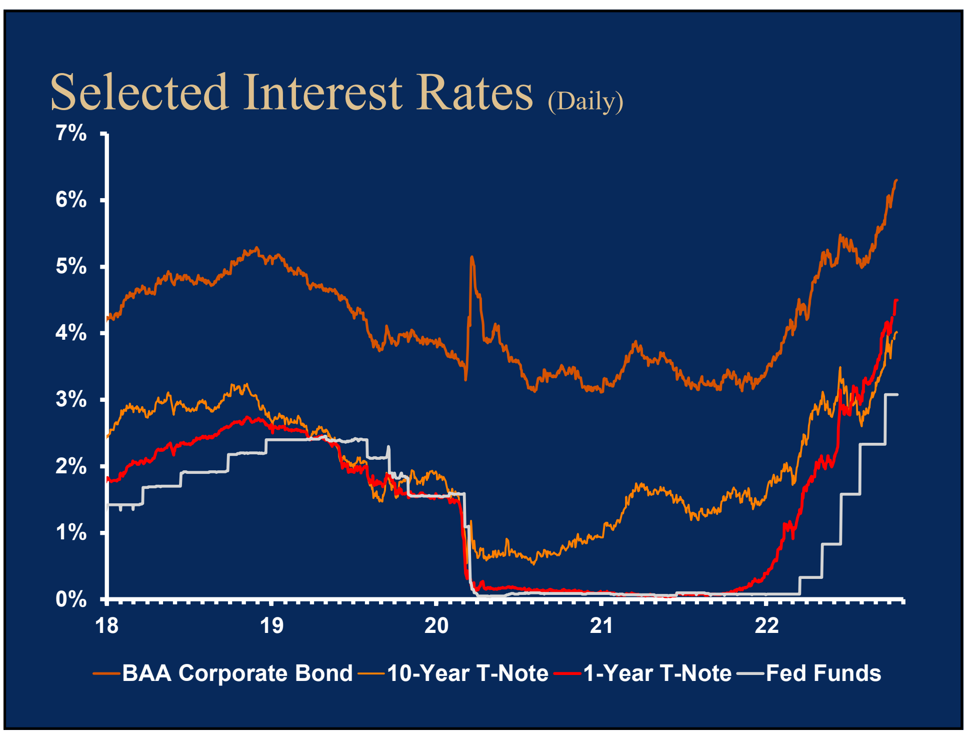
Brookfield, Wisconsin
November 16, 2022
Charts Updated October 18, 2022

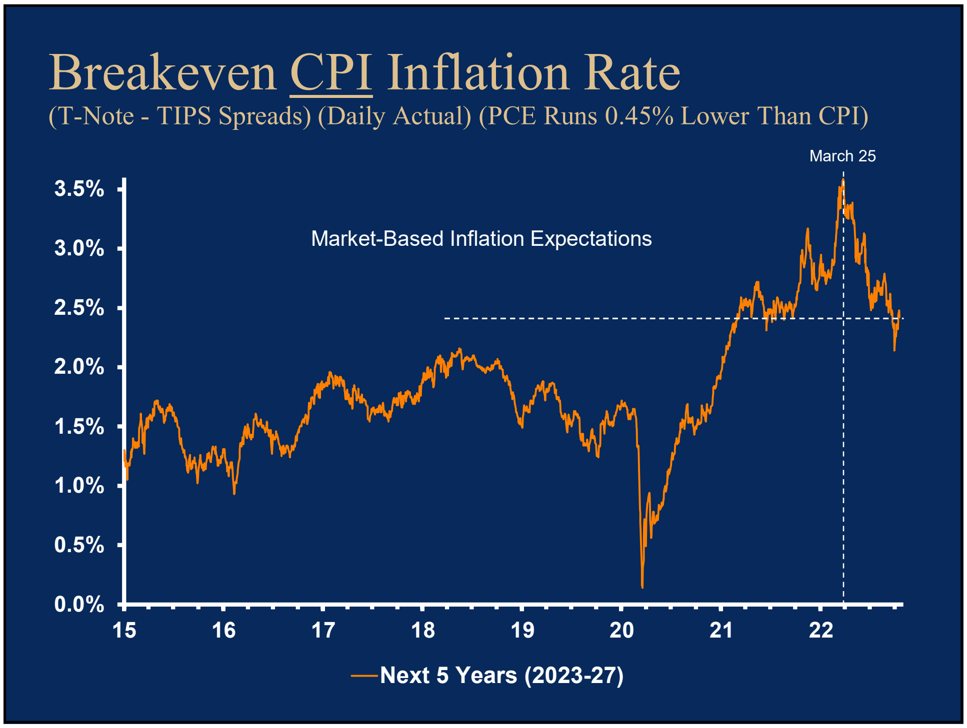
WICPA Accounting and Auditing Conference

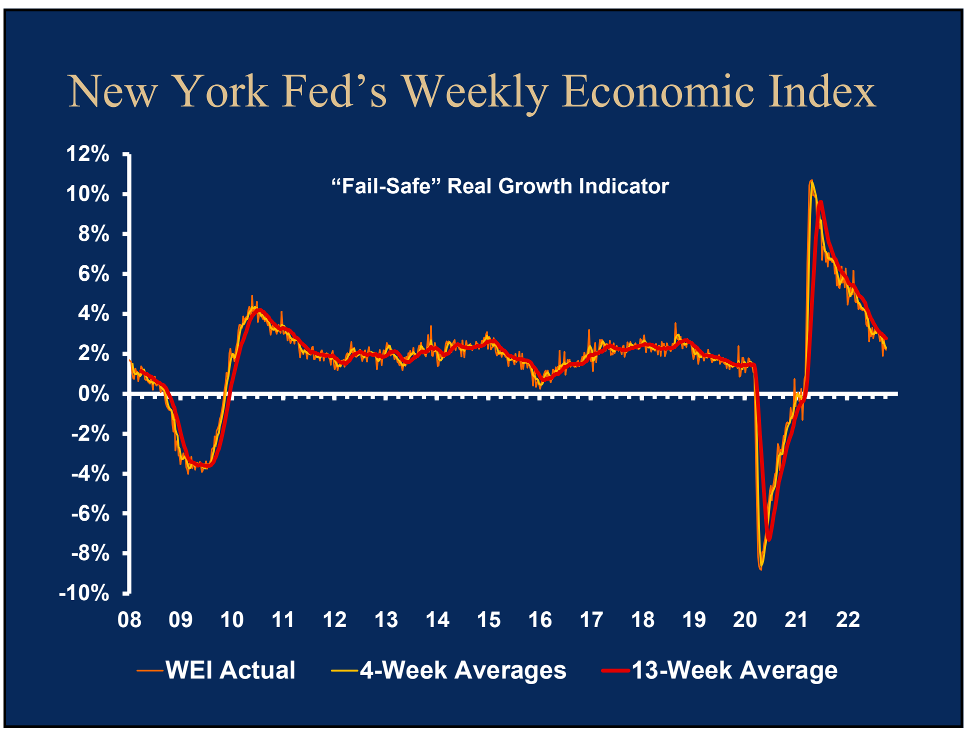
The Economic and Market Outlook
2022 – 2028

Why So Much Confusion?


S&P 500 Common Stock Index (Days)
4800
4550
4300
4050
3800
3550
1/22
2/22
3/22
4/22
5/22
6/22
7/22
8/22
9/22
10/22
Jackson Hole
FedEx Warning
Powell Press
Fed Panic I
Fed Panic I


Selected Interest Rates (Daily)
7%
6%
5%
4%
3%
2%
1%
0%
18
19
20
21
22
BAA Corporate Bond
10-Year T-Note
1-Year T-Note
Fed Funds


Breakeven CPI Inflation Rate
(T-Note - TIPS Spreads) (Daily Actual) (PCE Runs 0.45% Lower Than CPI)
March 25
Market-Based Inflation Expectations
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
15
16
17
18
19
20
21
22
Next 5 Years (2023-27)


New York Fed's Weekly Economic Index
"Fail-Safe" Real Growth Indicator
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
-6%
-8%
-10%
08
09
10
11
12
13
14
15
16
17
18
19
20
21
22
WEI Actual
4-Week Averages
13-Week Average

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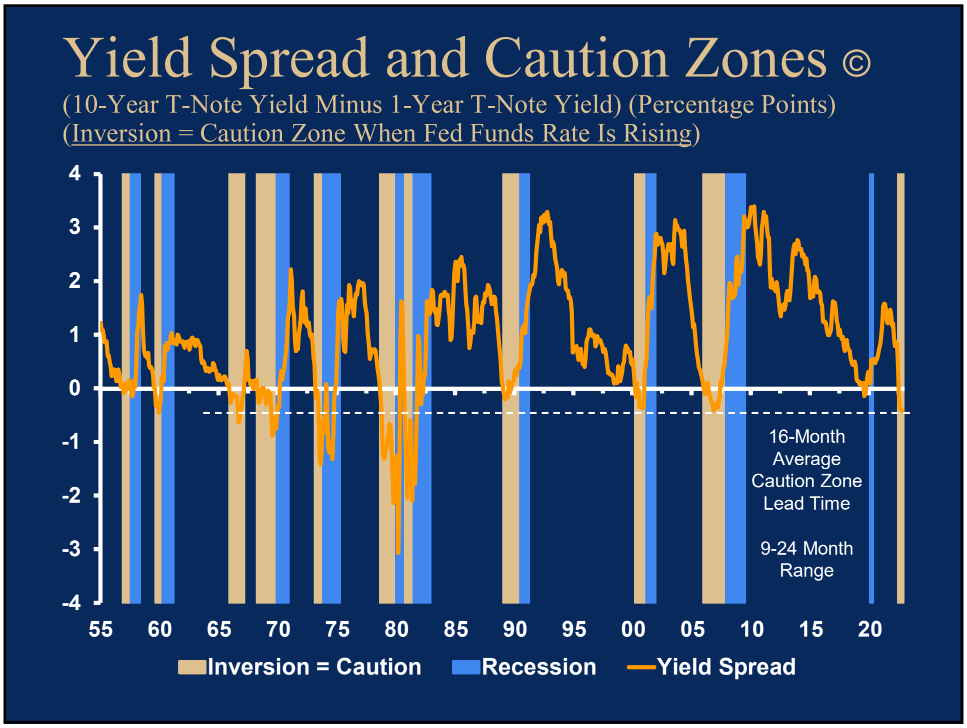
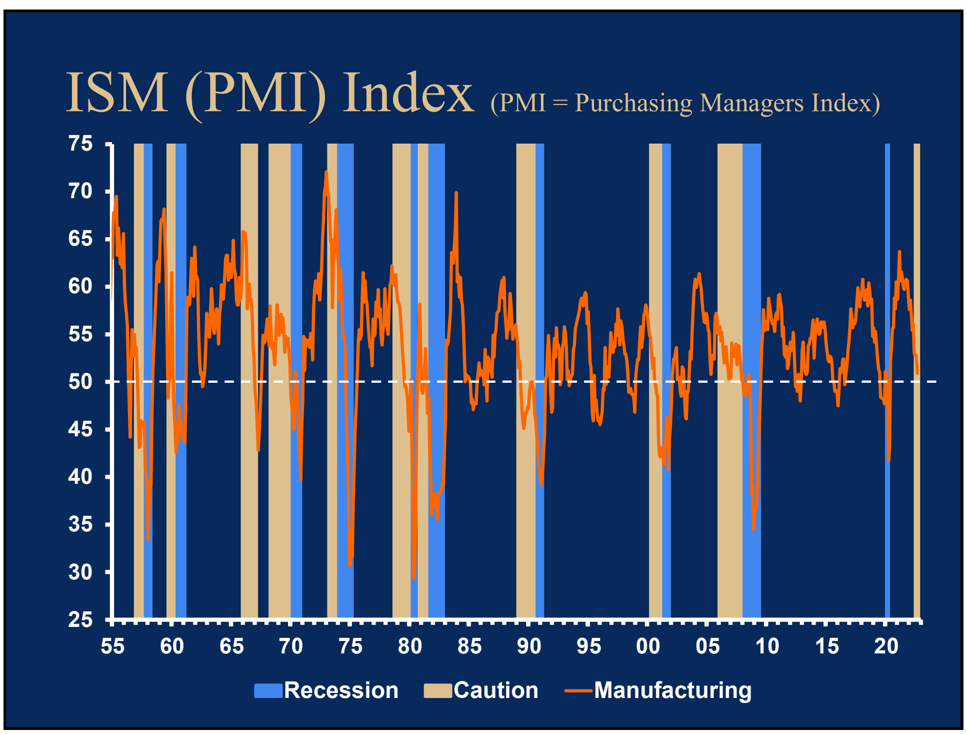
The Economic and Market Outlook 2022 – 2028

What Do “Best Indicators” Predict?

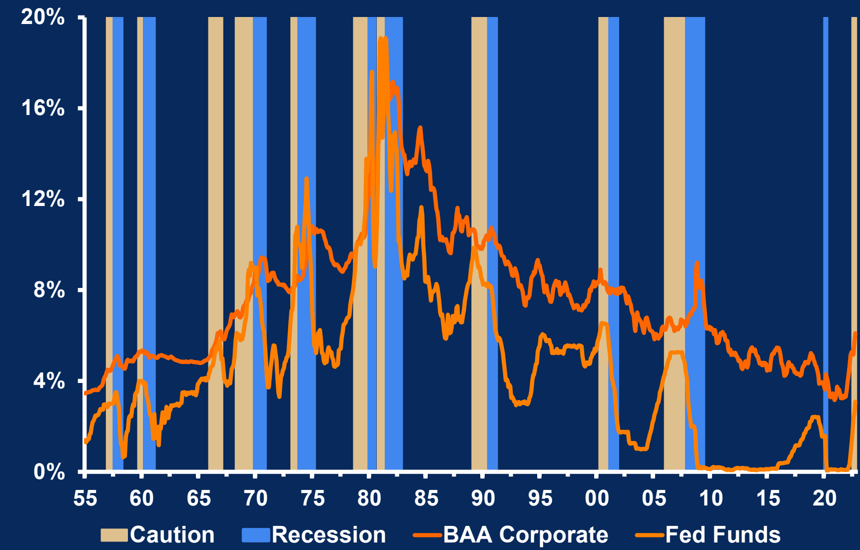
Interest Rates and Recessions

10 Recessions
Since 1955


Yield Spread and Caution Zones ©
(10-Year T-Note Yield Minus 1-Year T-Note Yield) (Percentage Points)
(Inversion = Caution Zone When Fed Funds Rate Is Rising)
4
3
2
1
0
-1
-2
-3
-4
55 60 65 70 75 80 85 90 95 00 05 10 15 20
16-Month Average Caution Zone Lead Time
9-24 Month Range
Inversion = Caution
Recession
Yield Spread

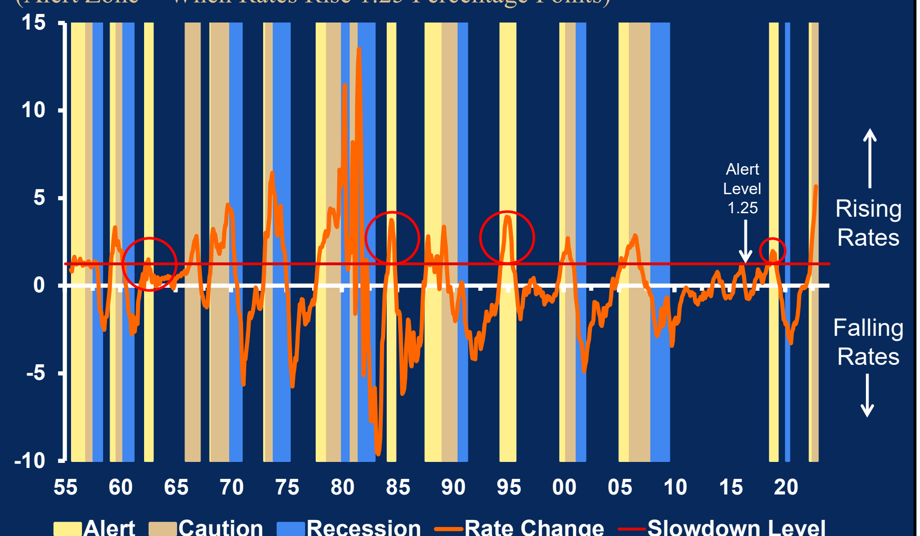

ISM (PMI) Index (PMI = Purchasing Managers Index)
75
70
65
60
55
50
45
40
35
30
25
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession
Caution
Manufacturing

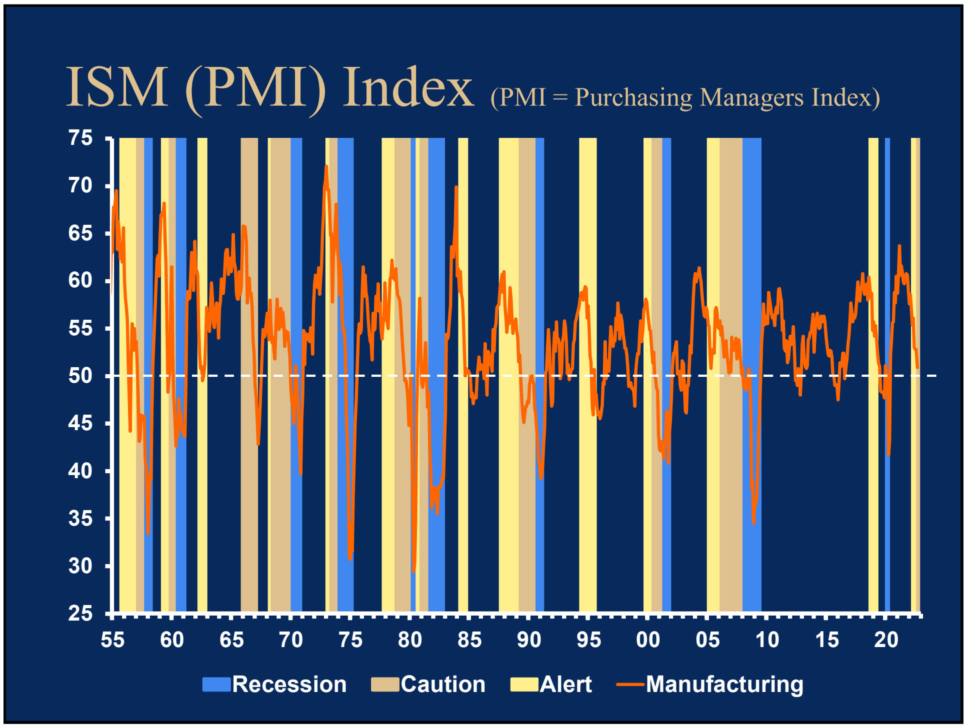
Interest Rates and Recessions



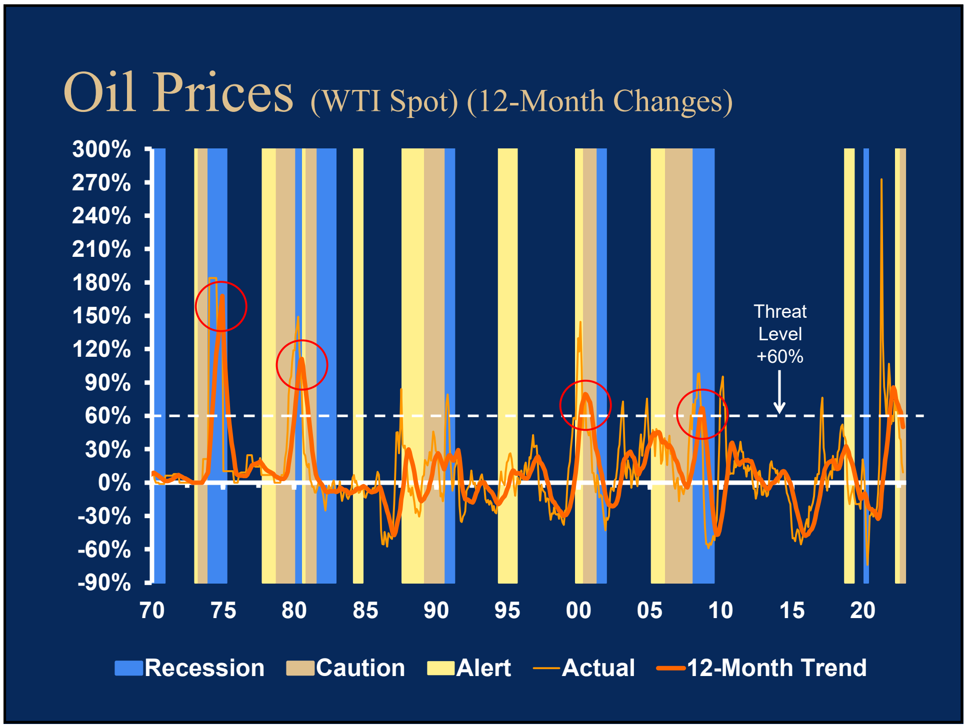
Rate Changes and Zempel Zones ©

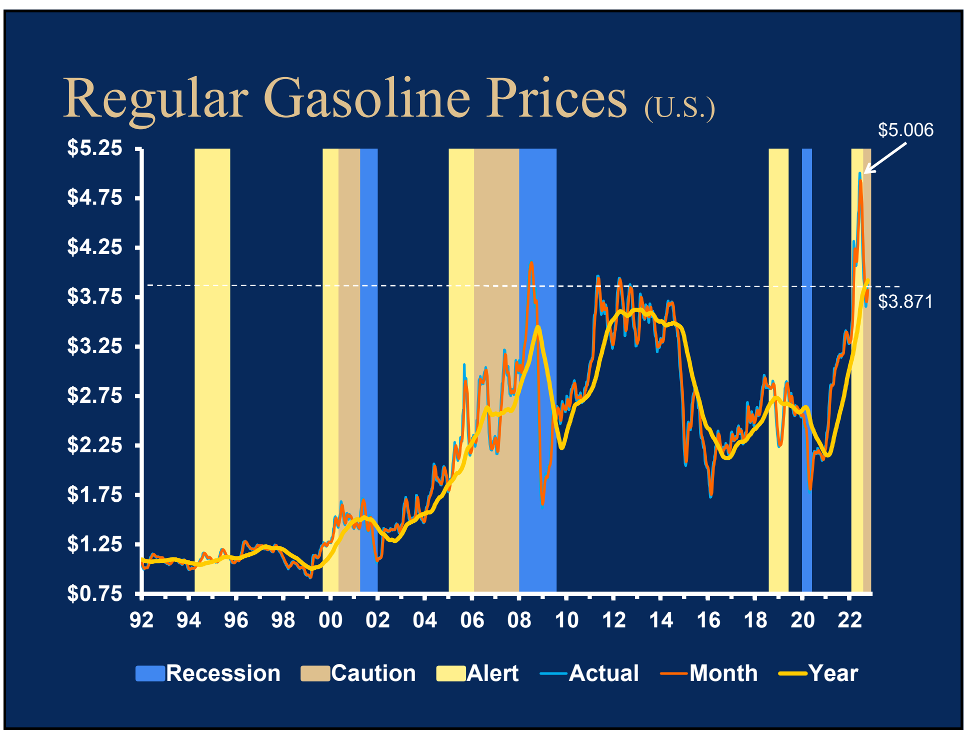
(BAA and Fed Funds) (Total 12-Month Change in Percentage Points)
(Alert Zone = When Rates Rise 1.25 Percentage Points)



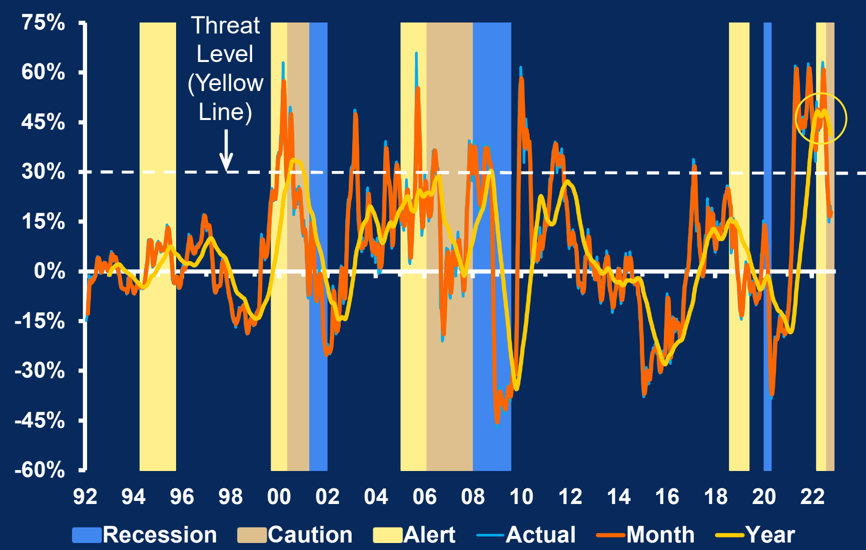

ISM (PMI) Index (PMI = Purchasing Managers Index)
75
70
65
60
55
50
45
40
35
30
25
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession
Caution
Alert
Manufacturing


Oil Prices (WTI Spot)
$140
$120
$100
$80
$60
$40
$20
$0
$115
$89
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession
Actual
12-Month Average


Oil Prices (WTI Spot) (12-Month Changes)
300%
270%
240%
210%
180%
150%
120%
90%
60%
30%
0%
-30%
-60%
-90%
70
75
80
85
90
95
00
05
10
15
20
Threat
Level
+60%
Recession
Caution
Alert
Actual
12-Month Trend


Regular Gasoline Prices (U.S.)
$5.25
$4.75
$4.25
$3.75
$3.25
$2.75
$2.25
$1.75
$1.25
$0.75
92
94
96
98
00
02
04
06
08
10
12
14
16
18
20
22
$5.006
$3.871
Recession
Caution
Alert
Actual
Month
Year

Regular Gasoline Prices (U.S. 52-Week Changes)



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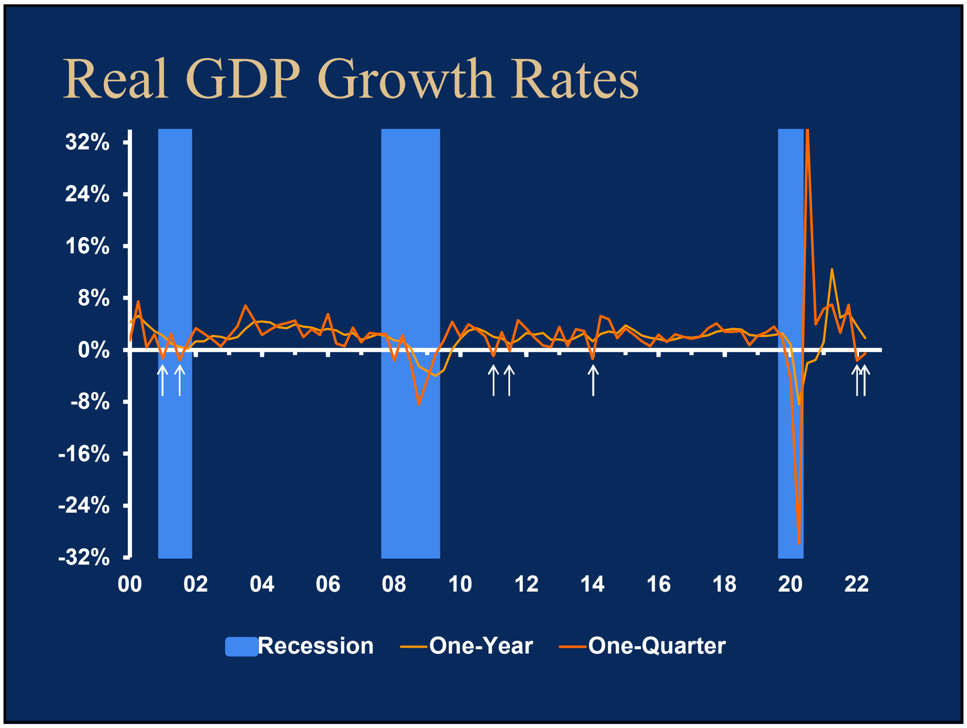
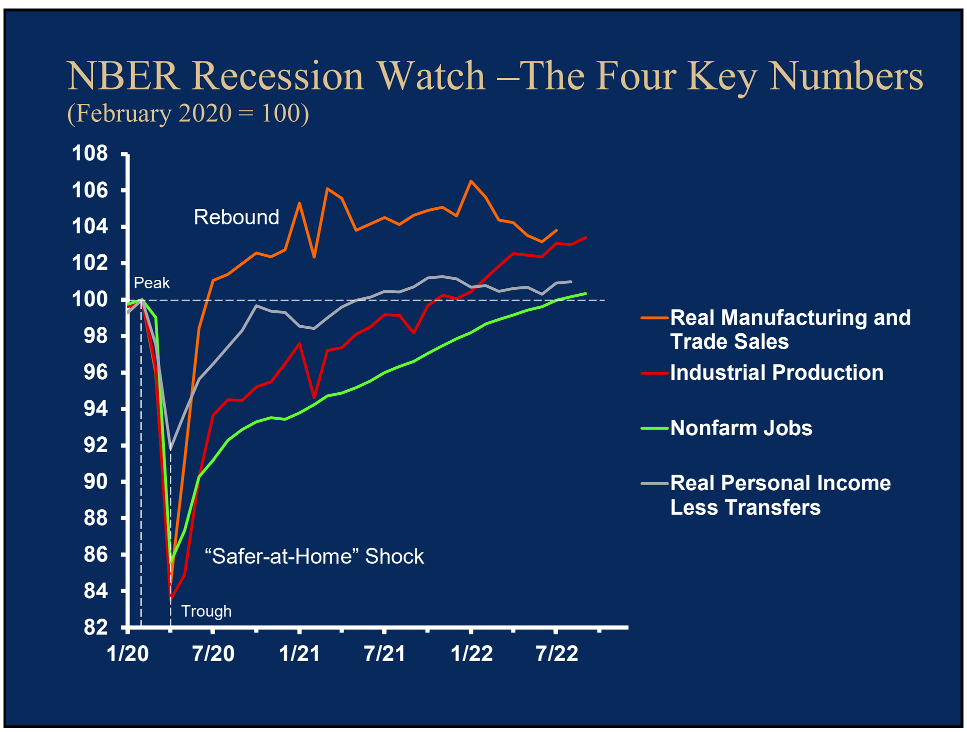
The Economic and Market Outlook
2022 – 2028

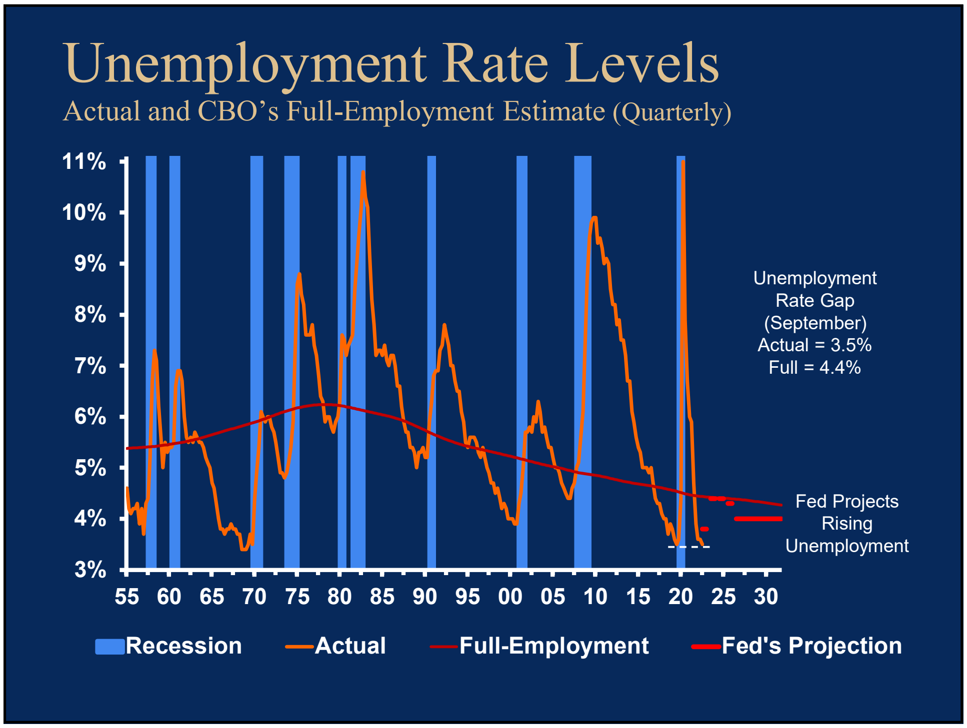
Has Recession Started?



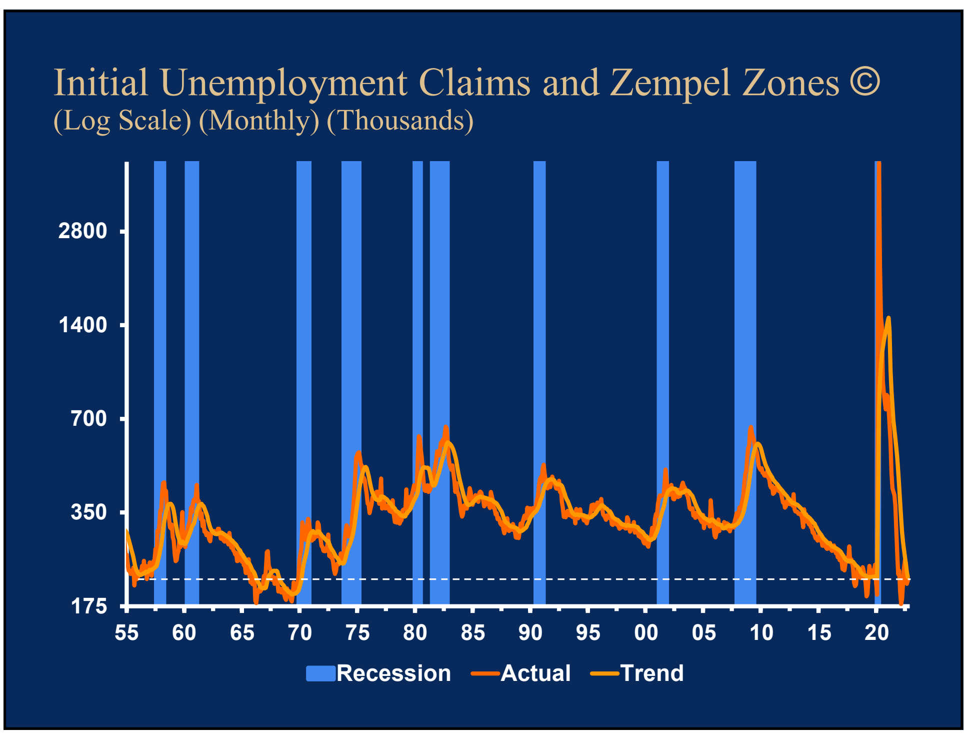
Real GDP Growth Rates
32%
24%
16%
8%
0%
-8%
-16%
-24%
-32%
00
02
04
06
08
10
12
14
16
18
20
22
Recession
One-Year
One-Quarter



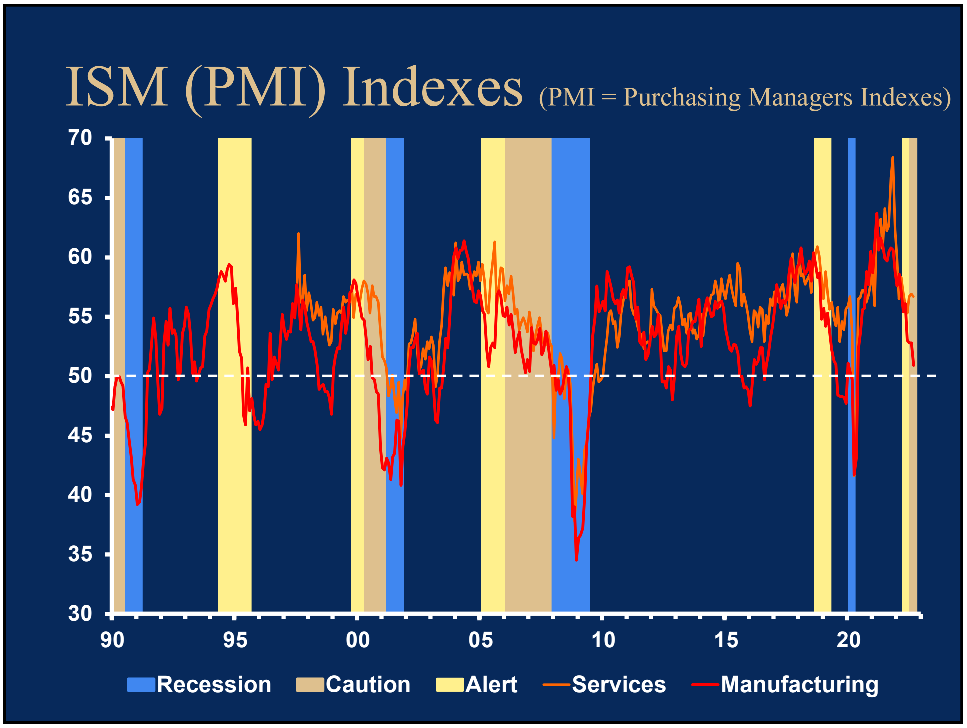
NBER Recession Watch –The Four Key Numbers
(February 2020 = 100)
108
106
104
102
100
98
96
94
92
90
88
86
84
82
1/20
7/20
1/21
7/21
1/22
7/22
Rebound
Peak
"Safer-at-Home" Shock
Trough
Real Manufacturing and Trade Sales
Industrial Production
Nonfarm Jobs
Real Personal Income Less Transfers

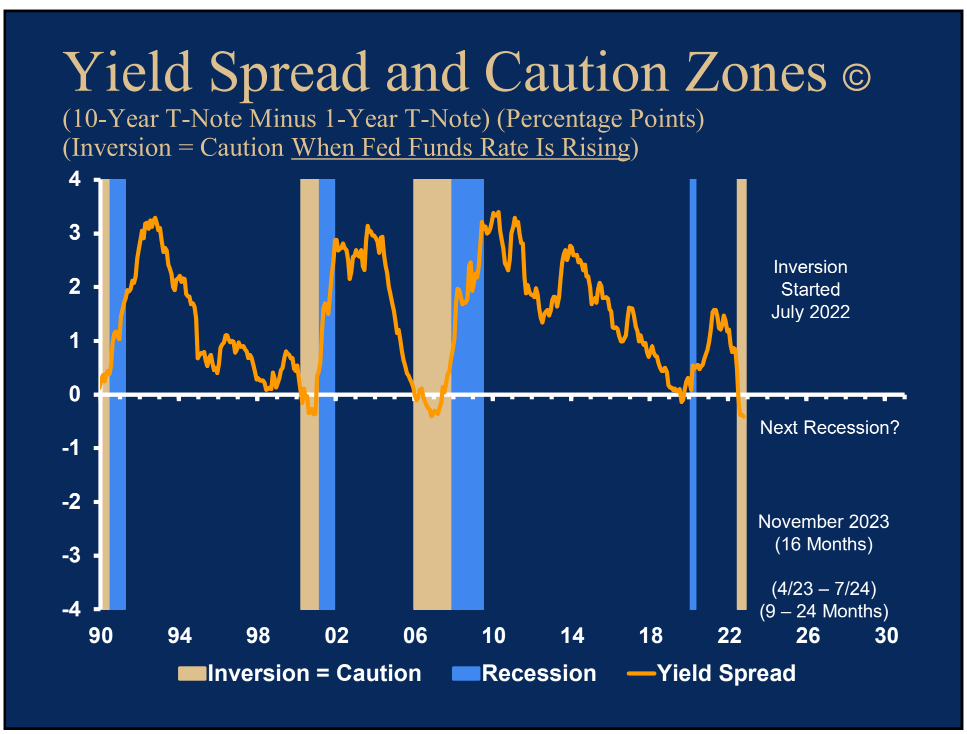


Unemployment Rate Levels
Actual and CBO's Full-Employment Estimate (Quarterly)
11%
10%
9%
8%
7%
6%
5%
4%
3%
55 60 65 70 75 80 85 90 95 00 05 10 15 20 25 30
Unemployment Rate Gap (September) Actual = 3.5% Full = 4.4%
Fed Projects Rising Unemployment
Recession
Actual
Full-Employment
Fed's Projection



Initial Unemployment Claims and Zempel Zones ©
(Log Scale) (Monthly) (Thousands)
2800
1400
700
350
175
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession
Actual
Trend


ISM (PMI) Indexes (PMI = Purchasing Managers Indexes)
70
65
60
55
50
45
40
35
30
90
95
00
05
10
15
20
Recession
Caution
Alert
Services
Manufacturing


Yield Spread and Caution Zones ©
(10-Year T-Note Minus 1-Year T-Note) (Percentage Points)
(Inversion = Caution When Fed Funds Rate Is Rising)
4
3
2
1
0
-1
-2
-3
-4
Inversion
Started
July 2022
Next Recession?
November 2023
(16 Months)
(4/23 – 7/24)
(9 – 24 Months)
90
94
98
02
06
10
14
18
22
26
30
Inversion = Caution
Recession
Yield Spread

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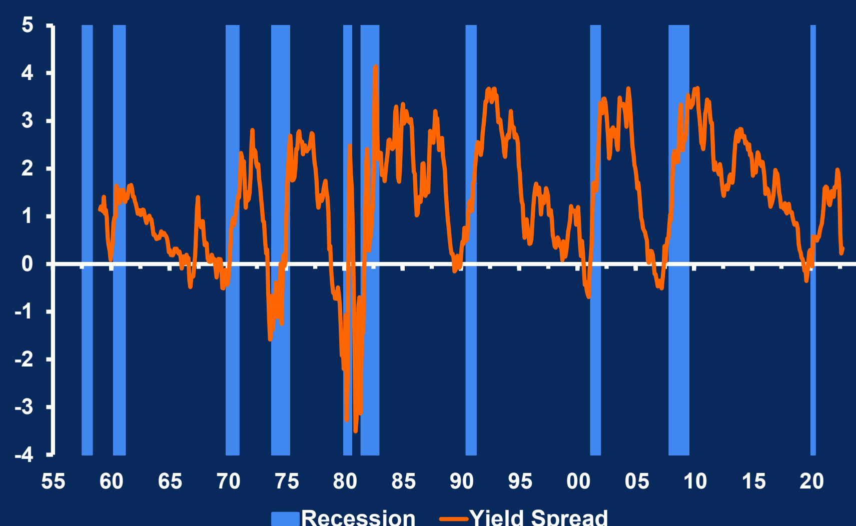
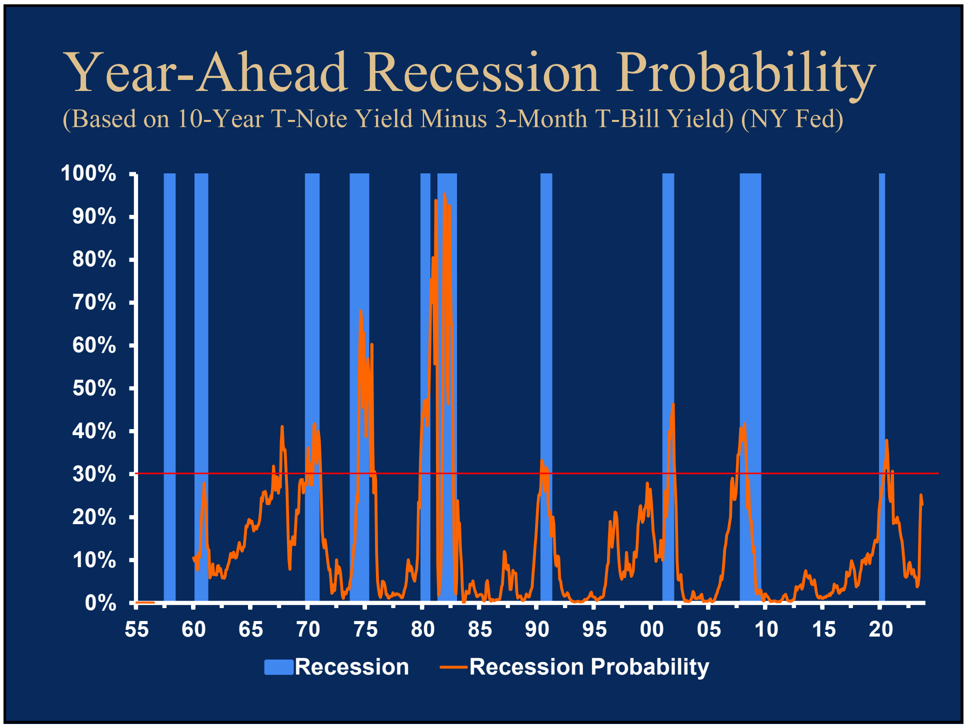
The Economic and Market Outlook 2022 – 2028

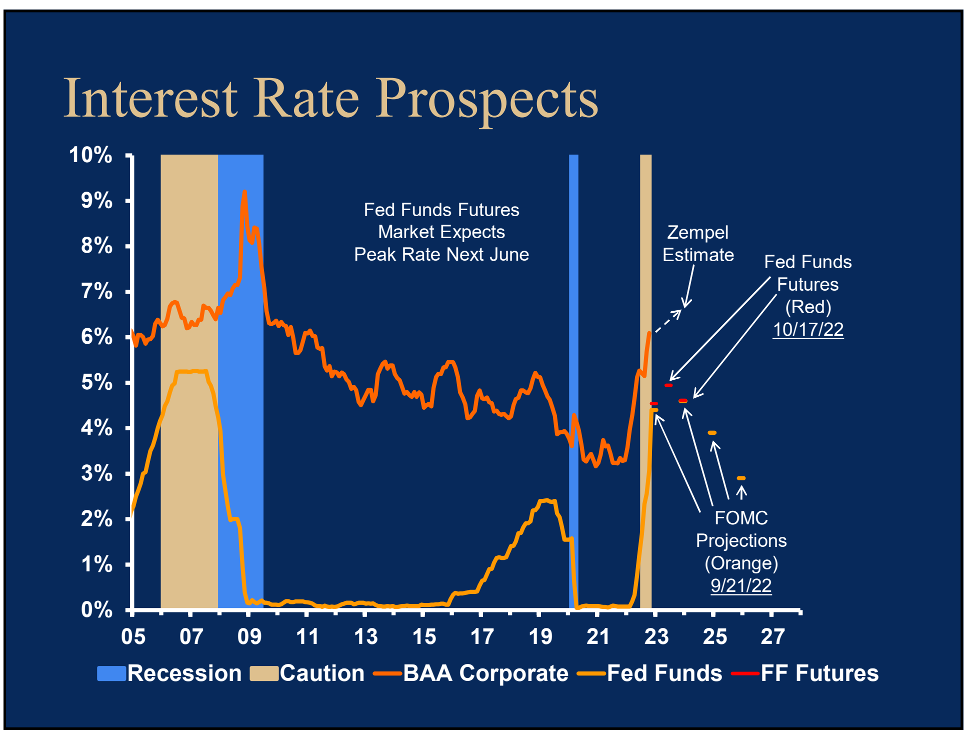
Can Recession Be Averted? Limited?

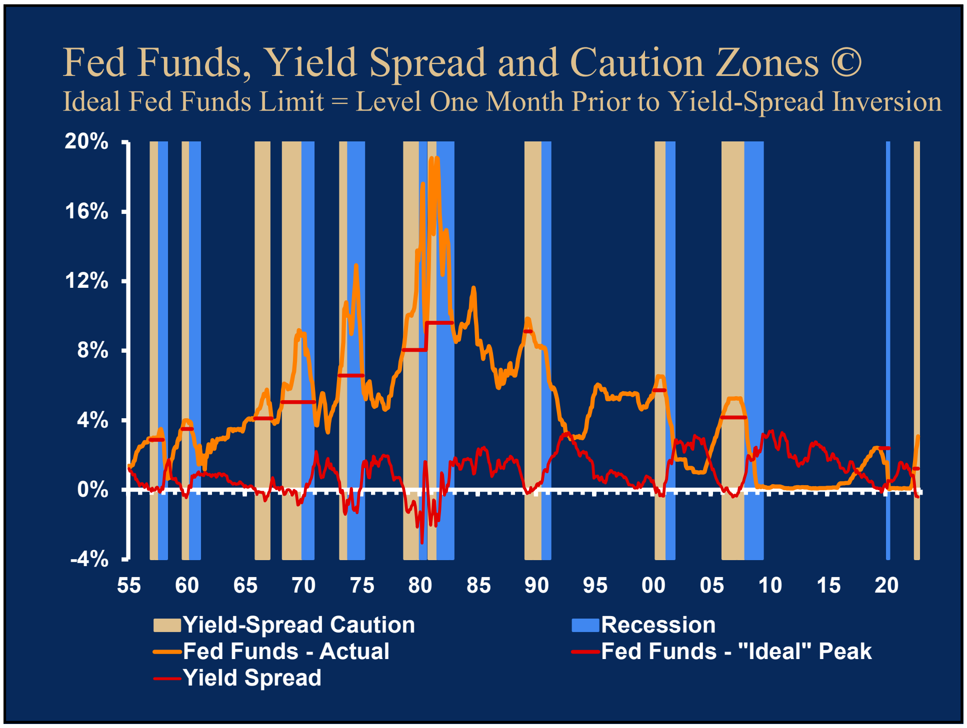
Yield Spread and Caution Zones ©

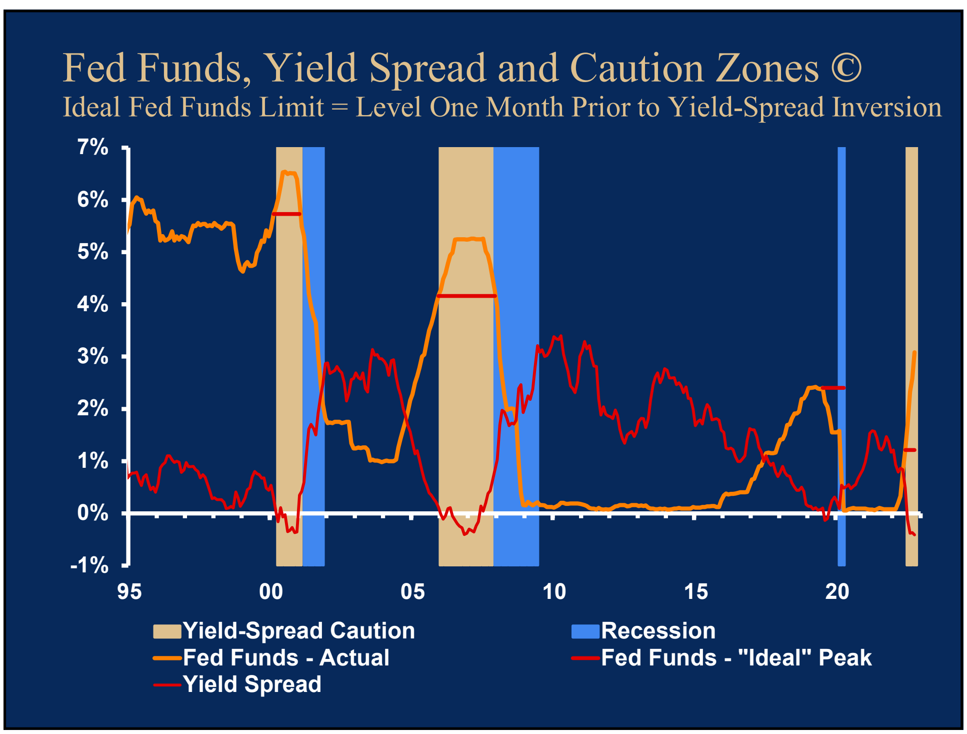
(10-Year T-Note Yield Minus 3-Month T-Bill Yield) (Percentage Points)

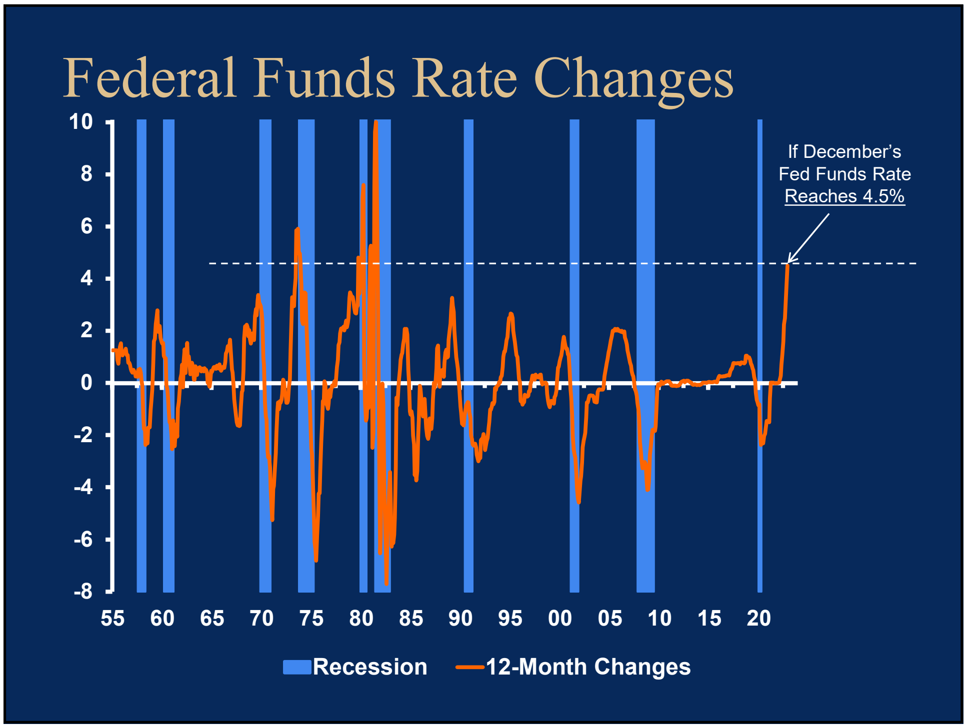



Year-Ahead Recession Probability
(Based on 10-Year T-Note Yield Minus 3-Month T-Bill Yield) (NY Fed)
Recession
Recession Probability

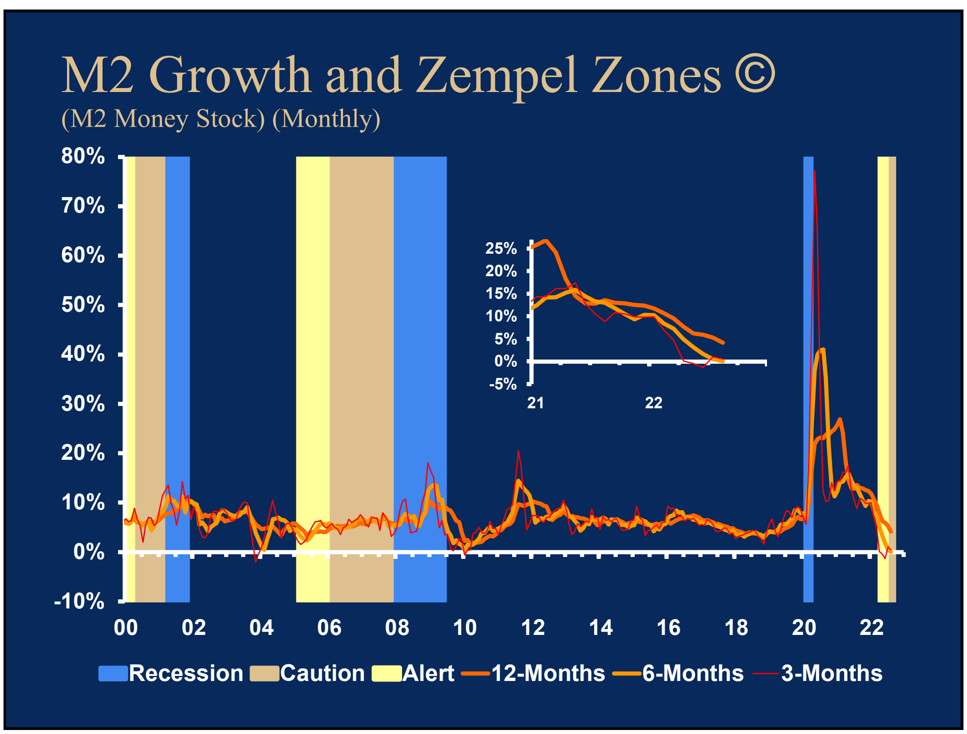

Interest Rate Prospects
Fed Funds Futures
Market Expects
Peak Rate Next June
Zempel
Estimate
Fed Funds
Futures
(Red)
10/17/22
FOMC
Projections
(Orange)
9/21/22
Recession
Caution
BAA Corporate
Fed Funds
FF Futures


Fed Funds, Yield Spread and Caution Zones ©
Ideal Fed Funds Limit = Level One Month Prior to Yield-Spread Inversion
20%
16%
12%
8%
4%
0%
-4%
55
60
65
70
75
80
85
90
95
00
05
10
15
20
Yield-Spread Caution
Recession
Fed Funds - Actual
Fed Funds - "Ideal" Peak
Yield Spread

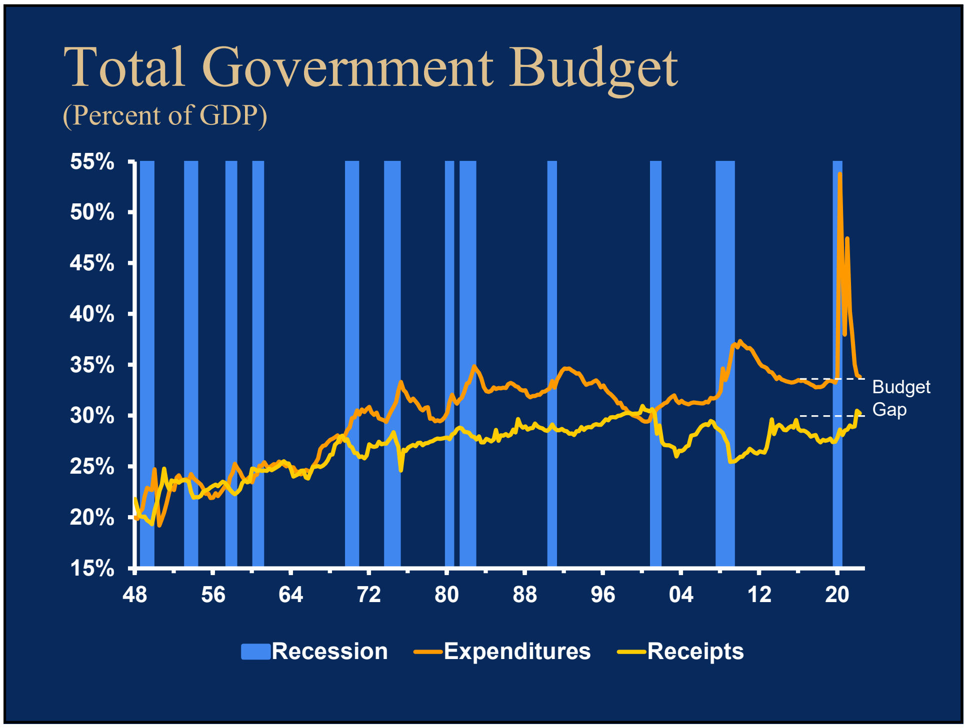

Fed Funds, Yield Spread and Caution Zones ©
Ideal Fed Funds Limit = Level One Month Prior to Yield-Spread Inversion
7%
6%
5%
4%
3%
2%
1%
0%
-1%
95
00
05
10
15
20
Yield-Spread Caution
Recession
Fed Funds - Actual
Fed Funds - "Ideal" Peak
Yield Spread

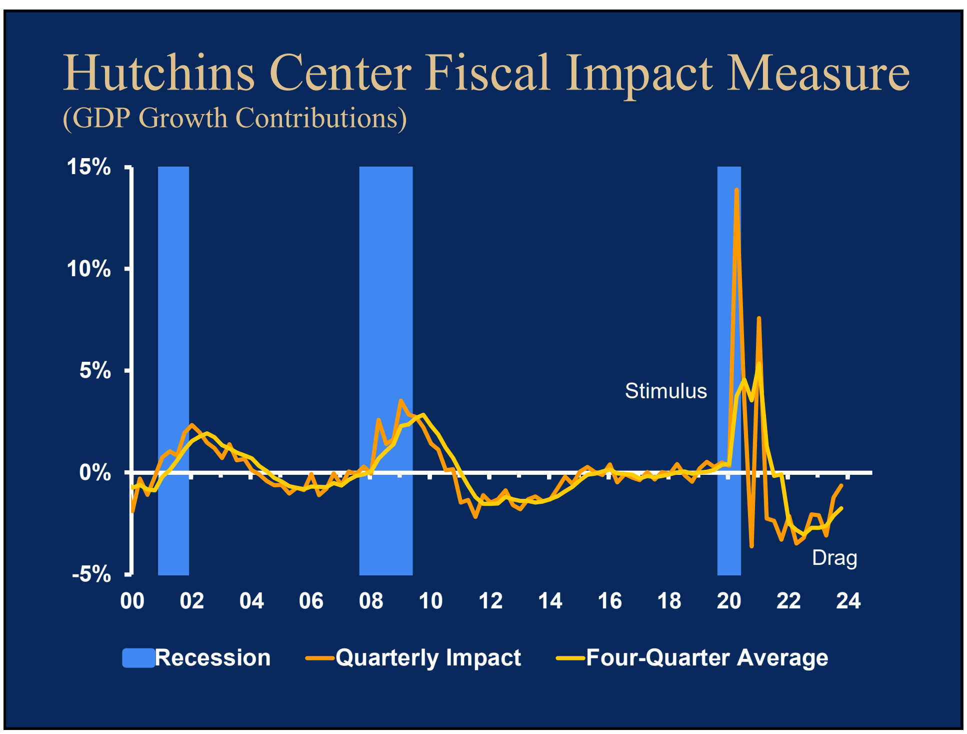


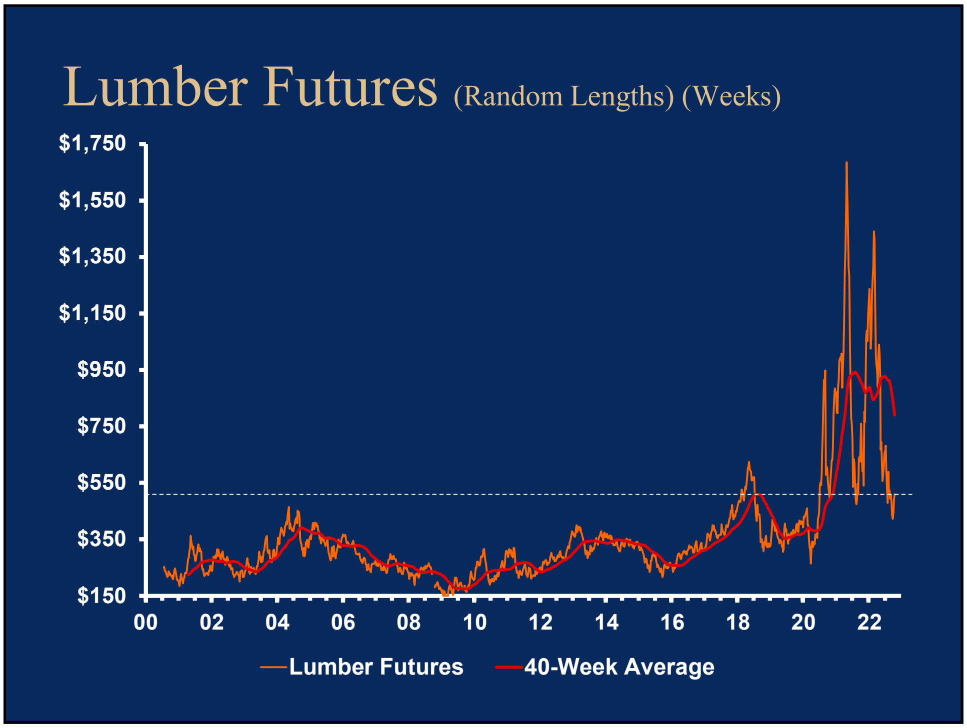
Federal Funds Rate Changes
10
8
6
4
2
0
-2
-4
-6
-8
55 60 65 70 75 80 85 90 95 00 05 10 15 20
If December's Fed Funds Rate Reaches 4.5%
Recession
12-Month Changes

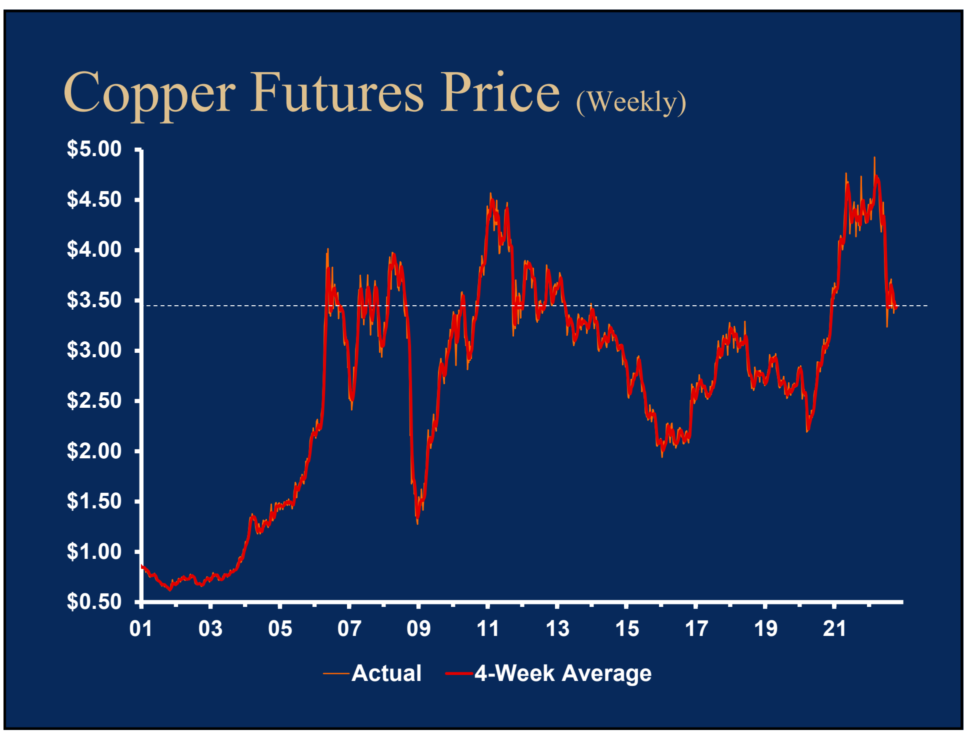


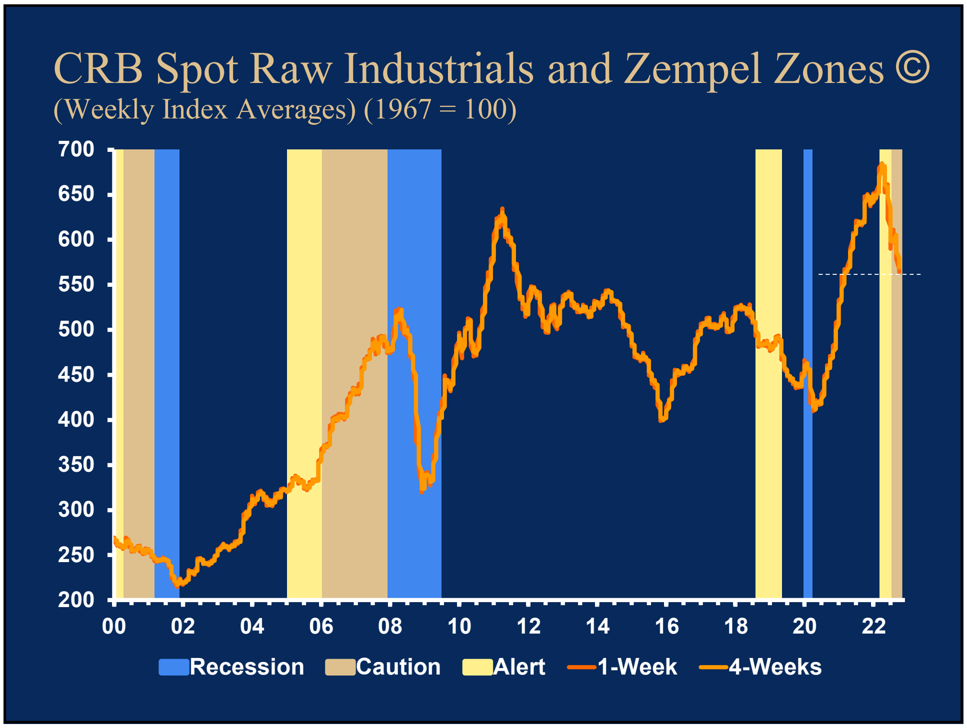
M2 Growth and Zempel Zones ©
(M2 Money Stock) (Monthly)
80%
70%
60%
50%
40%
30%
20%
10%
0%
-10%
00 02 04 06 08 10 12 14 16 18 20 22
25%
20%
15%
10%
5%
0%
-5%
21 22
Recession
Caution
Alert
12-Months
6-Months
3-Months

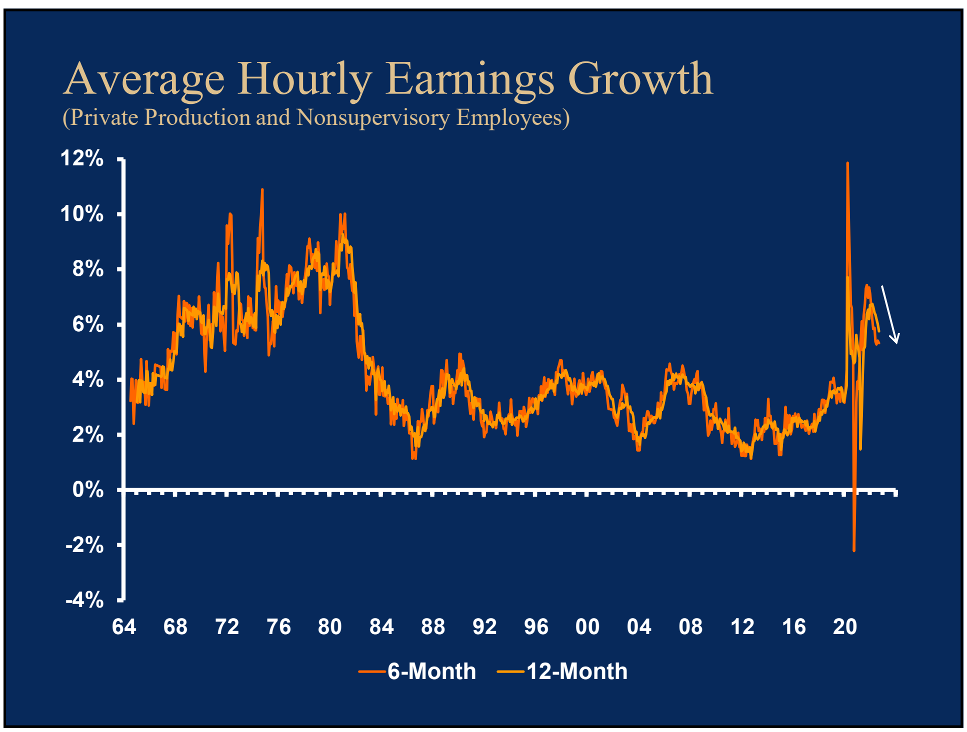

Total Government Budget
(Percent of GDP)
55%
50%
45%
40%
35%
30%
25%
20%
15%
48
56
64
72
80
88
96
04
12
20
Budget
Gap
Recession
Expenditures
Receipts

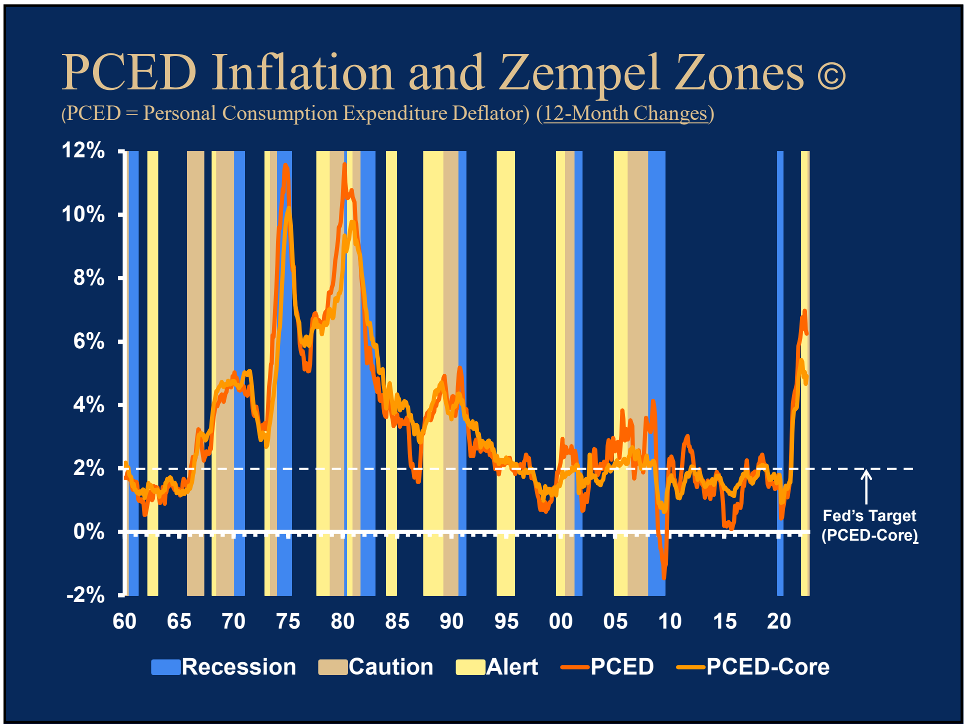

Hutchins Center Fiscal Impact Measure
(GDP Growth Contributions)
15%
10%
5%
0%
-5%
00
02
04
06
08
10
12
14
16
18
20
22
24
Stimulus
Drag
Recession
Quarterly Impact
Four-Quarter Average


Lumber Futures (Random Lengths) (Weeks)
$1,750
$1,550
$1,350
$1,150
$950
$750
$550
$350
$150
00
02
04
06
08
10
12
14
16
18
20
22
Lumber Futures
40-Week Average

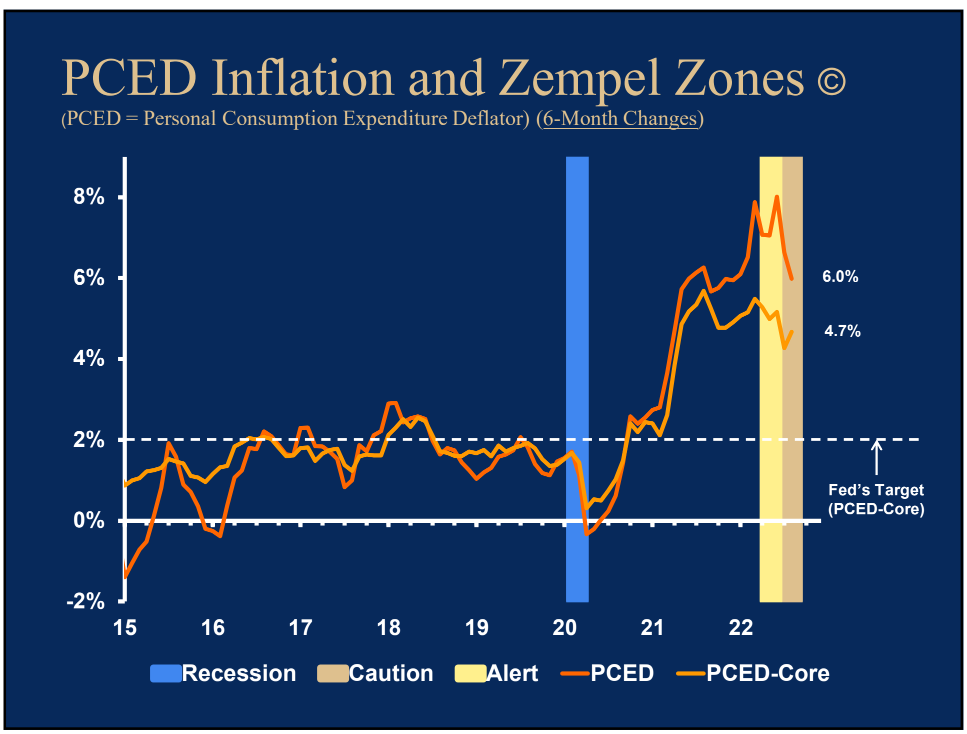

Copper Futures Price (Weekly)
$5.00
$4.50
$4.00
$3.50
$3.00
$2.50
$2.00
$1.50
$1.00
$0.50
01
03
05
07
09
11
13
15
17
19
21
Actual
4-Week Average


CRB Spot Raw Industrials and Zempel Zones ©
(Weekly Index Averages) (1967 = 100)
700
650
600
550
500
450
400
350
300
250
200
00
02
04
06
08
10
12
14
16
18
20
22
Recession
Caution
Alert
1-Week
4-Weeks


Average Hourly Earnings Growth
(Private Production and Nonsupervisory Employees)
12%
10%
8%
6%
4%
2%
0%
-2%
-4%
64
68
72
76
80
84
88
92
96
00
04
08
12
16
20
6-Month
12-Month



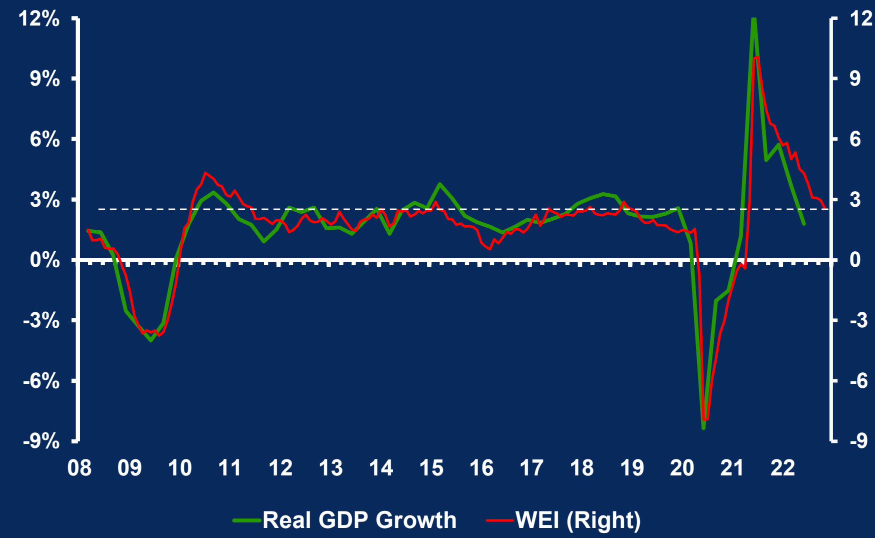
PCED Inflation and Zempel Zones ©
(PCED = Personal Consumption Expenditure Deflator) (12-Month Changes)
12%
10%
8%
6%
4%
2%
0%
-2%
60
65
70
75
80
85
90
95
00
05
10
15
20
Fed's Target (PCED-Core)
Recession
Caution
Alert
PCED
PCED-Core



PCED Inflation and Zempel Zones ©
(PCED = Personal Consumption Expenditure Deflator) (6-Month Changes)
8%
6%
4%
2%
0%
-2%
15
16
17
18
19
20
21
22
6.0%
4.7%
Fed's Target (PCED-Core)
Recession
Caution
Alert
PCED
PCED-Core

Real GDP Growth and WEI

(Real GDP's Four-quarter Growth Rate)
(WEI = NY Fed's Weekly Economic Index's Monthly Average)



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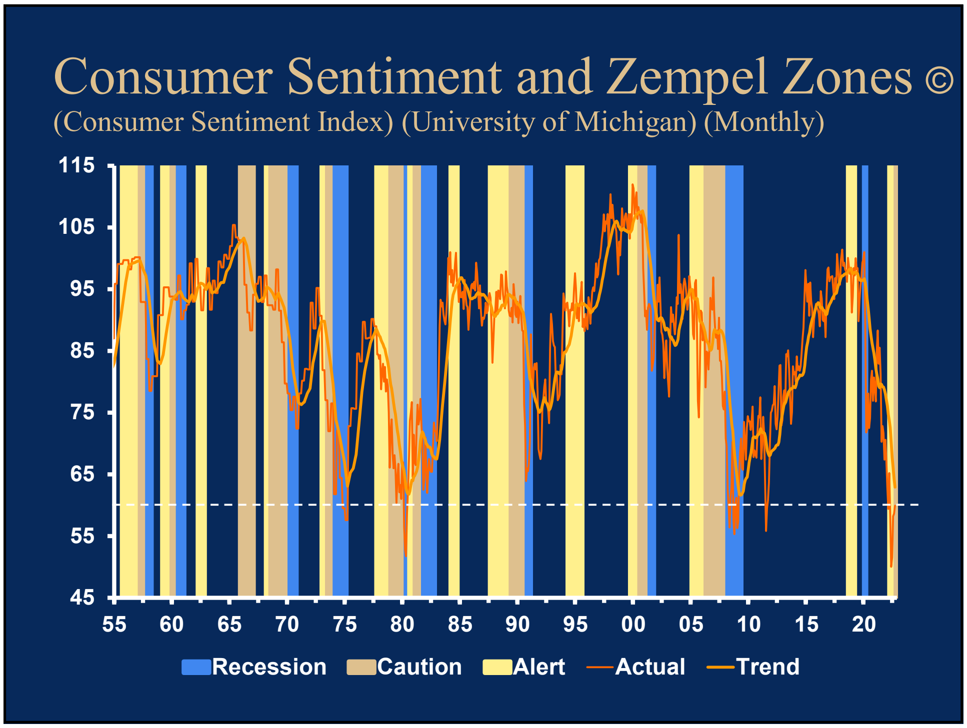
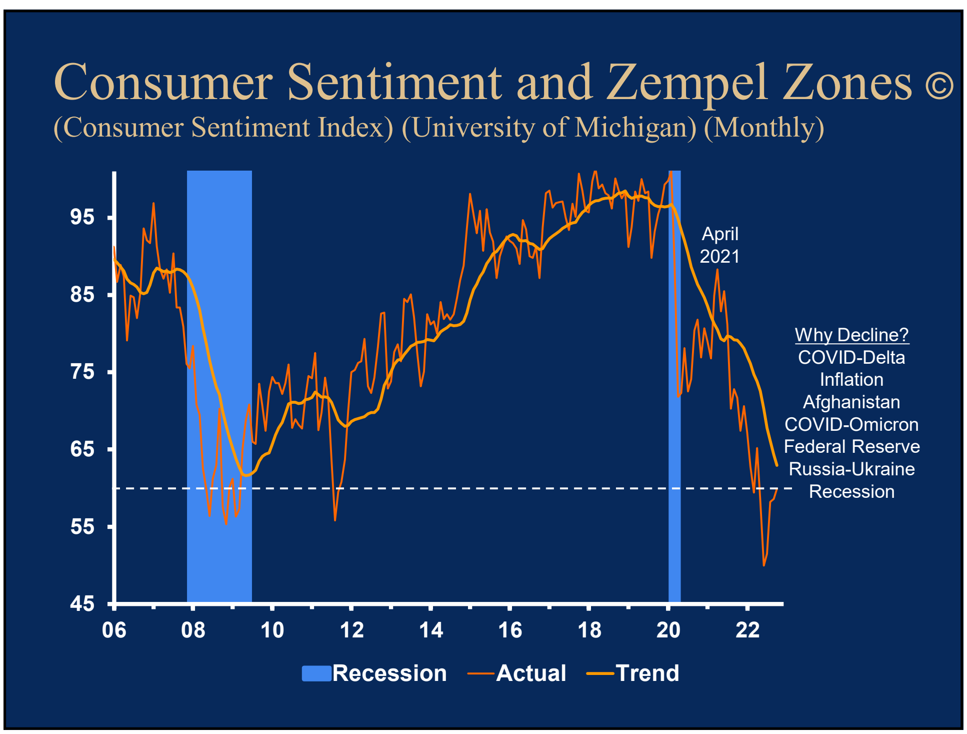
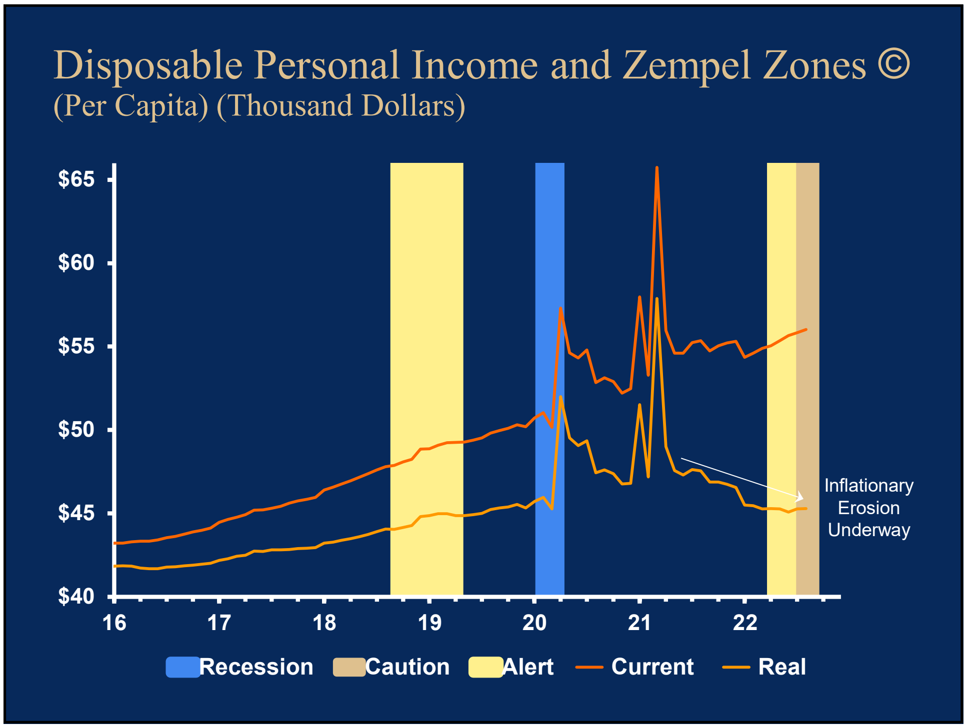
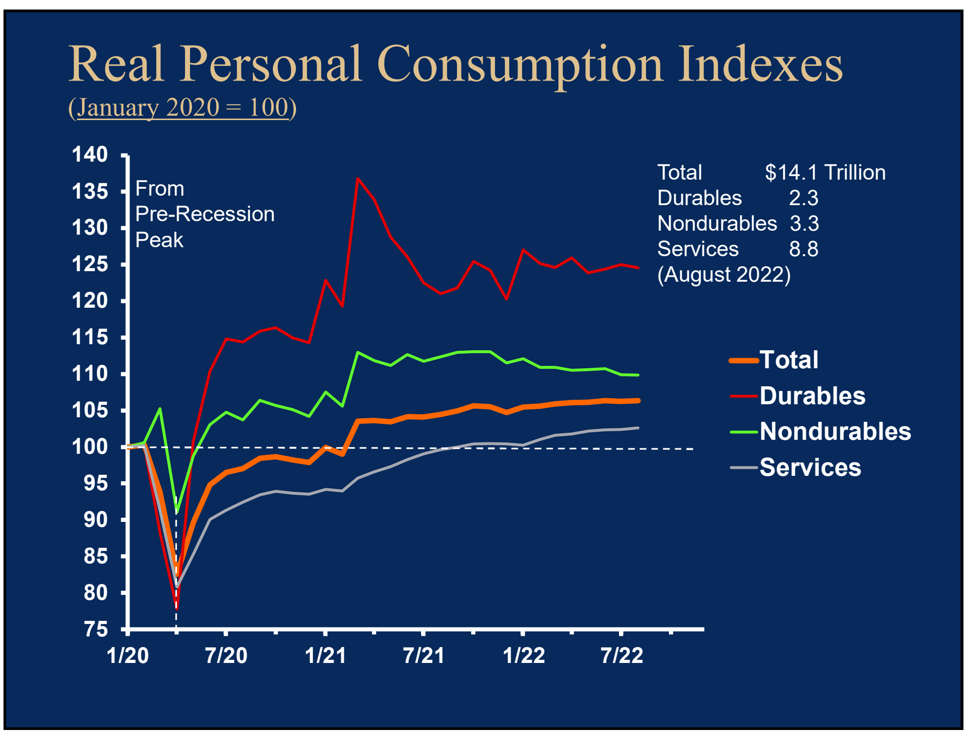
The Economic and Market Outlook
2022 – 2028

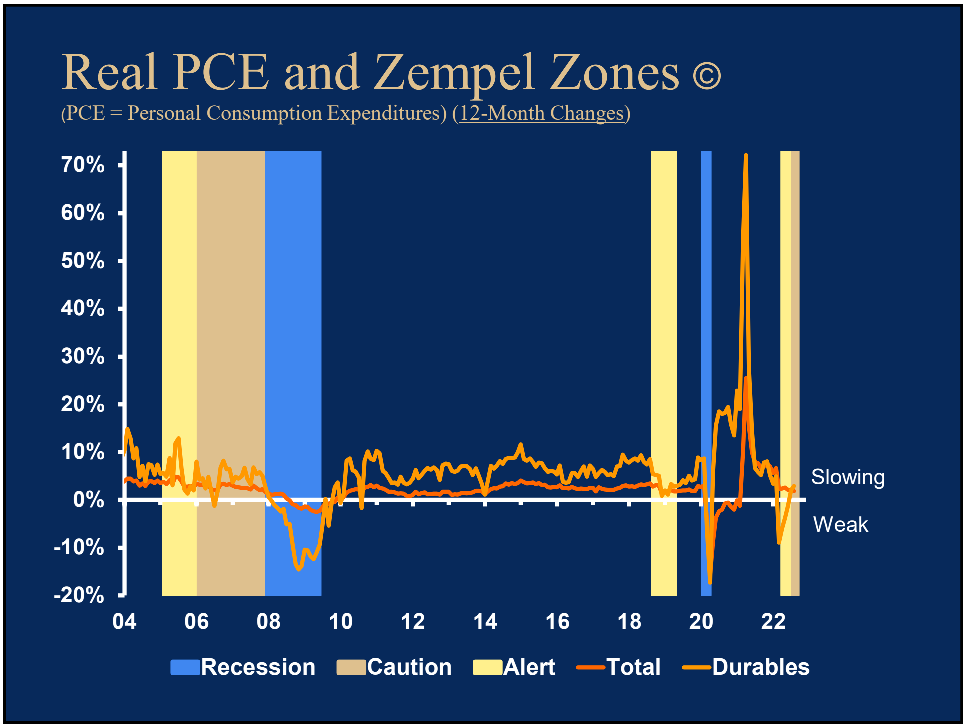
How Will Sectors Perform?

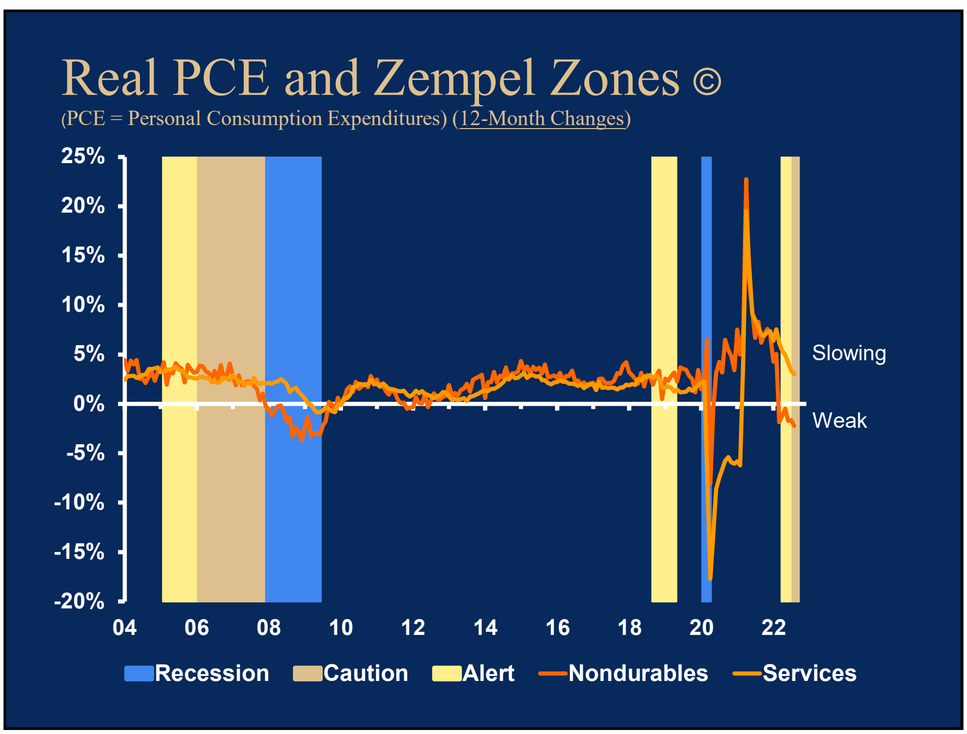

Consumer Sentiment and Zempel Zones ©
(Consumer Sentiment Index) (University of Michigan) (Monthly)
115
105
95
85
75
65
55
45
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession Caution Alert Actual Trend

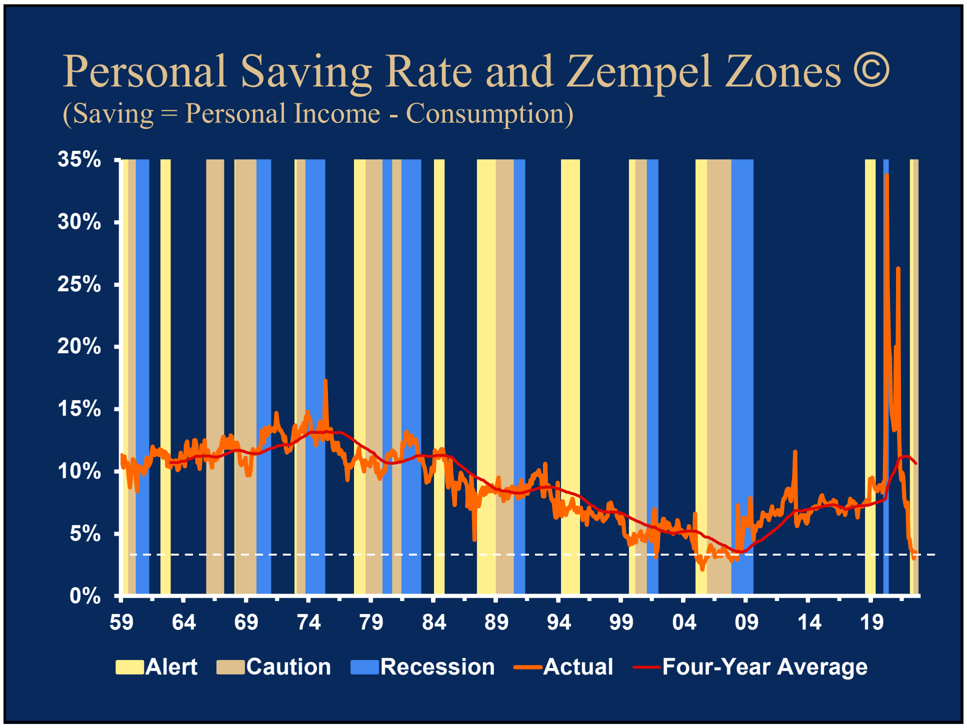

Consumer Sentiment and Zempel Zones ©
(Consumer Sentiment Index) (University of Michigan) (Monthly)
95
85
75
65
55
45
06 08 10 12 14 16 18 20 22
April
2021
Why Decline?
COVID-Delta
Inflation
Afghanistan
COVID-Omicron
Federal Reserve
Russia-Ukraine
Recession
Recession Actual Trend

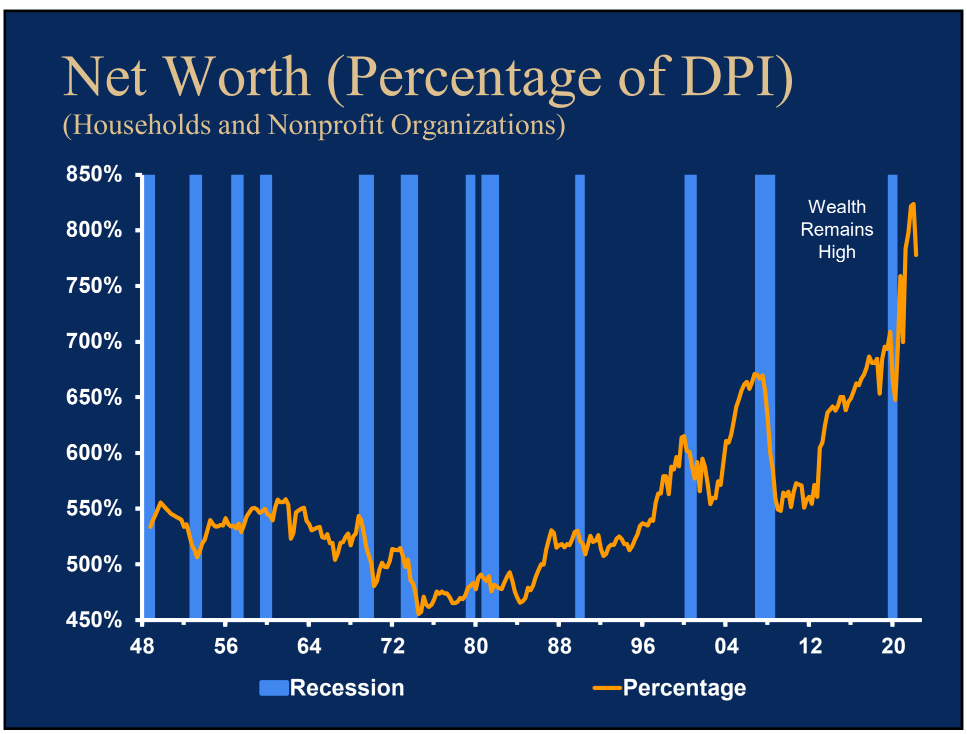

Disposable Personal Income and Zempel Zones ©
(Per Capita) (Thousand Dollars)
$65
$60
$55
$50
$45
$40
16
17
18
19
20
21
22
Inflationary Erosion Underway
Recession
Caution
Alert
Current
Real

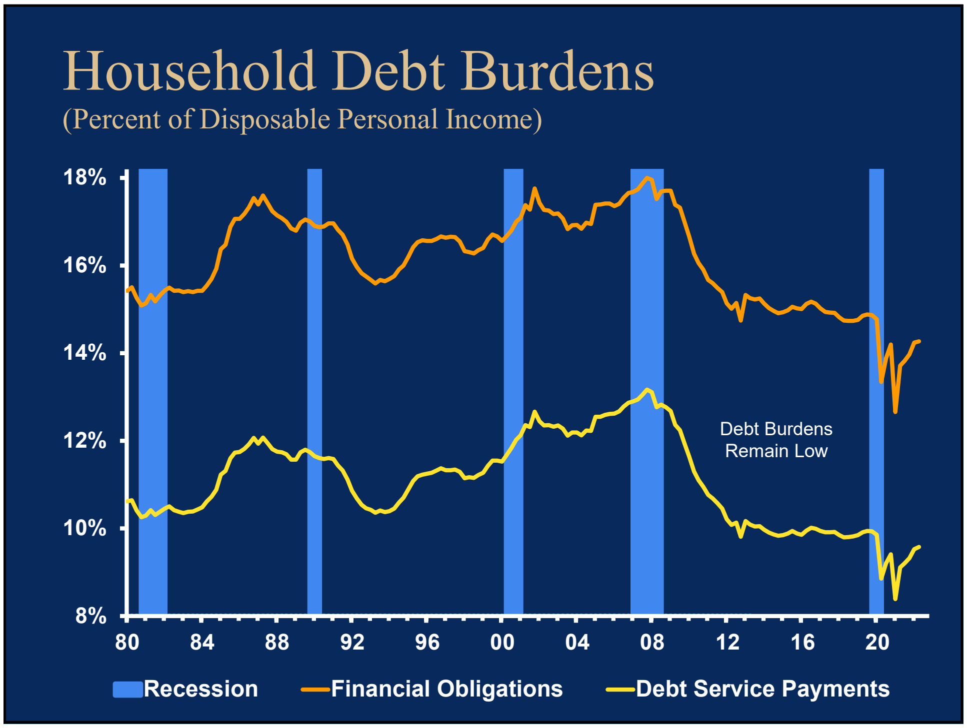

Real Personal Consumption Indexes
(January 2020 = 100)
140
135
130
125
120
115
110
105
100
95
90
85
80
75
1/20
7/20
1/21
7/21
1/22
7/22
From Pre-Recession Peak
Total $14.1 Trillion
Durables 2.3
Nondurables 3.3
Services 8.8
(August 2022)
Total
Durables
Nondurables
Services

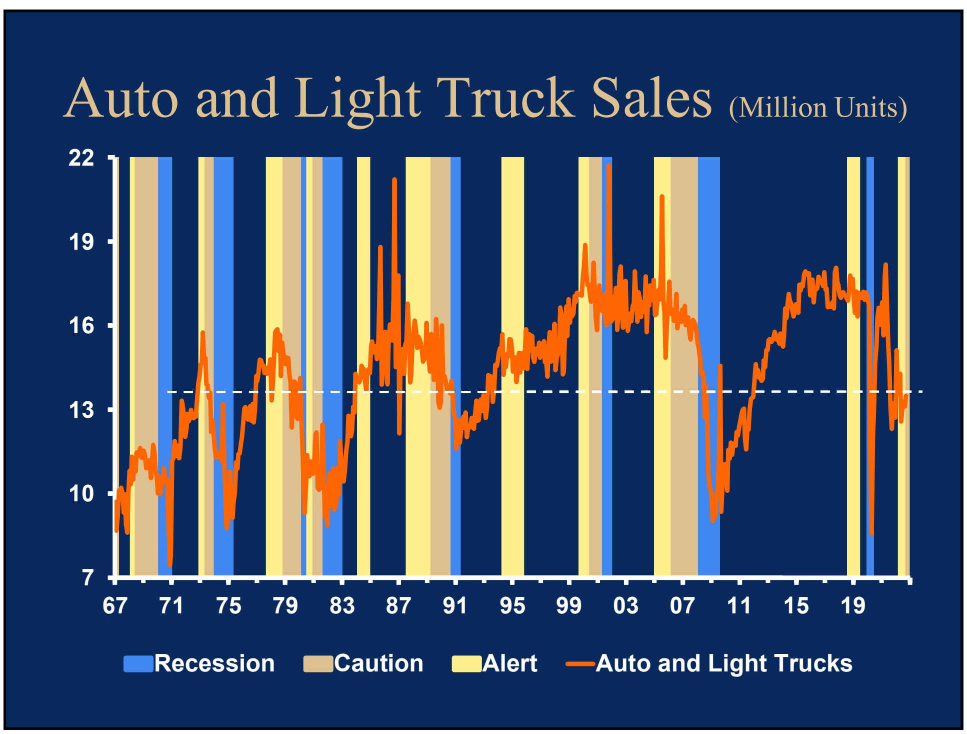

Real PCE and Zempel Zones ©
(PCE = Personal Consumption Expenditures) (12-Month Changes)
70%
60%
50%
40%
30%
20%
10%
0%
-10%
-20%
04
06
08
10
12
14
16
18
20
22
Slowing
Weak
Recession
Caution
Alert
Total
Durables


Real PCE and Zempel Zones ©
(PCE = Personal Consumption Expenditures) (12-Month Changes)
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
04
06
08
10
12
14
16
18
20
22
Slowing
Weak
Recession
Caution
Alert
Nondurables
Services

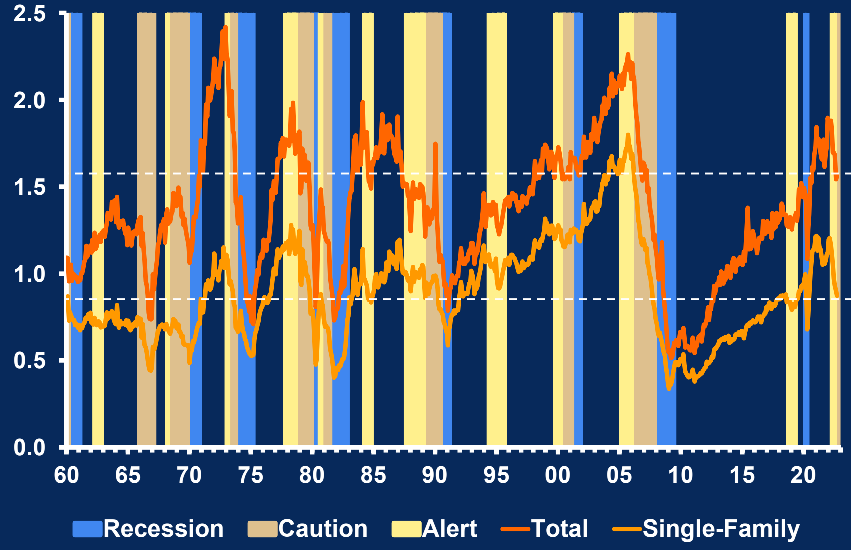

Personal Saving Rate and Zempel Zones ©
(Saving = Personal Income - Consumption)
35%
30%
25%
20%
15%
10%
5%
0%
59
64
69
74
79
84
89
94
99
04
09
14
19
Alert
Caution
Recession
Actual
Four-Year Average


Net Worth (Percentage of DPI)
(Households and Nonprofit Organizations)
850%
800%
750%
700%
650%
600%
550%
500%
450%
48
56
64
72
80
88
96
04
12
20
Wealth Remains High
Recession
Percentage


Household Debt Burdens
(Percent of Disposable Personal Income)
18%
16%
14%
12%
10%
8%
80
84
88
92
96
00
04
08
12
16
20
Debt Burdens Remain Low
Recession
Financial Obligations
Debt Service Payments

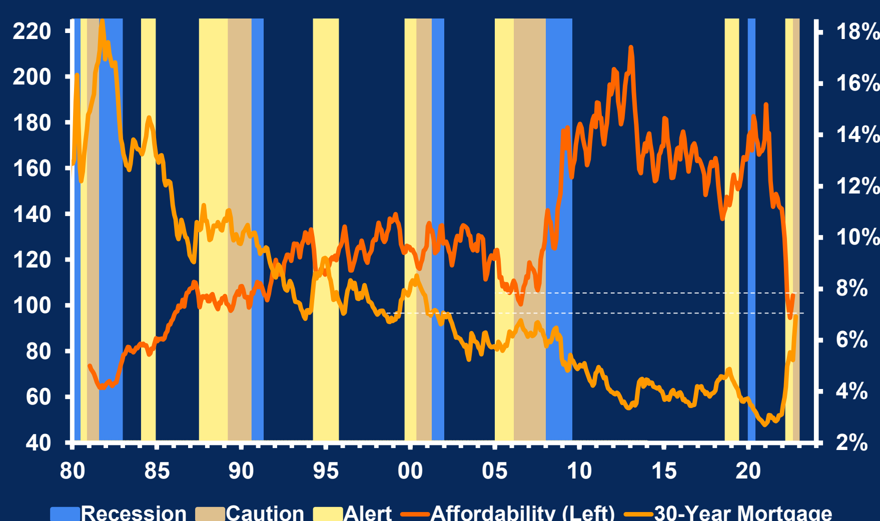

Auto and Light Truck Sales (Million Units)
22
19
16
13
10
7
67
71
75
79
83
87
91
95
99
03
07
11
15
19
Recession
Caution
Alert
Auto and Light Trucks

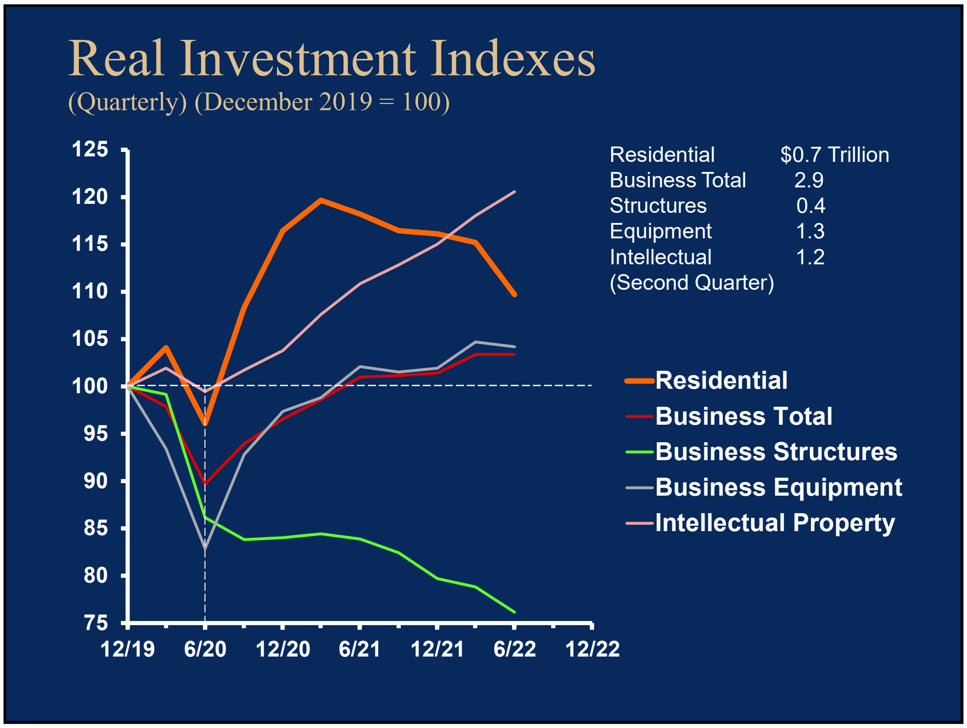
Housing Permits (Million Units)



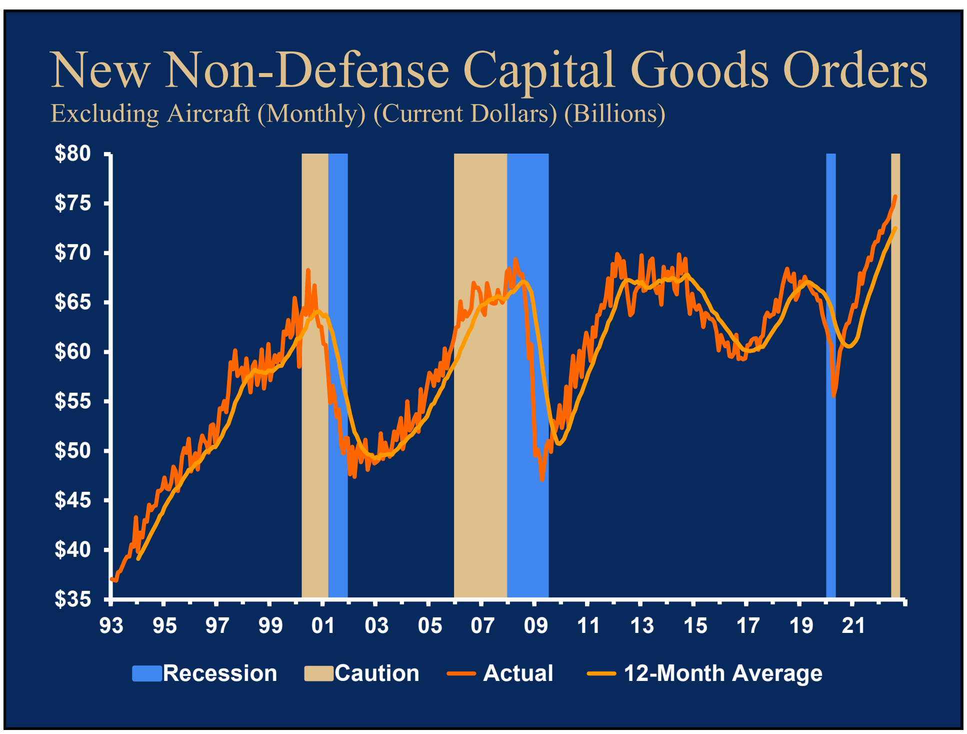
Mortgage Rate and Affordability

(National Fixed-Rate Average) (Fixed-Rate Affordability Index)

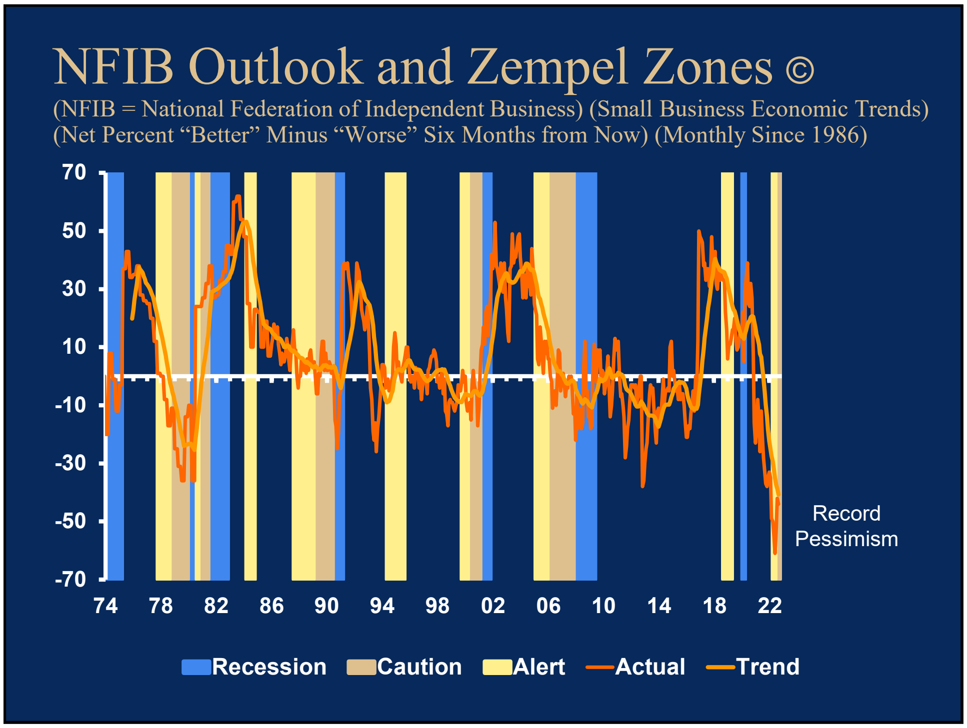


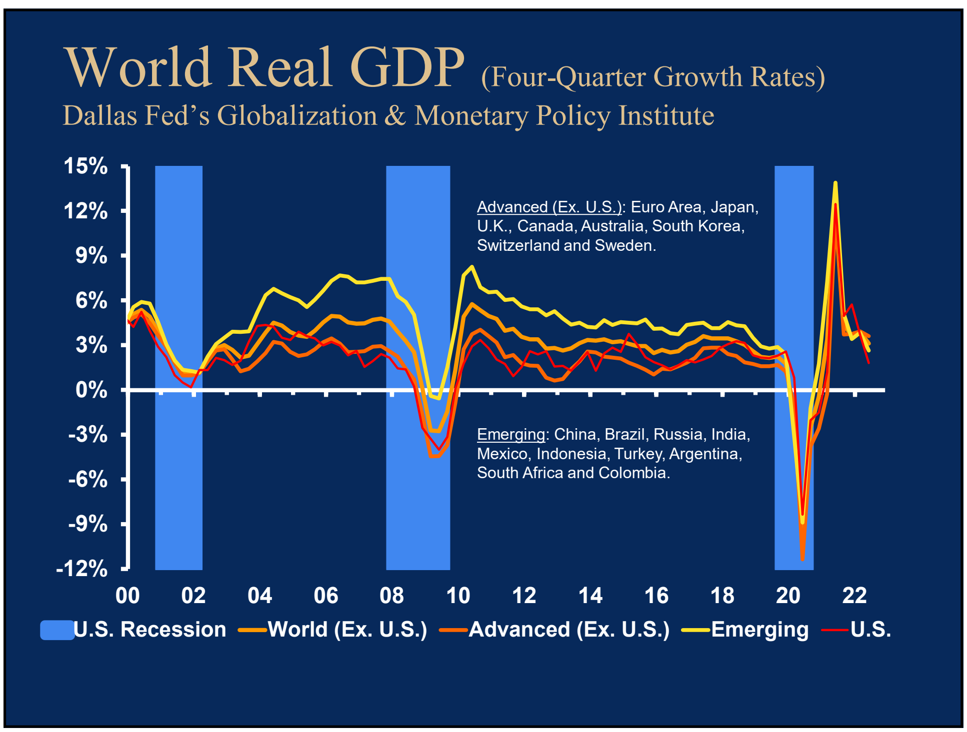


Real Investment Indexes
(Quarterly) (December 2019 = 100)
125
120
115
110
105
100
95
90
85
80
75
12/19
6/20
12/20
6/21
12/21
6/22
12/22
Residential $0.7 Trillion
Business Total 2.9
Structures 0.4
Equipment 1.3
Intellectual 1.2
(Second Quarter)
Residential
Business Total
Business Structures
Business Equipment
Intellectual Property



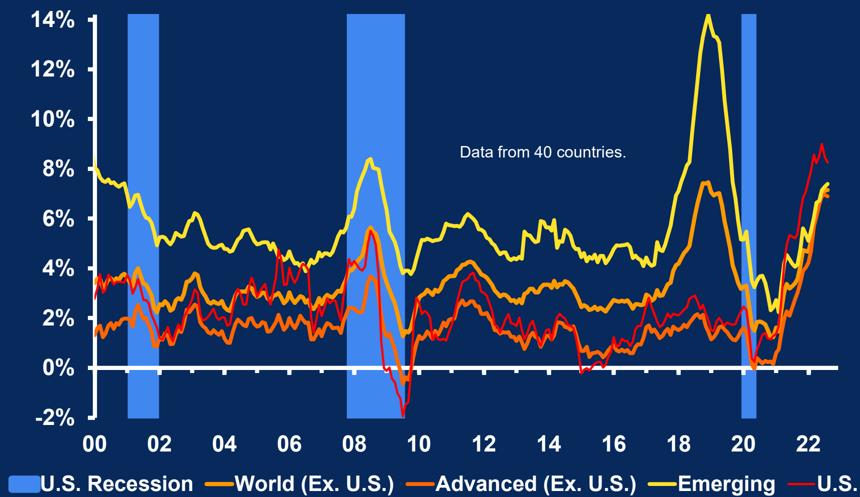
New Non-Defense Capital Goods Orders
Excluding Aircraft (Monthly) (Current Dollars) (Billions)
$80
$75
$70
$65
$60
$55
$50
$45
$40
$35
93
95
97
99
01
03
05
07
09
11
13
15
17
19
21
Recession
Caution
Actual
12-Month Average


NFIB Outlook and Zempel Zones ©
(NFIB = National Federation of Independent Business) (Small Business Economic Trends)
(Net Percent "Better" Minus "Worse" Six Months from Now) (Monthly Since 1986)
70
50
30
10
-10
-30
-50
-70
74
78
82
86
90
94
98
02
06
10
14
18
22
Record Pessimism
Recession
Caution
Alert
Actual
Trend


World Real GDP (Four-Quarter Growth Rates)
Dallas Fed's Globalization & Monetary Policy Institute
15%
12%
9%
6%
3%
0%
-3%
-6%
-9%
-12%
Advanced (Ex. U.S.): Euro Area, Japan, U.K., Canada, Australia, South Korea, Switzerland and Sweden.
Emerging: China, Brazil, Russia, India, Mexico, Indonesia, Turkey, Argentina, South Africa and Colombia.
00
02
04
06
08
10
12
14
16
18
20
22
U.S. Recession
World (Ex. U.S.)
Advanced (Ex. U.S.)
Emerging
U.S.

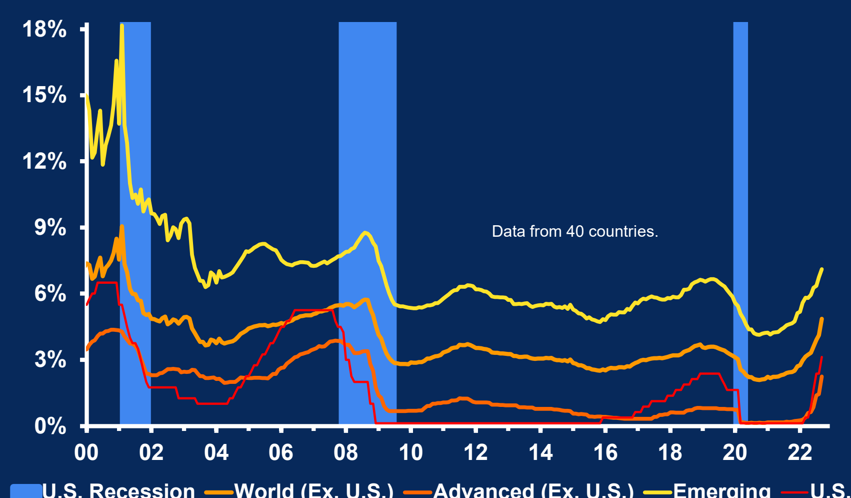
World Headline CPI Inflation Rates

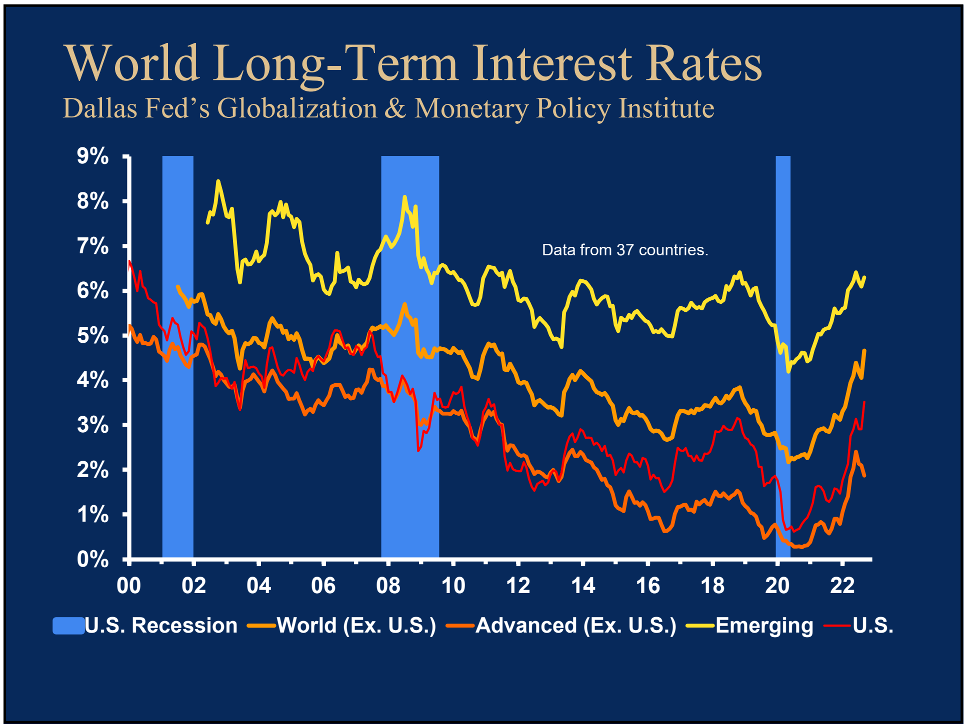
Dallas Fed's Globalization & Monetary Policy Institute



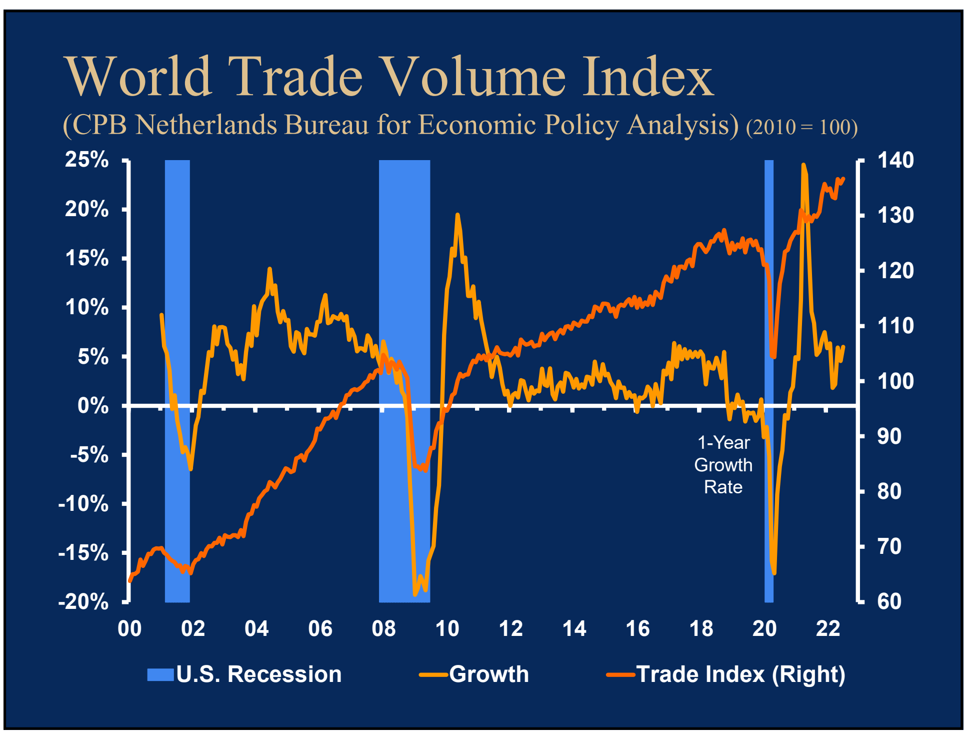
World Policy Short-Term Interest Rates

Dallas Fed's Globalization & Monetary Policy Institute

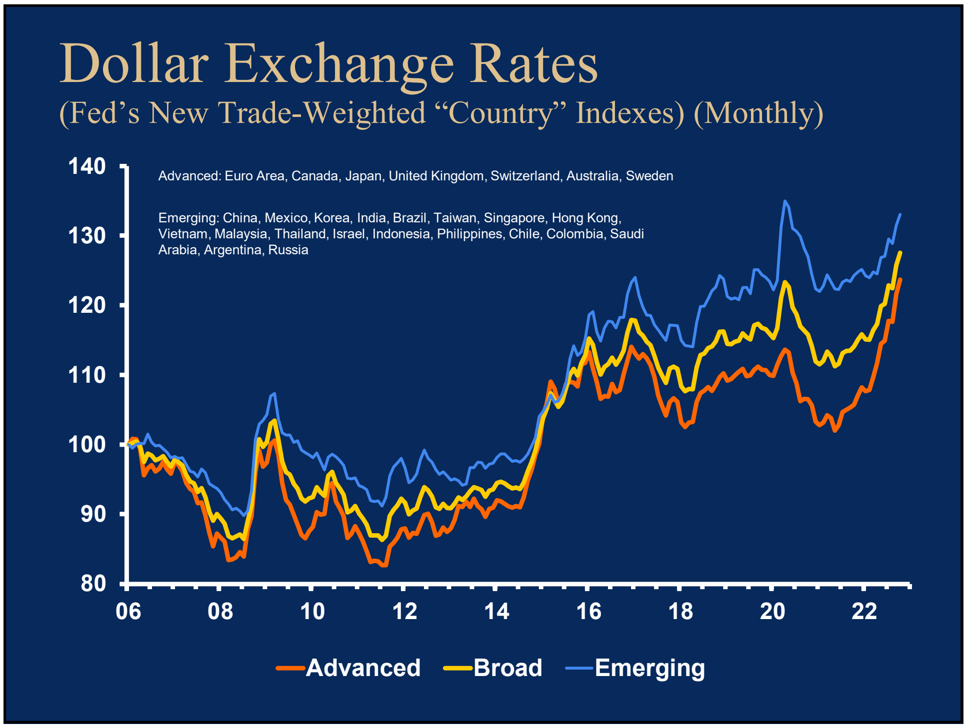


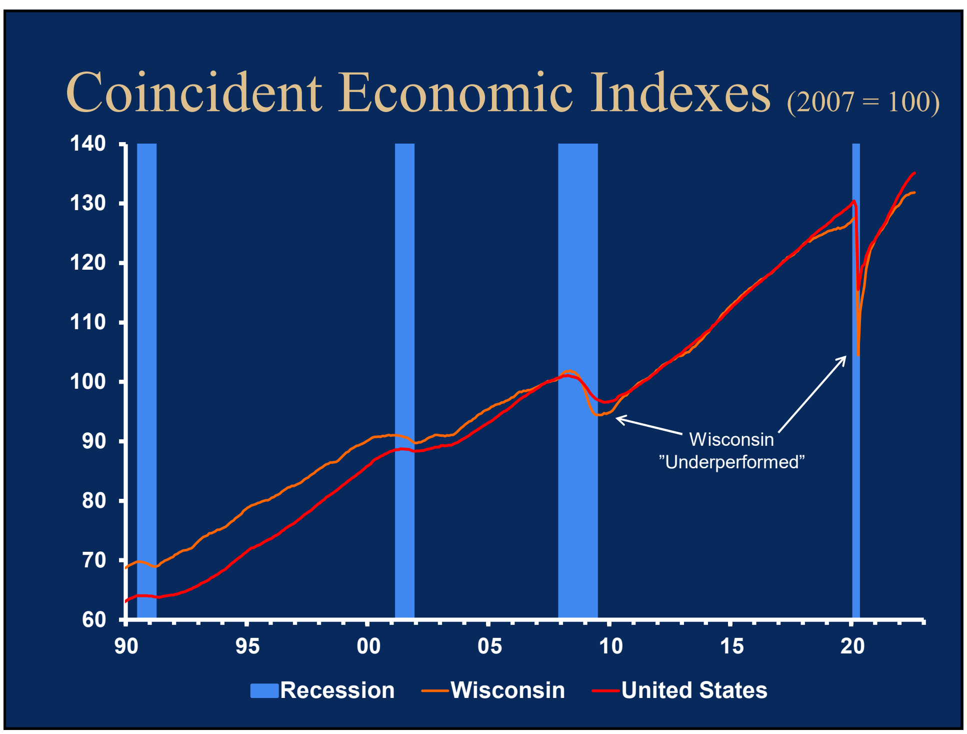


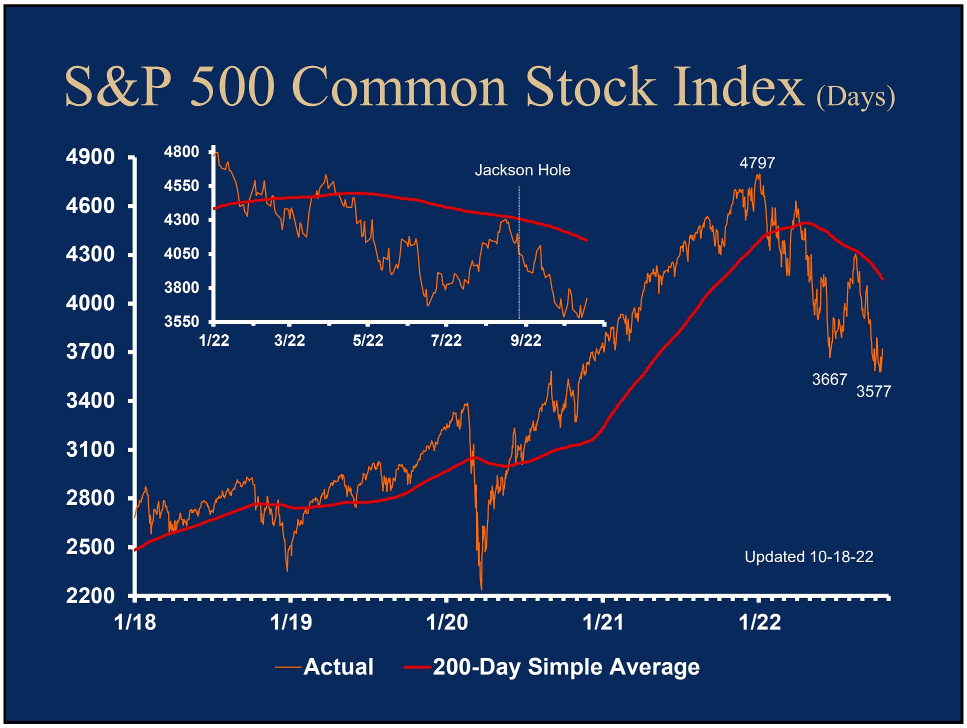
World Long-Term Interest Rates
Dallas Fed's Globalization & Monetary Policy Institute
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
00
02
04
06
08
10
12
14
16
18
20
22
Data from 37 countries.
U.S. Recession
World (Ex. U.S.)
Advanced (Ex. U.S.)
Emerging
U.S.

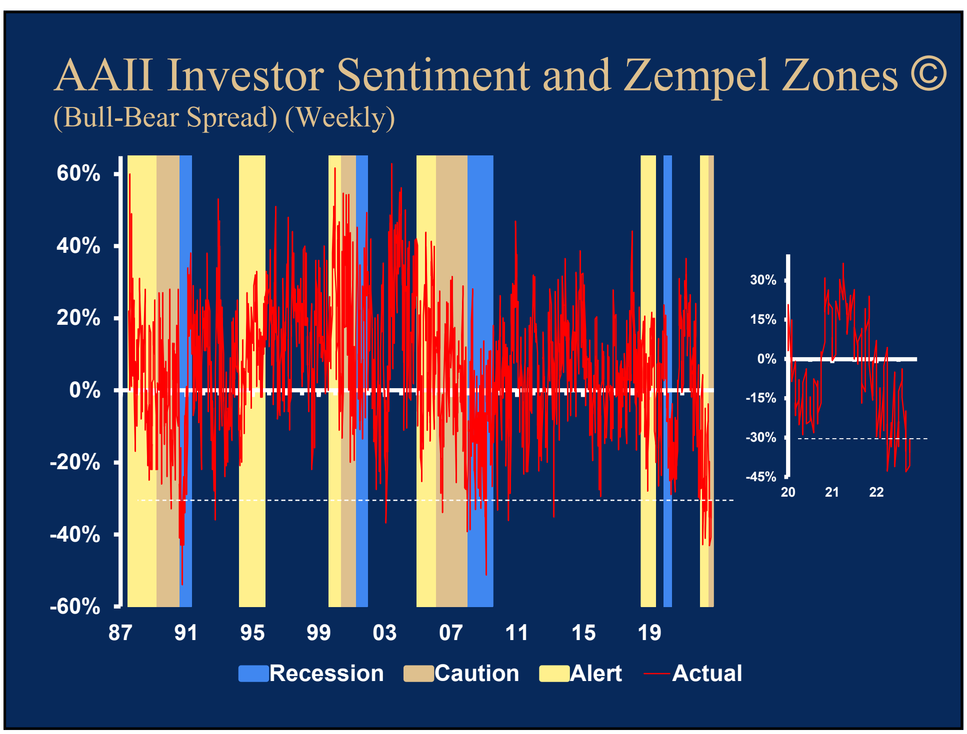


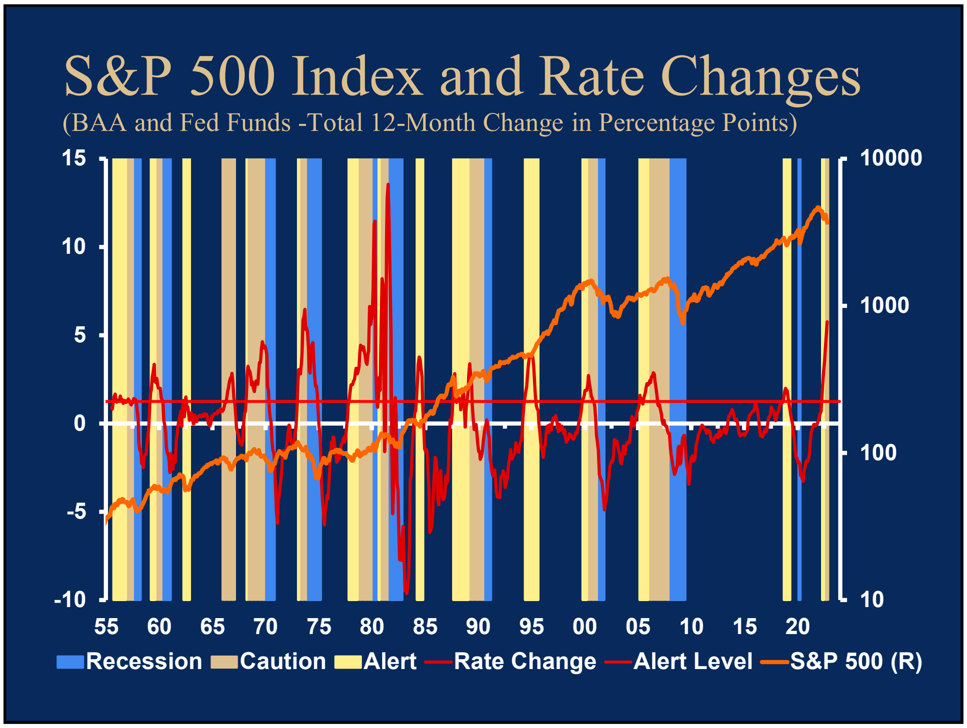
World Trade Volume Index
(CPB Netherlands Bureau for Economic Policy Analysis) (2010 = 100)
25%
20%
15%
10%
5%
0%
-5%
-10%
-15%
-20%
140
130
120
110
100
90
80
70
60
00
02
04
06
08
10
12
14
16
18
20
22
1-Year Growth Rate
U.S. Recession
Growth
Trade Index (Right)

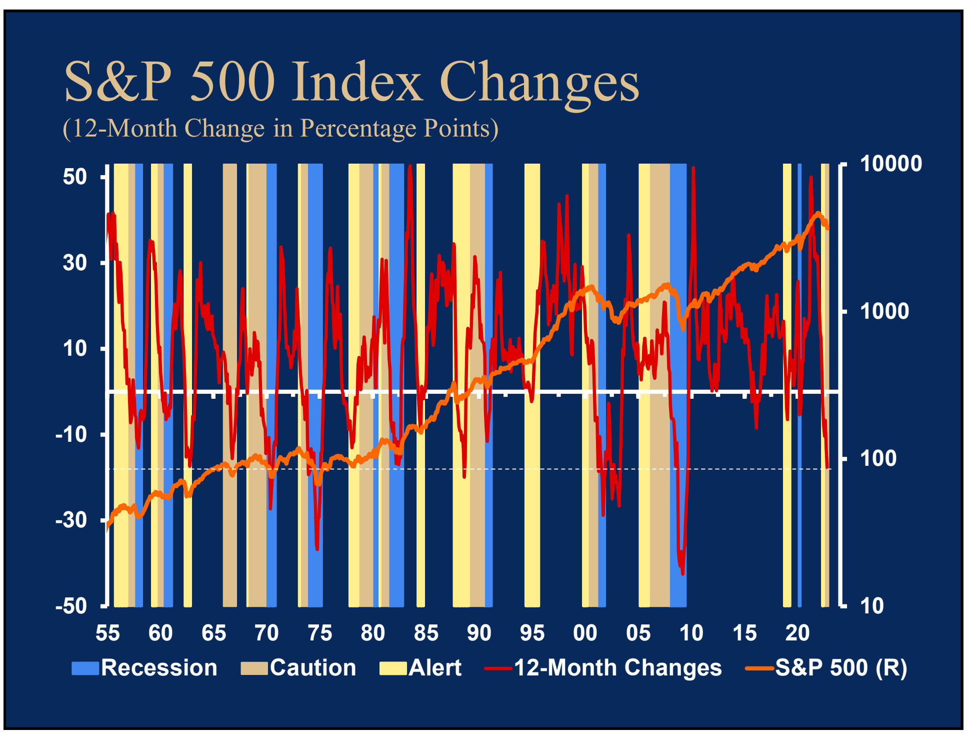

Dollar Exchange Rates
(Fed's New Trade-Weighted "Country" Indexes) (Monthly)
Advanced: Euro Area, Canada, Japan, United Kingdom, Switzerland, Australia, Sweden
Emerging: China, Mexico, Korea, India, Brazil, Taiwan, Singapore, Hong Kong, Vietnam, Malaysia, Thailand, Israel, Indonesia, Philippines, Chile, Colombia, Saudi Arabia, Argentina, Russia
140
130
120
110
100
90
80
06
08
10
12
14
16
18
20
22
Advanced
Broad
Emerging

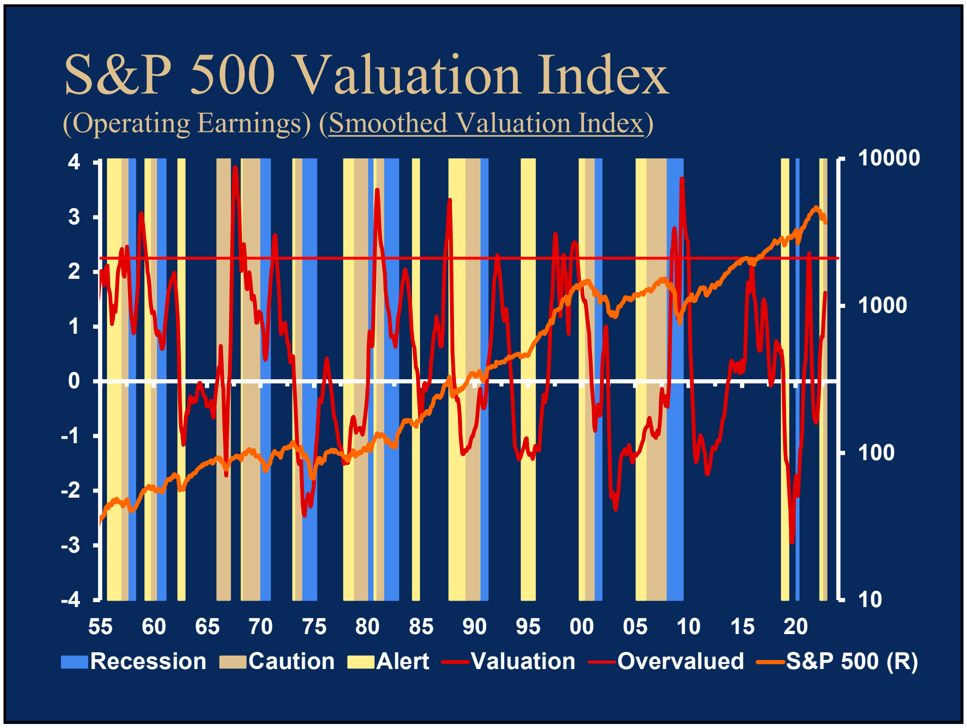

Coincident Economic Indexes (2007 = 100)
140
130
120
110
100
90
80
70
60
90
95
00
05
10
15
20
Wisconsin
"Underperformed"
Recession
Wisconsin
United States

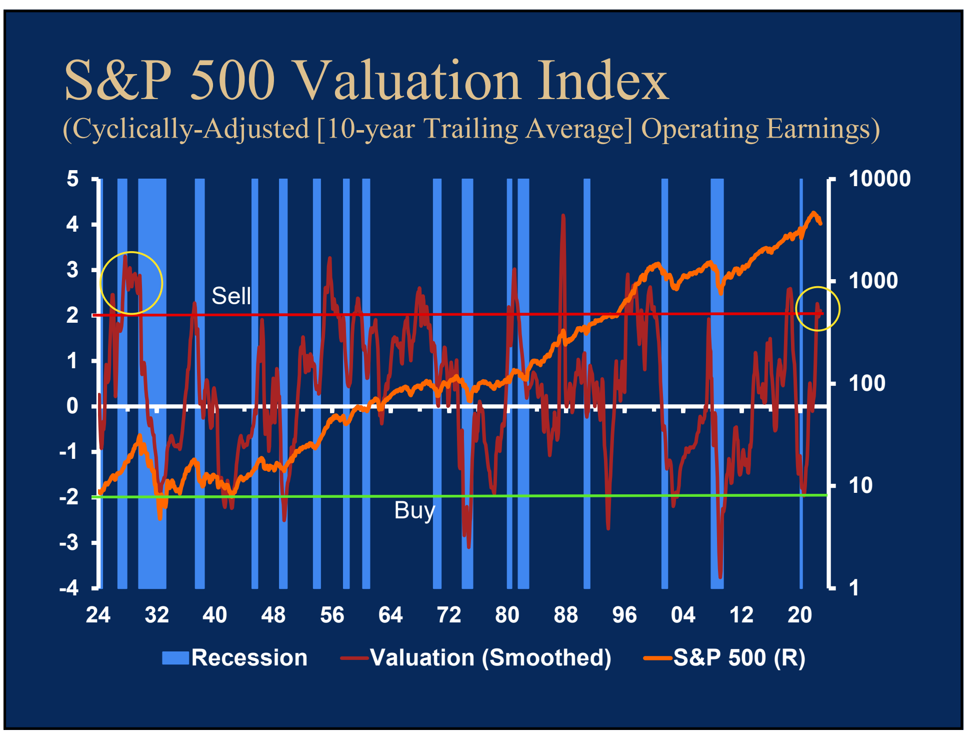

S&P 500 Common Stock Index (Days)
4900
4600
4300
4000
3700
3400
3100
2800
2500
2200
1/18
1/19
1/20
1/21
1/22
4800
4550
4300
4050
3800
3550
1/22
3/22
5/22
7/22
9/22
Jackson Hole
4797
3667
3577
Updated 10-18-22
Actual
200-Day Simple Average


AAII Investor Sentiment and Zempel Zones ©
(Bull-Bear Spread) (Weekly)
60%
40%
20%
0%
-20%
-40%
-60%
87
91
95
99
03
07
11
15
19
30%
15%
0%
-15%
-30%
-45%
20
21
22
Recession
Caution
Alert
Actual


S&P 500 Index and Rate Changes
(BAA and Fed Funds -Total 12-Month Change in Percentage Points)
15
10
5
0
-5
-10
10000
1000
100
10
55
60
65
70
75
80
85
90
95
00
05
10
15
20
Recession
Caution
Alert
Rate Change
Alert Level
S&P 500 (R)


S&P 500 Index Changes
(12-Month Change in Percentage Points)
50
30
10
-10
-30
-50
10000
1000
100
10
55
60
65
70
75
80
85
90
95
00
05
10
15
20
Recession
Caution
Alert
12-Month Changes
S&P 500 (R)


S&P 500 Valuation Index
(Operating Earnings) (Smoothed Valuation Index)
4
3
2
1
0
-1
-2
-3
-4
10000
1000
100
10
55 60 65 70 75 80 85 90 95 00 05 10 15 20
Recession
Caution
Alert
Valuation
Overvalued
S&P 500 (R)


S&P 500 Valuation Index
(Cyclically-Adjusted [10-year Trailing Average] Operating Earnings)
5
4
3
2
1
0
-1
-2
-3
-4
10000
1000
100
10
1
Sell
Buy
24 32 40 48 56 64 72 80 88 96 04 12 20
Recession
Valuation (Smoothed)
S&P 500 (R)

WICPA Accounting and Auditing Conference

The Economic and Market Outlook
2022 – 2028

Why So Much Confusion?
What Do “Best Indicators” Predict?
Has Recession Started?
Can Recession Be Averted? Limited?
How Will Sectors Perform?

Questions…

Clare W. Zempel, CFA, CBE
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Applied Economics and Financial Market Analysis
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CZempel@ZempelStrategic.com
(414) 351-1250

9:25 – 10:15 a.m.

Testing IT Controls in Today's Environment

Chris Semrow, CPA, CISA, *Senior Manager, BDO USA LLP*

TESTING IT CONTROLS IN TODAY'S ENVIRONMENT

November 16, 2022

CS1

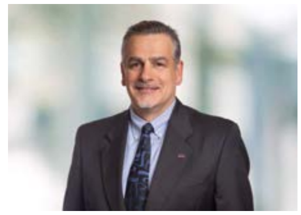
Session Agenda

- Introduction
- What are IT Controls? A Refresher
- Trends in Technology & IT Controls
- The Changing Landscape of Testing IT Controls
- Questions?

Slide 2

CS1 Chris Semrow, 10/19/2022

Introductions



Chris Semrow, CPA, CISA
csemrow@bdo.com
Senior Manager – BDO Digital

- ✓ 25+ Years of IT Audit & Assurance experience (Public & Private)
- ✓ 10+ Years IS/Business Consulting
- ✓ CPA & CISA Certificates
- ✓ Areas of Expertise:
  - ❖ IT Audit & IT Risk Assessments
  - ❖ ISO & Privacy
  - ❖ SOX / MAR Reporting
  - ❖ SOC Reporting (SOC 1, SOC 2)
  - ❖ Lean/Six Sigma, Business Process Improvement
  - ❖ Cybersecurity Assessments
  - ❖ Disaster Recovery / Business Continuity Process

IT Controls – A Refresher

IT Controls – A Refresher

IT General Controls (ITGCs) are the basic controls that can be applied to IT systems and infrastructure such as:

- Applications
- Operating Systems
- Databases
- IT Infrastructure (Servers, workstations, firewalls, etc)

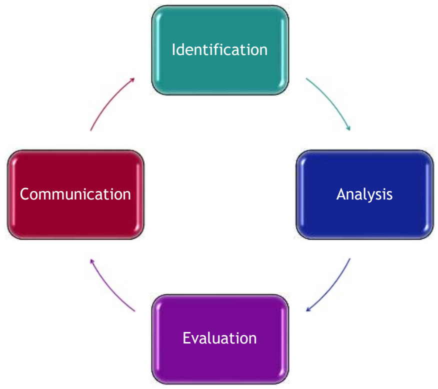
Objective of ITGCs is to ensure the integrity of the data and processes that these systems and areas support.

ITGCs are routinely examined by external audit firms and if these controls aren't sufficient, it could have disastrous results on your financial reporting or security controls (SOX audits)

IT Controls – A Refresher

IT Controls – A Refresher

First step: IT Risk Assessment



* Audits are performed with a focus on risk; specifically identifying potential risk, threats and vulnerabilities to IT operations, integrity of data, internal controls, automated controls and application controls are key objectives.

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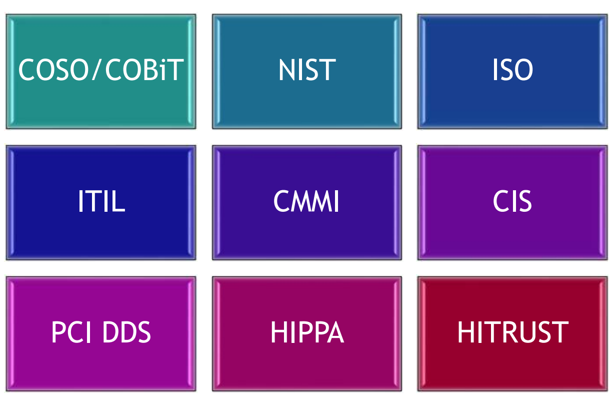
IT Controls – A Refresher

IT General Controls are based on a framework:



There are many frameworks for organizations to leverage and utilize in their IT controls structure. None are more "correct" than any other; the organization decides which is appropriate for their environment.

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Trends in Technology & IT Controls

BDO

Trends in Technology & IT Controls

Emerging Technologies:

Robotic Process Automation (RPA)	Enterprise Metaverse
Artificial Intelligence (AI)	Cloud-Native Platforms
Machine Learning Code Generation	Virtual & Augmented Reality
Data Analytics	Cybersecurity
Cryptocurrency & Bitcoin	Quantum Computing

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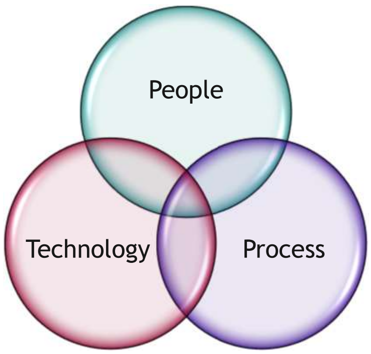
Trends in Technology & IT Controls

Golden Triangle:



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Trends in Technology & IT Controls

Challenges for businesses today:

- Technology & Process:
  - Corralling the emerging technologies to work for an organization
    - No longer the "It will take jobs away…" mentality
    - Automation is critical to being successful in today's environment
  - New technologies:
    - "How can we use those advanced technologies to handle the high volume, high transaction work that we have in our workflows and processes?"
- People:
  - Staffing shortages
  - Hybrid workforce
  - Becomes necessary to embrace technology as a solution

BDO

Trends in IT Controls & IT Testing/Audit

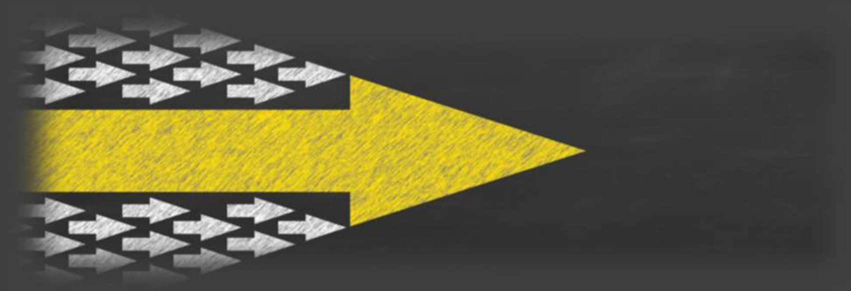
Trends in IT Controls & IT Testing/Audit:

Cybersecurity domains, while not emerging, still represent a strong foundational area for review (more emphasis):	ITGC's and automated process controls are part of the core audit plan:	Data Privacy continues to be a prominent, high-risk area for organizations (given the rise in regulatory compliance and the evolution of the cloud):
• Threat & Vulnerability Management assessments	• Backup & Recovery effectiveness	• Data Governance assessment
• Identity & Access Management design and implementation	• Segregation of Duties assessment	• Privacy Regulation compliance
• IT Asset Management audits	• IT Change Management effectiveness	• Cloud Strategy & Governance
• Network Configuration & Hardening review	• Continuous controls monitoring	• Cloud Migration assessments
• Remote, Wireless and Mobile security assessment		
• IT Operational risk assessment		

Trends in IT Controls & IT Testing/Audit

- Data Analytics
- Compliance Landscape
- Understanding the Cloud & "_aaS" Model
- What's a SOC Report?
- Cyber, Cyber Cyber

- The Changing Landscape of Testing IT Controls



BDO

The Changing Landscape of Testing IT Controls

Where Do We Test in 2022 & Beyond?

How Do We Test in 2022 & Beyond?

What Do We Test in 2022 & Beyond?

BDO

Where Do We Test in 2022 & Beyond – People & Process

- Prior to 2020 vs Post 2020 - **VAST DIFFERENCE**
  - Location, Location, Location
- Pivot to a Remote Model
  - Stay-at-Home workforce
  - Flexibility to work non-traditional hours (Flex Time)
- Challenges from this:
  - How to manage this "New" workforce
    - Productivity – What's going to happen?
    - Efficiency & Effectiveness of conducting work
    - Technical expertise & infrastructure to support
    - Mental well being of the workforce

BDO

How Do We Test in 2022 and Beyond - People

- With a focus on Remote & Mobility:
  - Planning & Project Management
    - Effective and well practiced project management, processes and technology capabilities
      - Use the cloud
      - Be more agile
      - Emphasize Time management
      - Rely on Data Analytics
  - Enable the Future of Work
    - Digital Transformation
    - Revisit the Tools of the Trade
    - Data Strategy
    - Shift from Centralized to De-Centralized Mind Set
  - The Human Side
    - Respect & Promote the Work/Life Balance
    - Focus on Communication
    - Leadership Matters

BDO

How Do We Test in 2022 and Beyond - Technology

Robotic Process Automation (RPA)

- A rules-based software application programmed to automate activities
- Best used with repetitive tasks that interact with multiple applications
  - Tasks occur with significant frequency with a significant effort
- Replicates human interactions with technology, mimicking common tasks
- Contributes to both cost and hours savings

BDO

How Do We Test in 2022 and Beyond - Technology

Examples of RPA:

- Configured to identify & respond to potential fraud situations (e.g. money laundering)
- Help detect suspicious logs associated IT Systems
- SOD Testing (user access testing) can automated through RPA.
- RPA can be used to perform reconciliations of data between systems
- RPA can assist with entire audit populations rather than sampling

Key Considerations for RPA:

- Testing strategies should consider data quality, upstream/downstream dependencies on systems & humans
- Governance structure needs to consider scaling and risk control management of automation
- With RPA, comes a shift in an organization’s culture, working practices and overall structure
- Potential non-technical personnel develop RPA creates a need for more governance over this

BDO

How Do We Test in 2022 and Beyond - Technology

Data Analytics
- Involves analyzing complete sets of data to identifying anomalies and trends for further investigation
- Allows for a deeper understanding of an organization's data
- Many organizations are reevaluating processes and procedures to make better use of their data
- Used in many organizations in continuous auditing and monitoring of data to identify risks and anomalies

BDO

How Do We Test in 2022 and Beyond - Technology

Advantages of Data Analytics
- Can be used to conduct better advanced planning, identifying problem areas early
- Can yield higher-quality audit evidence, using more data than audit sampling
- More likely to uncover a variety of anomalies that can provide management with more relevant results

Disadvantages of Data Analytics
- Use of Data Analytics can be restricted by using inaccessible or inaccurate data
  - Or data that cannot be converted into a format to be useful
- Requires a new set of competencies in which personnel may not have the training or experience
- Cost involved in tools to conduct Data Analytics

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What Do We Test in 2022 and Beyond

Areas of Focus:
- Cybersecurity
  - Network Controls (Firewall, VPN, Vulnerability Management, DLP, etc)
  - Mobile Computing & Handheld Devices
- Cloud
  - Ever-Changing Landscape (Hybrid, Multi-Cloud, XaaS)
  - Cloud Native Applications & Edge Computing

What do we Test in 2022 and Beyond

Areas of Focus:
- Compliance
  - Cyber Resillience
  - Ever-Changing Landscape of Compliance (US and Abroad)
    - US – State legislation
    - Abroad – Russia, China, etc.
- Vendor / Third Party Suppliers
  - Automation & Digitalization – big focus “need to have”
  - Data Analytics is a game changer
  - Cloud & Mobility

Thank You!

10:30 – 11:20 a.m.

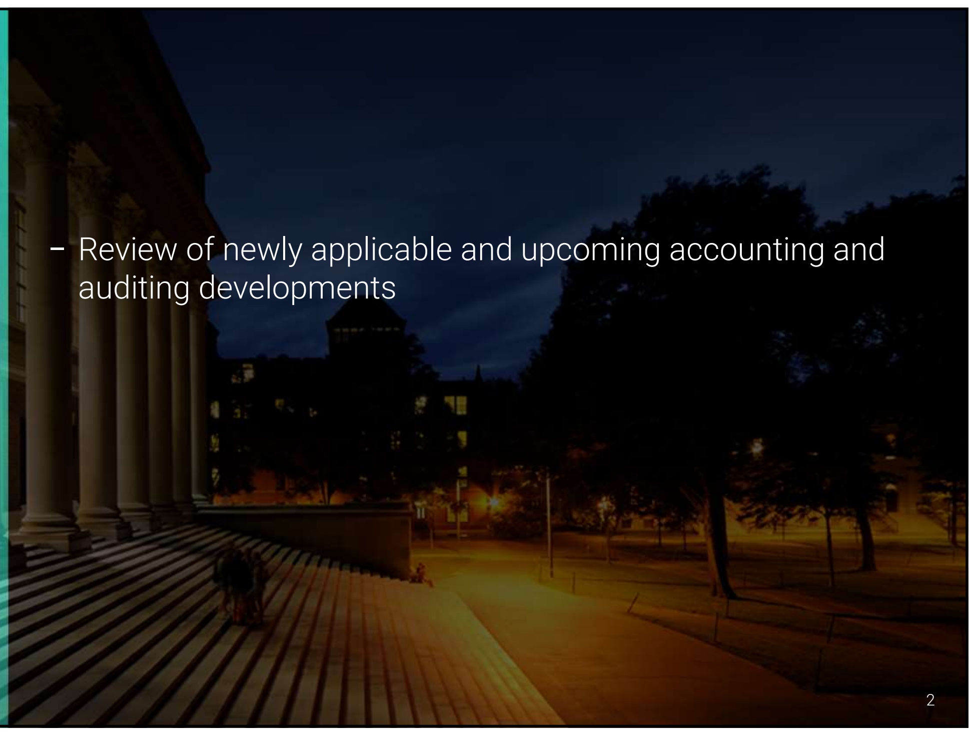
GASB & FASB Update

Anthony Cervini, CPA, CFE, *Partner-in-Charge, Sikich LLP*

Ryan Lay, CPA, *Partner, Baker Tilly*

2022 FASB Update

November 17, 2022



Overview

- Review of newly applicable and upcoming accounting and auditing developments

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Presenter

Ryan Lay, CPA
Audit Partner
Baker Tilly US, LLP

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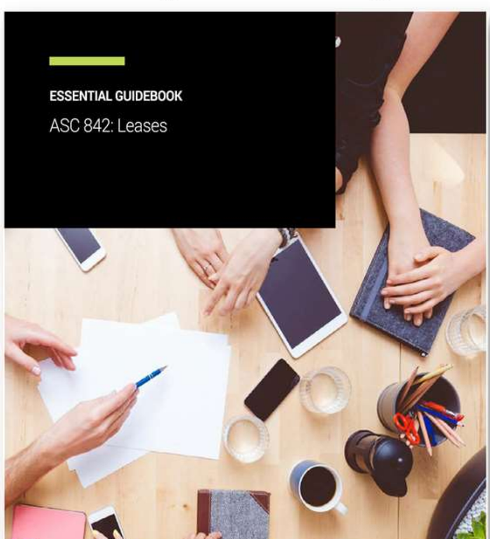
Accounting and auditing developments



- Audit opinion revisions
- Derivatives and hedging
- Retirement benefits
- Contributed nonfinancial assets
- Reference rate reform
- Leases
- Measurement of credit losses on financial instruments
- Intangibles – goodwill and other
- 2022 issued standards

Major revisions: Audit opinion

Most significant changes

1. Moving the opinion to the first part of the report
2. Adding more titles
3. Disclosing management's and the auditor's responsibility for going concern issues
4. Introducing key audit matters (KAM)
5. Expanding the disclosure of auditor responsibilities.

Major changes are detailed in the following AU-C sections

- AU-C 700—Forming an Opinion and Reporting on Financial Statements
- AU-C 701—Communicating Key Audit Matters in the Independent Auditor's Report
- AU-C 705—Modifications to the Opinion in the Independent Auditor's Report
- AU-C 706—Emphasis-of-Matter Paragraphs and Other-Matter Paragraphs in the Independent Auditor's Report

5

Major revisions: Audit opinion

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Exhibit
Example of New Report Form
Independent Auditor's Report

[Appropriate Addressee]

Opinion
We have audited the financial statements of ABC Company, which comprise the balance sheet as of December 31, 20X1, and the related statement of income, changes in stockholders' equity, and cash flows for the year then ended, and the related notes to the financial statements. In our opinion, the accompanying financial statements present fairly, in all material respects, the financial position of ABC Company as of December 31, 20X1, and the results of its operations and its cash flows for the year then ended in accordance with accounting principles generally accepted in the United States of America.

Basis for Opinion
We conducted our audits in accordance with auditing standards generally accepted in the United States of America (GAAS). Our responsibilities under those standards are further described in the Auditor's Responsibilities for the Audit of the Financial Statements section of our report. We are required to be independent of ABC Company and to meet our other ethical responsibilities, in accordance with the relevant ethical requirements relating to our audits. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matter
As discussed in Note X to the financial statements, subsequent to the date of the financial statements, there was a fire in ABC Company's production facilities. Our opinion is not modified with respect to this matter.

Key Audit Matters
Key audit matters are those matters that were communicated with those charged with governance and, in our professional judgment, were of most significance in our audit of the financial statements of the current period. These matters were addressed in the context of our audit of the financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

[Description of each key audit matter in accordance with AU-C 701]

Other Matter
The financial statements of ABC Company for the year ended December 31, 20X0, were audited by another auditor, who expressed an unmodified opinion on those statements on March 31, 20X1.

6

Major revisions: Audit opinion

Responsibilities of Management for the Financial Statements

Management is responsible for the preparation and fair presentation of the financial statements in accordance with accounting principles generally accepted in the United States of America, and for the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the financial statements, management is required to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for [insert the time period set by the applicable financial reporting framework].

Auditor's Responsibilities for the Audit of the Financial Statements

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. Reasonable assurance is a high level of assurance but is not absolute assurance and therefore is not a guarantee that an audit conducted in accordance with GAAS will always detect a material misstatement when it exists. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control. Misstatements are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users made on the basis of these financial statements.

In performing an audit in accordance with GAAS, we:

- Exercise professional judgment and maintain professional skepticism throughout the audit.
- Identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error, and design and perform audit procedures responsive to those risks. Such procedures include examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements.
- Obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of ABC Company's internal control. Accordingly, no such opinion is expressed.
- Evaluate the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluate the overall presentation of the financial statements.
- Conclude whether, in our judgment, there are conditions or events, considered in the aggregate, that raise substantial doubt about ABC Company's ability to continue as a going concern for a reasonable period of time.

We are required to communicate with those charged with governance regarding, among other matters, the planned scope and timing of the audit, significant audit findings, and certain internal control–related matters that we identified during the audit.

[Signature of the auditor's firm]
[City and state where the auditor's report is issued]
[Date of the auditor's report]

Accounting and auditing developments

ASU No. 2017-12, Derivatives and Hedging (Topic 815): Target Improvements to Accounting for Hedging Activities

1. Alignment of risk management activities and financial reporting
2. Risk component hedging
3. Accounting for the hedged item in fair value hedges of interest rate risk
4. Recognition and presentation of the effects of hedging instruments
5. Amounts excluded from the assessment of hedge effectiveness
6. Other simplifications of hedge accounting guidance

— Objective is to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements

— Makes certain targeted improvements to simplify the application of the hedge accounting guidance in current GAAP

Effective date: Nonpublic companies will be required for reporting periods beginning after Dec. 15, 2020 (calendar 2021, fiscal year 2022).

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Accounting and auditing developments

ASU No. 2018-14, Compensation-Retirement Benefits-Defined Benefit Plans – General (Subtopic 715-20):
Disclosure Framework – Changes to the Disclosure Requirements for Defined Benefit Plans

Removes current required disclosures	Requires additional disclosures
– Amount and timing of plan assets expected to be returned to employer – Reconciliation of opening to closing balances of plan assets in Level 3 (include disclosure of transfers into and out of Level 3 and purchases of Level 3 assets)	– Weighted average interest crediting rates for cash balance plans and other plans with promised interest crediting rates – Explanation of reasons for significant gains and losses related to changes in the benefit obligation

Clarifies disclosure requirements

- Projected benefit obligation and fair value of plan assets for PBOs > plan assets
- Accumulated benefit obligation and fair value of plan assets for ABOs > plan assets

Effective date: Fiscal years ending after Dec. 15, 2021 (calendar 2021, fiscal year 2022).

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Accounting and auditing developments

ASU No. 2020-07, Not-for-Profit Entities (Topic 958)
Presentation and Disclosures by Not-for-Profit Entities for Contributed Nonfinancial Assets

Statement of activities

Requires a separate line item for contributed nonfinancial assets

Footnotes

Requires disclosure of the following for contributed nonfinancial assets recognized in the period

- Disaggregation by category
- Whether the assets were monetized or utilized
- Organization's policy for monetizing rather than utilizing the assets
- Associated donor-imposed restrictions, if any
- Valuation techniques and inputs used to arrive at fair value

Effective for annual periods beginning after June 15, 2021 (fiscal & calendar year 2022).

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Accounting and auditing developments

ASU No. 2020-04, Reference Rate Reform (Topic 848): Facilitation of the Effects of Reference Rate Reform on Financial Reporting

- Allows organization's optional expedients and exceptions for applying generally accepted accounting principles to contracts, hedging relationships, and other transactions affected by reference rate reform if certain criteria are met
  - Contract modifications
  - Excluded components
  - Fair value hedges
  - Cash flow hedges
- Only applicable if agreements reference LIBOR or another reference rate expected to be discontinued

Effective for all entities as of Mar. 12, 2020, through Dec. 31, 2022. There is currently a proposed standard to extend the sunset date to December 31, 2023

Accounting and auditing developments

ASU No. 2016-02, Leases (Topic 842)

Goal is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the statement of financial position.

The ASU will require a lessee to recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term.

Effective date: Nonpublic companies will be required to apply the standard for fiscal years beginning after Dec. 15, 2021 (calendar year 2022, fiscal year 2023).

Accounting and auditing developments

ASU No. 2016-02, Leases (Topic 842):

Considerations:

- Leases for no or de minimis consideration are not subject to the guidance in Topic 842
  - Subject to the contributions received guidance in Subtopic 958-605, *Not-for-Profit Entities – Revenue Recognition*
  - Also subject to the presentation and disclosure guidance in ASU 2020-07
- Leases for below-market consideration
  - For example, lease of office space for 50% of rent paid by other tenants for the same square footages
  - NFPs may need to consider both Topic 842 and the inherent contribution guidance under Subtopic 958-605

Accounting and auditing developments

ASU No. 2016-02, Leases (Topic 842):

Lessee Model – Initial Measurement:

- Lease liability (obligation to make the lease payments)
  - Measured a the present value of the future minimum lease payments
- Right-of-use asset
  - Lease liability + initial direct cost + lease prepayments – lease incentives received
- Discount rate
  - Use the rate charged by the lessor if known
  - The incremental borrowing rate
  - All private companies & NFPs <u>may elect</u> to use the risk-free rate rather then its borrowing rate (and can use both by class of underlying asset)
  - Rate as of the implementation date for the remaining lease term (no need to go back in time)

Accounting and auditing developments

ASU No. 2016-02, Leases (Topic 842):

Lessee Model – Subsequent Accounting:

- Finance lease
  - Unwind liability using effective interest method
  - Front-loaded expense pattern similar to capital leases under ASC 840 with interest & amortization recognized separately
  - Interest determined on the lease liability in each period during the lease term as the amount that produces a constant periodic discount rate
  - ROU asset generally amortized on a straight-line basis
- Operating lease
  - Unwind liability using the effective interest method
  - Straight-line expense over term
  - ROU asset: reduced by the difference between the annual straight-line lease expense & the annual interest cost on the lease liability (i.e. amortize the asset to achieve straight-line total lease expense)
  - For leases with escalating lease payments, lessee recognizes only rent expense on straight-line basis. Difference in asset amortization & liability is cumulative difference of payments & expense

Accounting and auditing developments

ASU No. 2016-02, Leases (Topic 842)

Lease Disclosures

Qualitative

- Nature of leases
- Leases that have not yet commenced but create significant rights and obligations for the lessee
- Significant assumptions and judgments made in application
- Main terms and conditions of any sale and leaseback transactions
- Whether accounting policy election was made for short-term lease exemption

Quantitative

- Finance lease expense, segregated between amortization and interest
- Operating, short-term lease, variable lease costs
- Sublease income
- Gains and losses arising from sale and leaseback transactions
- Lease payment maturity analysis (similar to that in Topic 840 disclosures)
- Separately for operating and finance leases:
  - Cash paid for amounts in lease liabilities, segregated between operating and financing
  - Lease liabilities arising from obtaining ROU assets
  - Weighted-average remaining lease term
  - Weighted-average discount rate for leases

Accounting and auditing developments

ASU No. 2016-13, Financial Instruments-Credit Losses Topic (326): Measurement of Credit Losses on Financial Instruments

- Significant shift in the way credit losses are recorded – requires entities to estimate and record credit losses expected over the contractual life of an asset or liability on day one
- Goal is to improve financial statement users' access to more timely information about credit losses
- Standard does not prescribe one method for estimating expected losses but does provide examples so entities can decide what makes sense for their organization
- Dollar impact after adoption will be recorded through a cumulative effect adjustment to net assets
- Main financial instruments affected: loans, receivables, and financial guarantees

Nonpublic companies will be required to apply the standard for annual periods beginning after Dec. 15, 2022 (calendar year 2023, fiscal year 2024). Early adoption is permitted.

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Accounting and auditing developments

ASU No. 2016-13, Financial Instruments-Credit Losses Topic (326): Measurement of Credit Losses on Financial Instruments

CECL adoption considerations

CECL implementation

- CECL training
- Gap analysis
- Data stratification
- Model selection and validation
- Parallel runs
- Governance, compliance, and risk restructuring
- Internal controls testing

CECL outsourced modeling

- Staffing augmentation
- Fully outsourced modeling
- Model back testing

CECL model validation

- Review of processes, documentation, and policies
- Partial or full replication of CECL model
- Back-testing of estimates
- Stress-testing and sensitivity analyses

Data analytics and model risk management

Leveraging data collected for models to inform broader business processes and decision making

- Loan portfolio analytics
- Stress testing and scenario analysis
- Capital adequacy analysis
- Data quality

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Accounting and auditing developments

ASU No. 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment

Simplifies the subsequent measurement of goodwill

- Eliminates step #2 of the goodwill impairment test
- Annual (or interim) goodwill impairment test still required
  - Compare the fair value of the reporting unit with the carrying amount
  - Impairment charge if carrying value exceeds fair value of the reporting units
- Eliminates the requirement for qualitative assessment and step #2 calculation for zero or negative carrying value items

Effective date: Fiscal years beginning after Dec. 15, 2022 (calendar year 2023, fiscal year 2024).

Accounting and auditing developments

2022 Issued Standards

- ASU No. 2022-01 – *Derivatives and Hedging (Topic 815): Fair Value Hedging – Portfolio Layer Method*
  - Allow multiple hedged layers to be designated for a single closed portfolio of financial assets
  - Effective date: Fiscal years beginning after December 15, 2023 (calendar year 2024, fiscal year 2025). Early adoption is permitted.

- ASU No. 2022-02 – *Financial Instruments – Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*
  - Eliminate accounting guidance for Troubled Debt Restructurings by creditors in Subtopic 310-40 while enhancing disclosure requirements for certain loan refinancings and restructurings
  - For public business entities, required to disclose current period gross write-offs by year of origination for financing receivables and net investments in leases
  - Effective date: Fiscal years beginning after December 15, 2022 (calendar year 2023, fiscal year 2024). Early adoption is permitted.

Accounting and auditing developments

2022 Issued Standards

- ASU No. 2022-03 – *Fair Value Measurement (Topic 820): Fair Value Measurement of Equity Securities Subject to Contractual Sale Restrictions*
  - Clarify contractual restriction on sale of an equity security is not considered in measuring fair value
  - Effective date: Fiscal years beginning after December 15, 2024 (calendar year 2025, fiscal year 2026). Early adoption is permitted.

- ASU No. 2022-04 – *Liabilities – Suppler Finance Programs (Subtopic 405-50): Disclosure of Supplier Finance Program Obligations*
  - Require buyer in supplier finance program disclose sufficient information about the program to allow a user of the financial statements to understand the program's nature, activity during the period, changes from period to period, and potential magnitude
  - Effective date: Fiscal years beginning after December 15, 2022 (calendar year 2023, fiscal year 2024), except for the amendment for rollforward information, which is effective for fiscal years beginning after December 15, 2023 (calendar year 2024, fiscal year 2025). Early adoption is permitted.

Let's connect.

Ryan Lay, CPA
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12:05 – 12:55 p.m.

Retention, Post-COVID-19, Company Culture & Labor Shortages

Melodi Bunting, CPA, CMA, CGMA, MBA, *Senior Manager, Wegner CPAs*

Angela Wurtz, PHR, *Recruiting Manager, Wegner CPAs*

Wegner CPAs

Retention, Post COVID, Company Culture, & Labor Shortages

Presented by Angela Wurtz

Angela Wurtz

Recruiting Manager, Wegner CPAs

Angela has been in the HR field, with an emphasis on Talent Acquisition, for the last 15 years. She has recruited for a variety of industries and roles including healthcare, manufacturing, business consulting, and public accounting. She earned her Bachelor of Science degree in Business Management with a concentration in Human Resources Development and is also PHR certified.

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Melodi Bunting

Senior Manager, Advisory Services Wegner CPAs

Melodi returned to public accounting when she joined Wegner CPAs' in 2014 after teaching in higher education, consulting with not-for-profits, and preparing consolidations and international reporting for a retailer. While at Wegner she has been developing and teaching a variety of internal and external training opportunities as well as working with the audit team performing audits, reviews and advisory services.

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Agenda

- Retaining and attracting talent
- Remote work and company culture
- Work-life balance
- Employer trends post COVID?
- Status of the current labor market
- The future labor market

How do you retain and attract talent in this market?

RETAIN

- Hybrid work options is becoming mainstream!
- Manager’s role are changing.
- Be ok with change – evolve with changing workplace trends

How do you retain and attract talent in this market?

ATTRACT

- Be where the emerging talent is
- Interview and hire efficiently
- Make recruiting a team effort

Remote work is here to stay – and there are benefits!

- Happier employees
- Lower overhead costs
- Improved recruiting
- Less tension

Why is leadership concerned with remote work?

COLLEAGUES AND TEAMS BEING SILOED FROM EACH OTHER

COLLEAGUES FEELING LESS CONNECTED WITH ONE ANOTHER.

What can employers do to keep remote workers engaged?

- Communication
- Expectations
- Accountability
- Culture

Post COVID trends

- Remote work is here to stay
- Talent shortage
- Shorter work weeks
- Health & well-being

Current labor market

- Unemployment was 3.5% in September
- Increased competition for workers
- Employers are trying to figure out how to keep up with inflation
- Burnt out employees

Future labor market

- Number of job seekers will increase
- Preference for remote work
- Rise of digitalization
- Need to hire more creatively

Contact Us

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THANK YOU
Wegner CPAs

1:05 – 1:55 p.m.

ESG State of Play: An Introduction to ESG

Karen Baum, CPA, CFE, *Sustainability & ESG Services Leader, BDO USA LLP*

With You Today

KAREN BAUM, CPA,CFE

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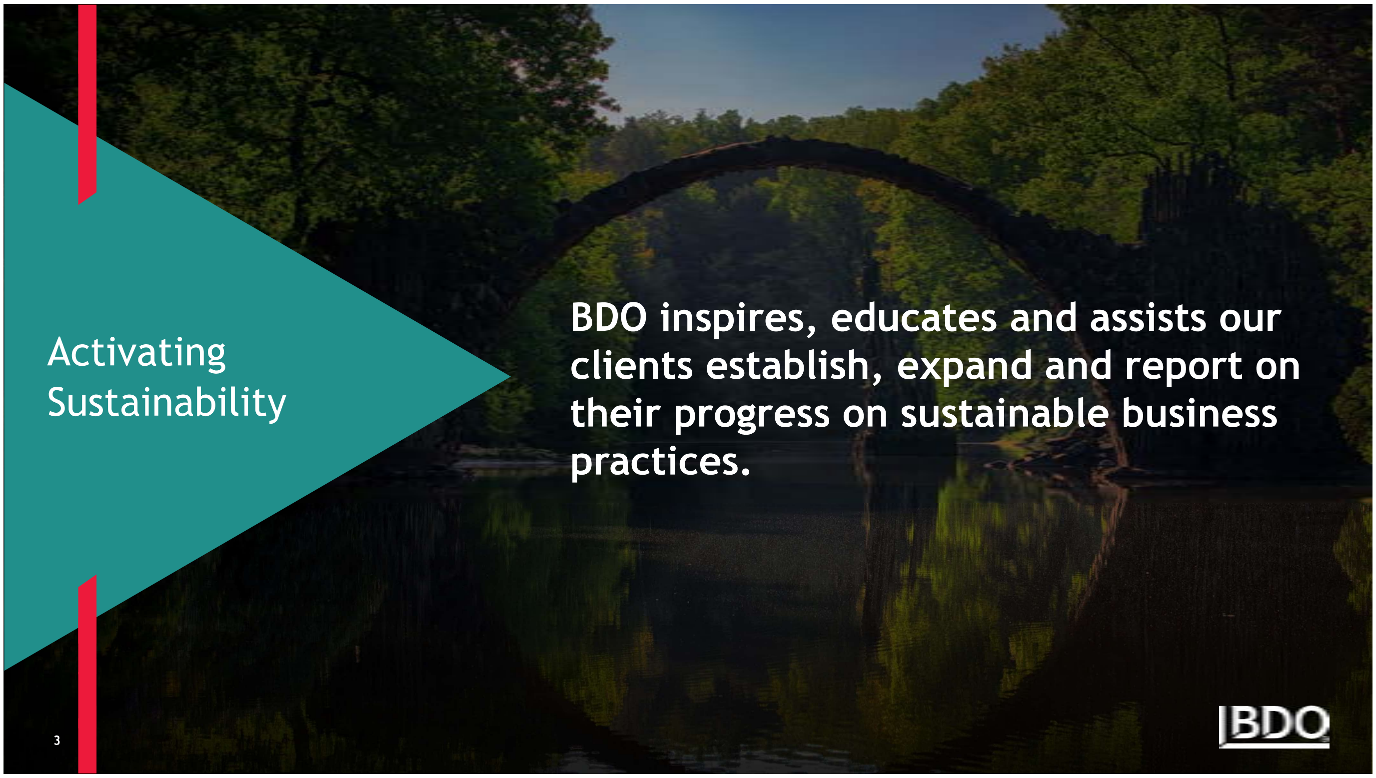
Activating
Sustainability
BDO inspires, educates and assists our clients establish, expand and report on their progress on sustainable business practices.
3
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LEVEL SETTING:
What is ESG?
What are ESG’s
Market Drivers?
4
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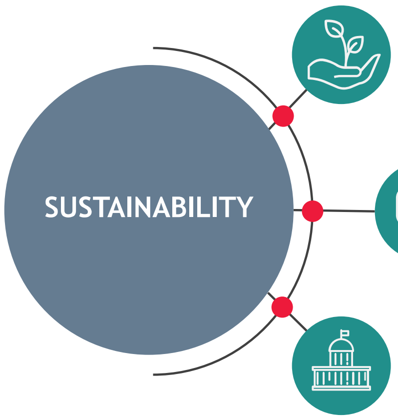
ESG Will Drive Reporting & Disclosure



ENVIRONMENTAL

- Climate change
- Loss of biodiversity
- Pollution
- Water and waste management
- Deforestation
- Renewable energy
- Greenhouse gas emissions
- Resource availability
- Sustainable products / packaging

SOCIAL

- Health, well-being & safety
- Diversity, equity & inclusion
- Human capital development
- Supply chain standards
- Innovation of better products and services
- Community and social vitality
- Employment and wealth generation
- Ownership structure

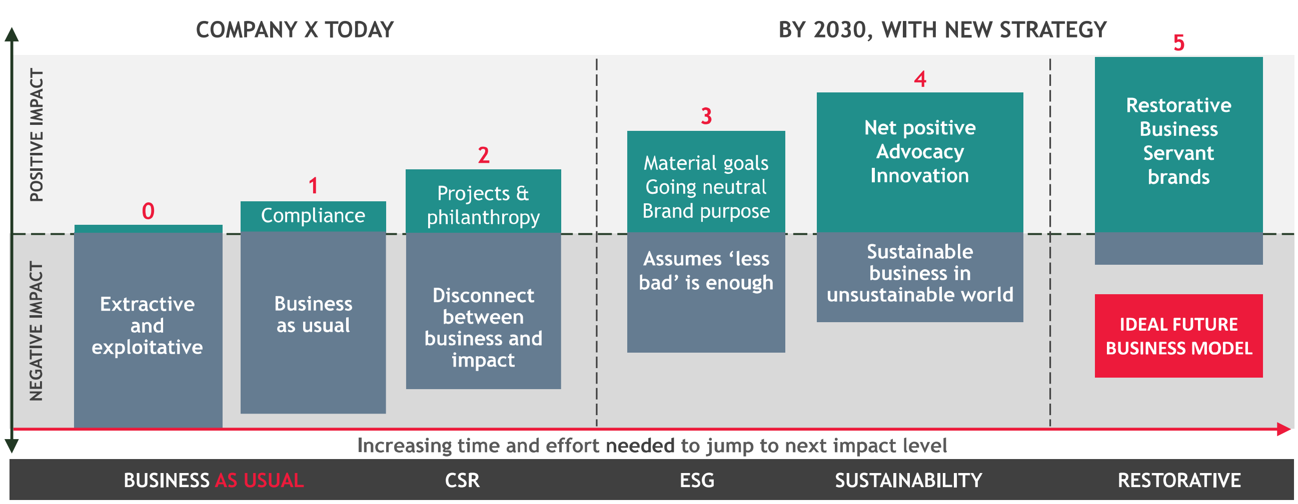
GOVERNANCE

- Governing purpose
- Quality of governing body
- Stakeholder engagement
- Leadership diversity
- Risk and opportunity oversight
- Lobbying & political contributions
- Anti-bribery & corruption
- Corporate resiliency
- Executive compensation
- Ethical behavior
- Tax transparency
- Data security & data privacy

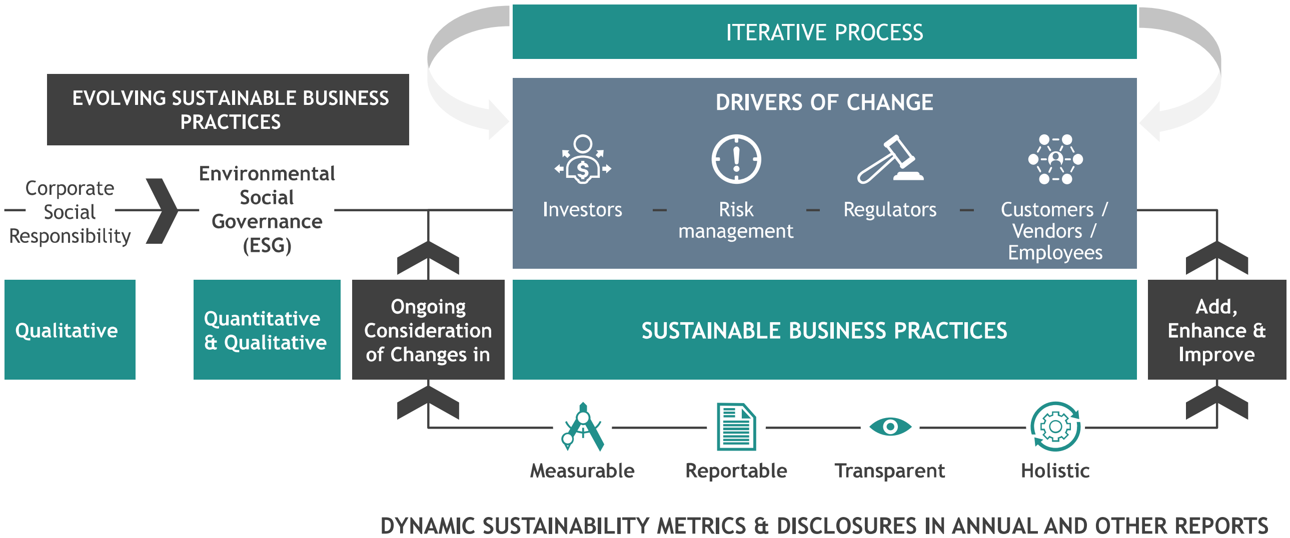
This is not intended as an all-inclusive list of ESG factors and will vary in relevance and importance by company

... AND CORPORATE VALUE

The Sustainability Leadership Journey



How Sustainability Is Changing the Business Landscape



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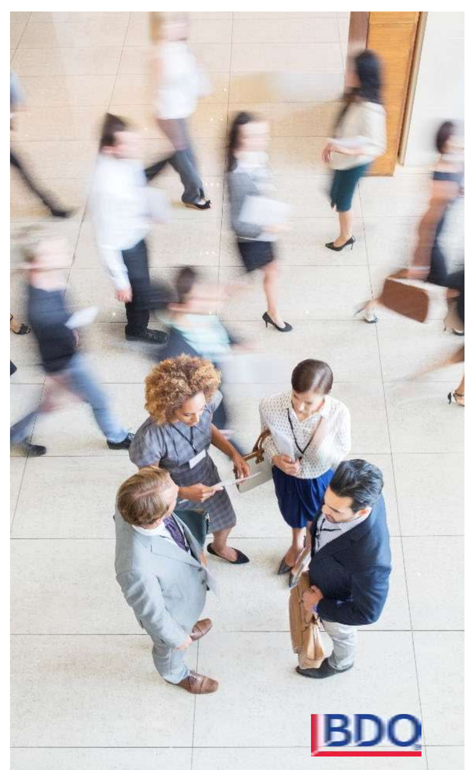
ESG: Market and Stakeholder Drivers

- Private Equity and broader investor community
- Sustainable lending and green bonds
- Lenders basing access to capital/rates on ESG rating/maturity
- Transparency surrounding ESG factors and voluntary disclosures
- Client demands for alignment with their ESG commitments
- Competitive and supply chain pressures
- Executive compensation tied to ESG performance
- Employee expectations
- Public pressure/reputational and brand risk
- Expanding regulation/pressure for disclosure
- Shareholder activism
- Environmental and social activism
- ESG rating agencies



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Sustainability Is Transformational: Some Examples …

ENERGY TRANSITION

Corporations continue to make large carbon removal commitments to help fight climate change. Microsoft and Alphabet collectively pledged to invest $400 million in carbon removal programs and Salesforce announced a new commitment to invest $100 million in the purchase of carbon credits.

CIRCULAR ECONOMY

Walmart, the world's largest retailer has set the goal to become a regenerative company with net zero emissions by 2040. HP and Nestle, among others, commit to the use of 75% and 100%, respectively, recycled materials in product packaging by 2025.

GENDER EQUALITY

The Council and European Parliament announced an agreement on a new law setting targets for EU companies to improve gender balance on corporate boards. The new directive would promote increased representation of women on boards.

SUSTAINABLE FINANCE

The SEC proposed two rule changes that would prevent misleading or deceptive claims by U.S. funds on their ESG qualifications and increase disclosure requirements for those funds.

SUPPLY CHAIN

EU announced new rules requiring companies to integrate due diligence procedures into policies to identify actual or potential adverse human rights and environmental impacts, prevent or mitigate potential impacts and end or minimize actual impacts.

CORPORATE REPORTING

The comment period for the SEC's proposed new climate disclosure requirements for public companies recently concluded. The proposed EU Corporate Sustainability Reporting Directive (CSRD) will require comprehensive ESG reporting for public and private companies meeting certain size requirements. The International Sustainability Standards Board (ISSB) recently launched a consultation on its first two proposed standards.

Benefits of Adopting a Sustainability Program

- Bolsters and reinforces corporate image and reputation, and improves employee and customer retention
- Defines an innovative vision of the business by identifying non-financial drivers
- Improves access to credit and the ability to attract investment
- Allows you to compete with those already disclosing their sustainability focus
- Drives true corporate value creation and simultaneously benefit the planet
- Satisfies the expectations of stakeholders that you are maintaining your social license to operate
- Systematically reports the link between strategy and financial performance including impacts of ESG factors
- Identifies monitors and manages non-financial risks correctly
- Improves data quality for more effective information management and decision making

KEY CONSIDERATIONS before beginning your ESG journey:

- Embrace stakeholder capitalism
- Utilize change management best practices
- Recognize that lack of internal leadership alignment is a deal killer
- Define team roles as a critical first step
- Know that it's not a one and done process; it is iterative in nature
- Remember that it's a marathon, not a sprint
- Consider costs, both financial and human capital

BDO's SUSTAINABILITY INTEGRATION ROADMAP

- ACTIVATING
- REACTIVE
- PLANNING
- PROACTIVE
- STRATEGIC
- PURPOSE DRIVEN

PHASE OF THE ESG JOURNEY

Starting your ESG journey
↓
Identifying your most important ESG factors
↓
Developing your ESG strategic roadmap
↓
Managing your ESG infrastructure and ensuring the reliability of your ESG data
↓
Transforming your business to align with your ESG strategies

LEVEL OF GOVERNANCE

Emerging Management
↓
Basic Compliance Management
↓
Brand Management
↓
Leading Strategic Management
↓
Transformational Management

Getting Started

COACH & FRAME
Provide sustainability awareness training
Identify stakeholder requirements and other inputs to develop ESG strategy
Define the Board's role
Perform maturity / material risk assessment
Prioritize urgency/importance alongside effort/value
Develop a sustainability roadmap including selecting reporting framework(s)
Ensure internal controls in place for ongoing monitoring & compliance
Conduct iterative enhancements

SAMPLE ACTIVITIES

- Engage with internal and external stakeholders on sustainability issues
- Perform materiality analysis/gap assessment
- Define oversight responsibility among the board and/or within committees of the board
- Analyze business plans according to the Sustainable Development Goals (SDGs) and other frameworks
- Design / improvement of sustainability governance
- Develop sustainability policies and operational plans
- Update/development of the Code of Ethics
- Develop of Code of Conduct for suppliers
- Source education for employees and leadership on evolving sustainability and ESG matters
- Produce sustainability report using acceptable frameworks (e.g., WEF/IBC, GRI, VRF (SASB/IIRC), GBS, AA1000)

Perform an ESG Readiness Assessment

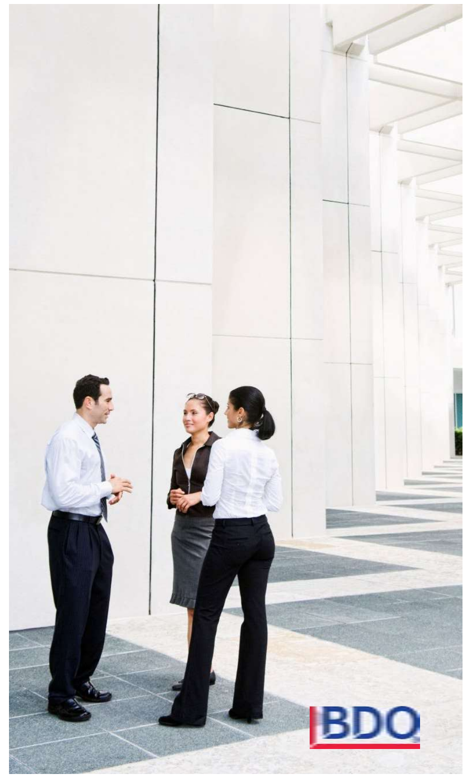
	What qualitative and quantitative information are we currently sharing internally/externally?
	Who is and how are we compiling this information?
	What is the knowledge level and learning being provided?
	What are we not yet doing/measuring/communicating that we should consider? (Gap analysis)
	Do we have adequate policies & procedures or do these need to be developed?
	How is what we defined in our scoping aligned with our ST/LT business strategy (ultimate objective)?
	Are the company's internal stakeholders ready to begin the journey?
	Have appropriate resources, such as financial or human capital, been allocated?

ESG Strategy Development

	Stakeholder Engagement: Determine relevant stakeholders and what matters to them (internally/externally)
	Materiality Assessment: Define specific ESG risk/opportunities material to your business
	ESG Roadmap: Define your strategy for prioritization and action; set goals and KPIs
	Data Collection and Controls: Identifying processes, systems and controls over data
	Reporting: Define reporting needs and identify standard(s) and framework(s)

Define Stakeholders

	Shareholders
	Employees
	Customers
	Strategic Partners
	Vendors/Suppliers/Lenders/Insurers/Sureties
	ESG Raters and Proxy Advisors
	Regulators
	Communities



Consideration of Materiality

IN THE CONTEXT OF FINANCIAL REPORTING:

IAS 1, Financial Statement Presentation
Information is material if omitting, misstating or obscuring it could reasonably be expected to influence the decisions that the primary users of general-purpose financial statements.

FASB Conceptual Framework - Concept Statement 8
Relevance and materiality: Relevance of information as being useful to investors while materiality is entity specific such that it is probable that the judgment of a reasonable person relying upon the report would have been changed or influenced by the inclusion or correction of the item.

SEC / U.S. Securities Law
Material information is information that a reasonable investor would consider important; an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote.

Consideration of Materiality

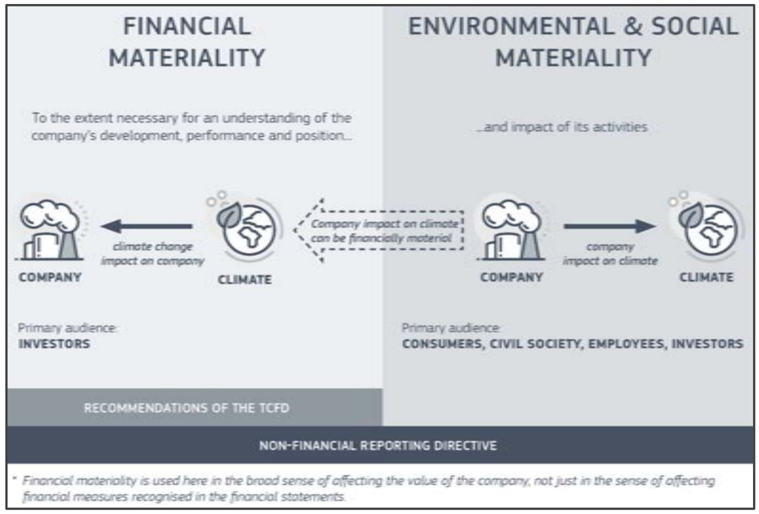
DOUBLE MATERIALITY

The concept of double materiality acknowledges that a company should report simultaneously on sustainability matters that are:

- financially material in influencing business value
- material to the market, the environment, and people

The Double Materiality perspective of the Non-Financial Reporting Directive.

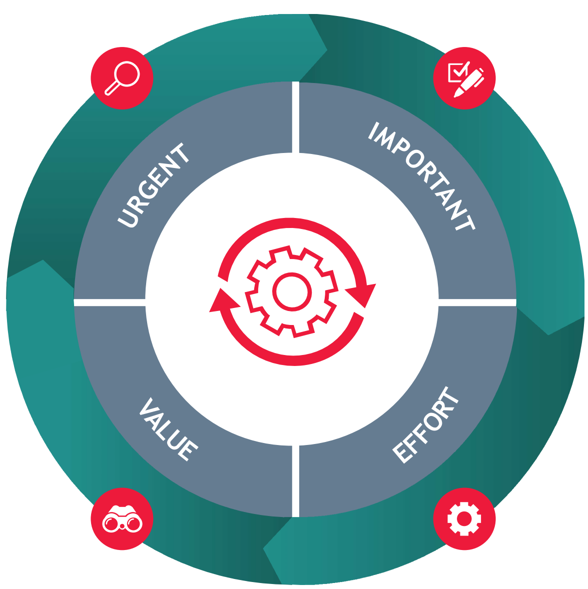
IN THE CONTEXT OF LONG-TERM VALUE CREATION



Source: Guidelines on Reporting Climate-related Information

Prioritize Action

- Risk Drivers
- Competition
- Regulation
- Disruption
- Legal



- S/T vs. L/T Focus
- Change management
- Strategy
- Emerging areas
- Resilience

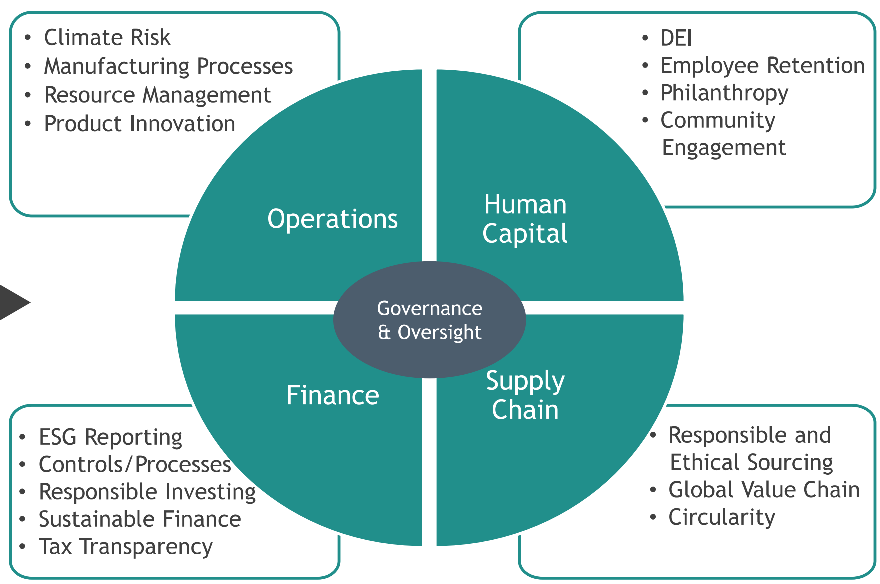
- Opportunities
- New business
- Talent
- Brand

- Resources
- Cost
- Advisors
- Systems

10 Key Elements of an Effective ESG Program

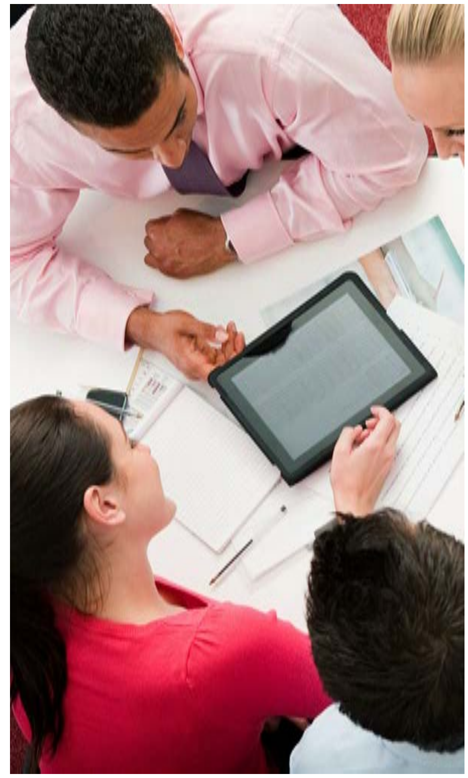
- Compelling vision and goals
- Active, visible leadership from the top
- Policies and procedures set the expectations
- Training - general and specific - for board, leadership and employees
- Transparency and communication
- Accountability up, down and across the organization
- Incentives, compensation, and benefits aligned to ESG measures
- Key performance measures, data analytics, dashboards
- Program management
- Monitoring, auditing and reporting

Functions Most Often Affected By the ESG Journey



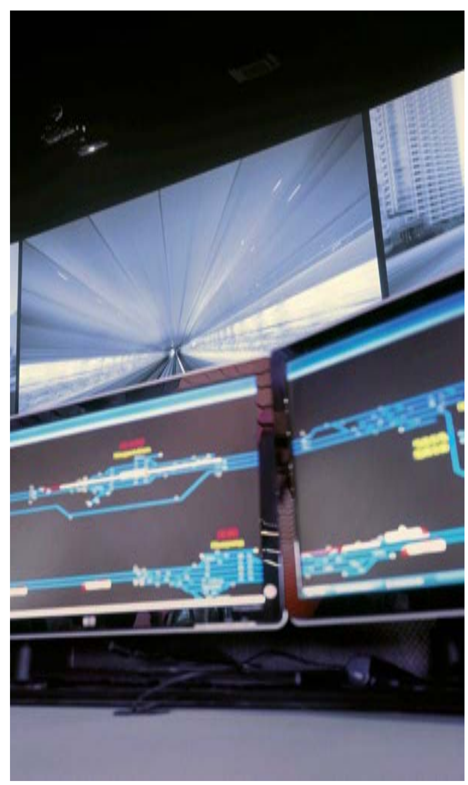
HUMAN CAPITAL:
Key ESG Impact Considerations

- Employees look to work for employers who demonstrate alignment with their values
- Investments in a diverse and equitable work environment is needed to remain competitive
- Increased scrutiny on disclosure of DEI and HCM data
- Stakeholder pressure to integrate ESG into executive compensation
- Issues like labor rights and pay equity may lead to regulatory, legal or reputational concerns



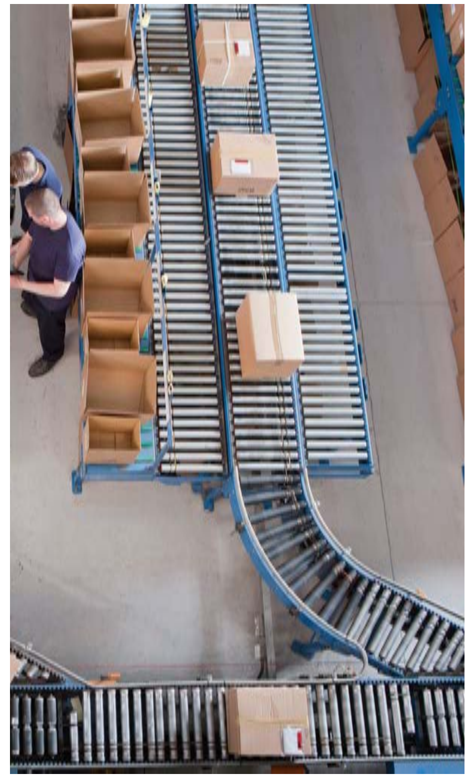
OPERATIONS:
Key ESG Impact Considerations

- Anticipated regulation mandating climate risk disclosures drives need to develop remediation strategies
- Pressure for market transitions away from fossil fuels
- Increasing costs for electricity, fuel and raw materials threaten margins
- Business impact on natural ecosystem and management of biodiversity
- Consumer demand for sustainably manufactured products drives need for product innovation



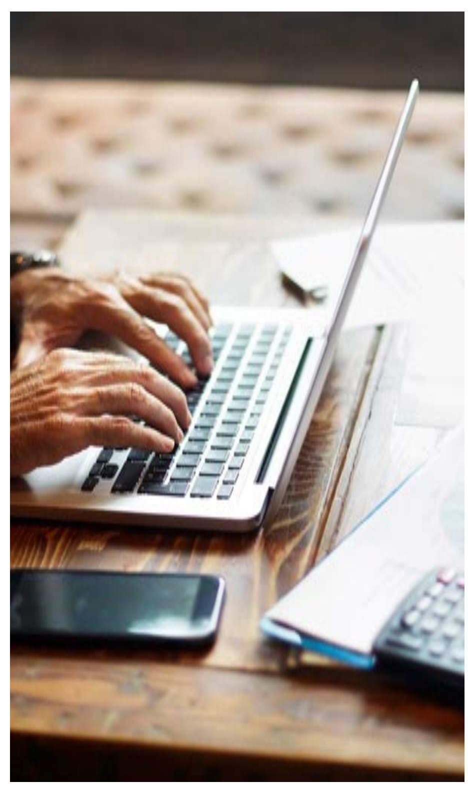
SUPPLY CHAIN:
Key ESG Impact Considerations

- Scrutiny on carbon intensity and human rights risks within supply chains
- Disruption of operations and impact on business continuity due to extreme weather
- Availability and accessibility issues due to global political instability
- Ethical sourcing, as well as considerations of impacts of operations on local communities can destabilize supply chains
- Addressing inefficiencies in logistics and warehousing to diversity in sourcing can have significant supply chain impacts



FINANCE
Key ESG Impact Considerations

- Total tax transparency is an expectation
- Anticipated ESG regulatory disclosures may mandate reporting and attestation of non-financial data
- Rise in impact investing and risk of stranded assets
- Reporting of non-financial data requires collection, management and monitoring of new data sets and controls and processes to ensure integrity
- Level of sustainable maturity can directly impact access to debt and equity capital



Unlocking a Successful ESG-Driven Tax Strategy

Aligning the tax function with an overarching ESG strategy across the business is a heavy lift.

To build and implement a responsible tax program will take time and requires careful consideration of an organization's overall **approach to tax**, **tax governance**, and **total tax contribution**.

Whether you are just beginning or at the stage of reassessing your approach based on changing market conditions, updates to your ESG strategy, or regulations, the BDO Tax ESG Cipher to the right can be used to guide these critical considerations and help ensure tax is meaningfully incorporated in ESG strategy.

The process should be iterative over time and when implemented successfully, will drive **improved decision- making on risk mitigation**, **strengthen risk awareness** and **increase transparency and accountability**.

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Sustainability Reporting and Attestation

May include both qualitative discussions and qualitative metrics such as measures of a company's performance against ESG risks, opportunities and related strategies

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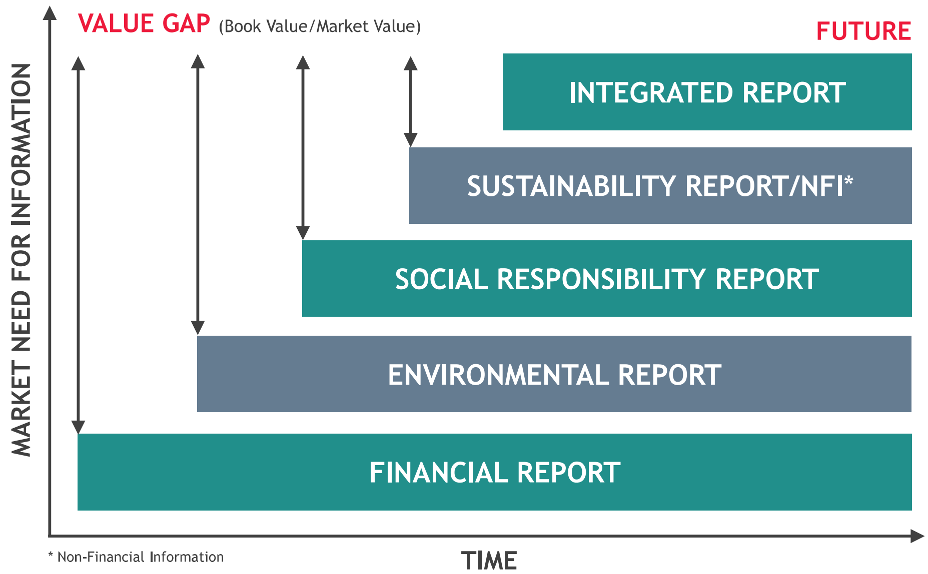
REPRESENTATION
OF VALUE OVER TIME

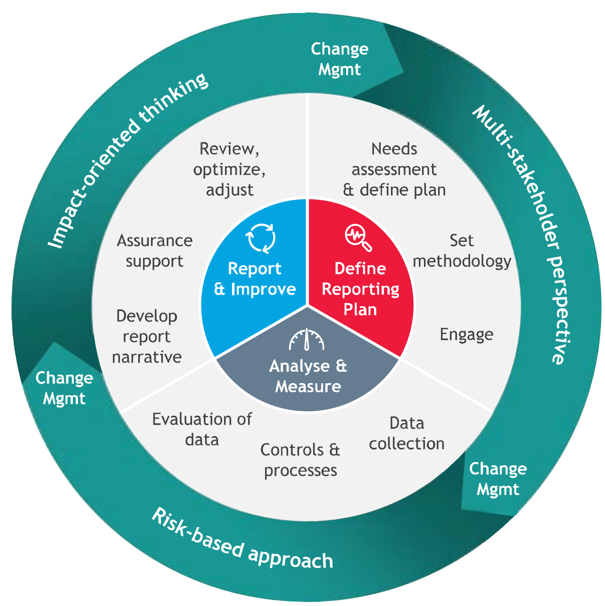
Evolution of Reporting



* Non-Financial Information

Reporting Process Phases

Integrating sustainability into a business is a transformation journey and ongoing process of monitoring, modification and rethinking 'how' you can ultimately embed sustainability across the organization.



Sustainability Reporting and Attestation Readiness Guide

BDO has prepared a practice aid of iterative considerations for management and boards to help them assess a company's readiness to report out on its sustainability strategy:

Taking Inventory

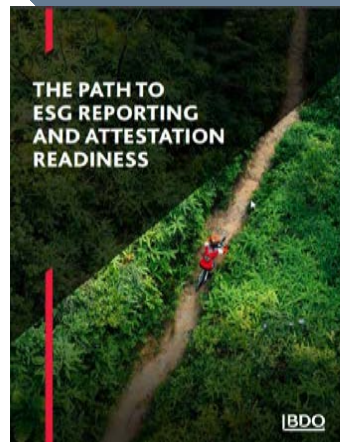
- ❑ Materiality assessment
- ❑ Competitive landscape
- ❑ Corporate story
- ❑ Reporting standards & frameworks
- ❑ Current state assessment

Establishing Governance Oversight

- ❑ ESG roles
- ❑ ESG goals/objectives
- ❑ Third party resources
- ❑ Progress and accountability
- ❑ Continuing education
- ❑ Board strategy & ERM agenda

ESG Reporting Readiness

- ❑ Reporting requirements
- ❑ Quantitative measures and data
- ❑ Data collection (processes, policies, procedures)
- ❑ Control effectiveness
- ❑ Qualitative information
- ❑ Draft disclosures
- ❑ Review as reasonable shareholder
- ❑ Third party attestation value



Access publication here

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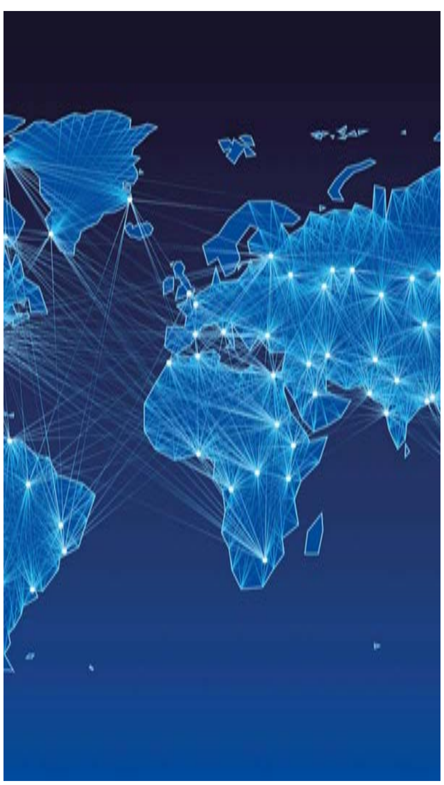

Examples of ESG Global Regulatory Landscape

U.S.

- On June 17, 2022, the comment period ended for the SEC proposed rules mandating climate-related disclosures by U.S. listed companies
- In May 2022, the SEC proposed rule changes that would prevent misleading or deceptive claims by U.S. funds on ESG qualifications and increase disclosure requirements

IISB (International Sustainability Standards Board)

- On July 29, 2022, the comment period ended for two ISSB proposals on sustainability reporting standards, one with respect to general standards and the second with respect to climate. ISSB will review at September 2022 meeting

EU Council

- In February 2022, adopted position on the Corporate Sustainability Reporting Directive (CSRD)
- In February 2022, the European Commission published its proposal for a Directive on Corporate Sustainability Due Diligence (CSDD). The Directive sets mandatory human rights' supply chain due diligence rules for large companies headquartered or operating in the EU
- In May 2022, the European Financial Reporting Advisory Group (EFRAG) released a sustainability standards draft, setting out the proposed rules and requirements for EU ESG reporting under the CSRD

Canada

- In April 2022, mandated reporting of climate-related financial risks for federally-regulated financial institutions

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ESG Frameworks / Standards

Framework Name	Where to Report	Focused Area	Information to Report	Topic-specific disclosures or multi-topic?	Industry Specific or Industry agnostic?	Standard/ Framework/ Guidelines	Target Reporter	Primary Audience
Carbon Disclosure Project (CDP)	CDP's Online Platform	Environment/ Governance	• Climate Change • Forest • Water Security • Supply Chain	Environmental Specific	Industry-Specific	Guidelines	Companies, Cities, States and Regions	Investors, buyers, other stakeholders
Sustainable Development Goals (SDG)	Sustainability Report	Environment/ Social/ Governance	• 17 SDG Goals	Multiple disclosures	Industry-agnostic	Guidelines	All Companies	Multiple stakeholder groups
Climate Disclosure Standards Board (CDSB)	Mainstream reports, such as annual reports, 10-K filing, or integrated reports.	Environment/ Social	• Climate • Water • Biodiversity • Social disclosures	Multiple disclosures	Industry-Specific	Guidelines	Companies, Cities, States and Regions	Investors, buyers, other stakeholders
International Integrated Reporting Council (IIRC)	Stand alone integrated report	Environment/ Social/ Governance	• Organizational overview • Governance Structure • Business Model • Risks and opportunity • Strategy • Performance • Outlook • Basis of Presentation	Framework which covers all financial and non-financial issues	Industry-agnostic	Framework	Public Companies	Investors and multiple stakeholder groups
Task Force on Climate-related Financial Disclosures (TCFD)	Annual Financial filings (Annual Report)	Environment/ Governance	• Governance • Risk Management • Strategy • Metrics and Target	Climate change specific	Industry-agnostic (+ some sector specific guidance)	Framework	All Companies	Investors, lenders, and insurers

ESG Frameworks / Standards

Framework Name	Where to Report	Focused Areas	Information to Report	Topic-specific disclosures or multi-topic?	Industry Specific or Industry agnostic?	Standard/ Framework/ Guidelines	Target Reporter	Primary Audience
WEF-IBC	Mainstream report (annual report or proxy statements)/ Sustainability Report	Environment /Social/ Governance	• Principles of Governance • Planet • People • Prosperity	Multiple disclosures	Industry agnostic	Framework	All companies	Investors and multiple stakeholder
Principles of Responsible Investment (UNPRI)	public and private Transparency Reports and Assessment Reports	Environment/ social	• 6 principals • Climate Change • Human Rights	Topic-specific relating to investment impacts such as climate-related impacts	Financial sector	Framework	All signatories companies	Investors
Global Reporting Initiative (GRI)	Corporate sustainability report	Environment/ social/ Governance	• General disclosures • Economics • Environment • Social	Multiple standards across economic, environment and social	Industry-agnostic (+ some sector specific guidance)	Standard	All companies	Multiple stakeholder groups
Sustainability Standards Board (SASB)	SEC form 10K, 20F fillings	Environment/ social/ Governance	• Environment • Social capital • Leadership and governance • Business model and innovation • Human capital	Multiple disclosures across economic, environment and social	Industry specific	Standard	All companies	Regulators
UN Global Compact	Annual communi cation on progress (COP)	Environment/ social/ Governance	• Human rights • Labor • Environment • Anti-corruption	Multiple disclosures across economic, environment and social	Industry specific	Standard	All companies	Regulators

Rating Agencies / Index

Rating Agencies	Total Companies Covered	Source of Info	Number of Topics	Companies Involvement	Scoring Scale	Update Frequency
MSCI	Over 14,000	Disclosures of the companies Database (government, science, NGO's) News and media	35	Companies are invited to verify the data	AAA (Leader) to CCC (Laggard)	Ongoing monitoring, annual in-depth review
S&P / DJSI	Over 10,000	Disclosures of the companies	20-30	Companies fill out questionnaire	0 (Lowest Risk) -40+ (Highest Risk)	Yearly
Sustainalytics / Morning Star	Over 14,000	Disclosures of the companies Media NGO	20	Companies are invited to provide feedback and additional data	0 (Lowest Risk) -40+ (Highest Risk)	Ongoing monitoring, annual in-depth review
ISS	Over 7,300	Disclosures of the companies Media NGOs	Up to 100	Companies are invited to provide feedback and additional data	A+ (Highest Performance) to D- (Lowest Performance)	Yearly
Reprisk	Over 200,000	Media Other public information Explicit exclusion From corporate reporting	73	No interaction	0(Lower Risk)-100 (Highest Risk) AAA (Low ESG risk Exposure) to D (High Risk Exposure)	Daily Update
Bloomberg	Over 11,800	Disclosures of the companies Multiple ESG third party providers	14 (includes 2100 fields)	Companies can request updates at any time	1-100	Daily Update
CDP	Over 13,000	Disclosures of the companies / Annual reporting process	3	Companies fill out questionnaire	A(Leadership) to D- (Disclosure) F = Failure to provide sufficient info.	Yearly
EcoVadis	Over 90,000	Customer-provided documentation Third-party endorsements (certifications, labels, etc.) News, Watchlist etc.	21	Companies fill out questionnaire	1 (Insufficient)-100 (Outstanding)	Yearly

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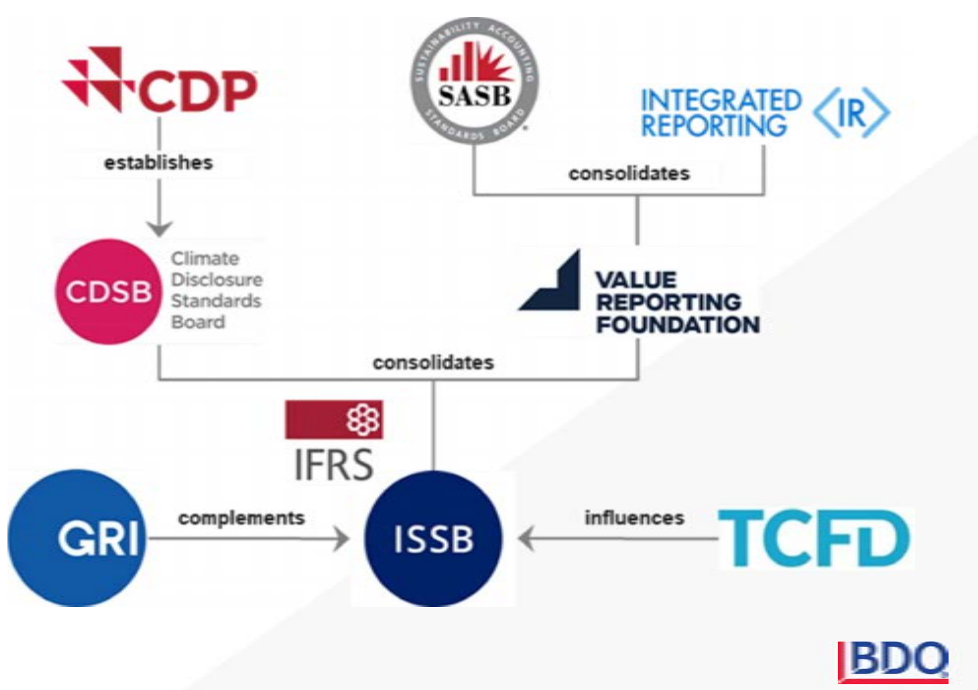
The Road to Reporting Convergence



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ISSB Launches Consultation on First Two Proposed Standards

- On March 31, 2022, the ISSB issued its first two exposure drafts on IFRS Sustainability Disclosure Standards:
  - IFRS S1 General Requirements for Disclosure of Sustainability-related Financial Information
  - IFRS S2 Climate-related Disclosures
- The proposals have been developed in response to requests from G20 leaders, the International Organization of Securities Commissions (IOSCO) and others for enhanced information from companies on sustainability-related risks and opportunities.
- The proposals set out requirements for the disclosure of material information about a company's significant sustainability-related risks and opportunities that are necessary for investors to assess a company's enterprise value and are not limited only to climate-related.
- The deadline for comments on both proposals was July 29, 2022.

Click here to learn more

European Union

CSRD Proposal

The European Commission's proposal revises the non-financial reporting directive (NFRD) from 2014 and will ensure the robustness of companies' commitments by introducing the following new features:

- an extension of the scope to all large companies and companies listed on a regulated market (except listed micro-companies)
- a certification requirement for sustainability reporting
- more detailed and standardized requirements on the information to be published by companies
- improved accessibility of information, by requiring its publication in a dedicated section of company management reports
- First standards to be adopted by October 2022
- Refer here for more information

CSRD Timing and Scope

Year ending 31 December 2024

- Companies within scope of current NFRD (approx. 12,000)
  - Large PIEs with >500 employees

Year ending 31 December 2025 (approx. 50,000)

- All listed companies, and all companies meeting two of the following criteria
  - >250 employees
  - >EUR 40m turnover
  - >EUR 20m assets

Later:

- Listed micro entities
  - <10 employees
  - < EUR 2m turnover or assets

European Union

CSDD Proposal

The proposed CSDD directive shall apply only to EU and non-EU companies of a considerable size and economic power - not SMEs, as defined in the EU. Would require companies to:

- integrate due diligence into their company policies and have in place a due diligence policy;
- identify actual and potential adverse human rights and environmental impacts;
- prevent or mitigate potential adverse impacts, and bring to an end or minimize actual impacts;
- establish and maintain a complaints procedure;
- monitor the effectiveness of the due diligence policy and measures; and.
- Annual report describing due diligence, adverse impacts, actions.

The directive sets out several corporate governance provisions, including directors' duties to set up and oversee the implementation of due diligence and to integrate it into the corporate strategy. For further information on the proposal, refer here and here.

CSDD Timing and Scope

Legislation expected to be finalized

- H1 2023

Two years after legislation finalized:

- EU companies
  - >500 employees
  - >EUR 150m net worldwide turnover
- Non-EU companies
  - >EUR 150m net EU turnover

Four years after legislation finalized

- EU companies
  - >250 employees
  - >EUR 40m net worldwide turnover if 50%+ generated in high risk sectors
- Non-EU companies
  - >EUR 150m net EU turnover if 50%+ generated in high risk sectors

REPORTING LANDSCAPE UPDATES

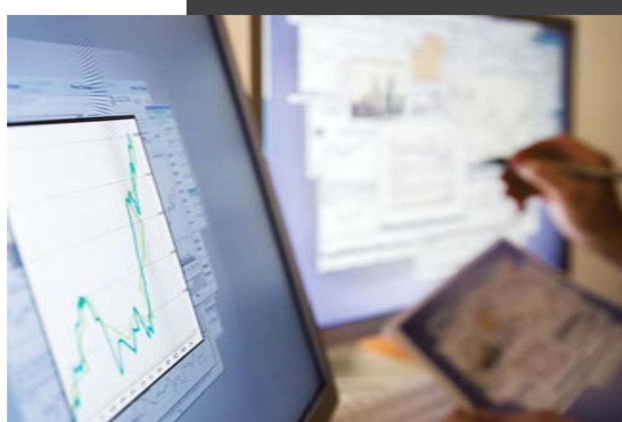
Current Disclosure in U.S.

PUBLIC COMPANIES

- Standalone reports including corporate social responsibility (CSR)/sustainability reports
- Company websites & marketing materials
- MD&A sections of annual & quarterly filings
- Earnings calls
- Proxy statements and 8-Ks

PRIVATE COMPANIES

- Nascent with respect to sustainability reports
- Sustainability statements, Code of Ethics and Reports have begun surface on company websites



Investors seeking ESG information do not necessarily expect any or all of that information to be presented in SEC filings, and sustainability disclosure on corporate websites may provide effective vehicles for this disclosure to investors.

SEC Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors

On March 21, 2022, the SEC proposed rule changes requiring certain climate-related disclosures. The disclosures are modeled in part on the TCFD disclosure framework and draws upon the Greenhouse Gas (GHG) Protocol accounting standards. The SEC reporting requirements would be phased in based on filer status beginning in the year following the effective date, with further phase in for attestation requirements. The comment period was extended to June 17, 2022.

Climate-Related Disclosure:
Reg S-K Subpart

Climate-Related Disclosure:
S-X Footnote

Other Climate-Related Disclosures:
Oversight, governance, transition plan, scope 1, 2 and 3 metrics, etc.

- Click here to access the proposed rule
- Click here to access the fact sheet
- Click here to access the SEC's press release
- Click here to access speeches and statements from Chair Gensler and Commissioners
- Refer to BDO's Insights here.

SEC Proposed Rules to Enhance and Standardize Climate-Related Disclosures for Investors

Phase-In Periods and Accommodations

Following tables assume proposed rules adopted with an effective date of December 2022 and filer has a December 31st fiscal year-end:

Registrant Type	Disclosure Compliance Date	
	All proposed disclosures, including GHG emissions metrics: Scope 1, Scope 2, and associated intensity metric, but excluding Scope 3	GHG emissions metrics: Scope 3 and associated intensity metric
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)
Accelerated Filer and Non-Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)
SRC	Fiscal year 2025 (filed in 2026)	Exempted

Filer Type	Scopes 1 and 2 GHG Disclosure Compliance Date	Limited Assurance	Reasonable Assurance
Large Accelerated Filer	Fiscal year 2023 (filed in 2024)	Fiscal year 2024 (filed in 2025)	Fiscal year 2026 (filed in 2027)
Accelerated Filer	Fiscal year 2024 (filed in 2025)	Fiscal year 2025 (filed in 2026)	Fiscal year 2027 (filed in 2028)

The State of Play in Sustainability Assurance

CONTRIBUTING TO THE GLOBAL ECONOMY

The State of Play in Sustainability Assurance

JUNE 23, 2021

KEY FINDINGS

91% of companies reviewed report some level of sustainability information

51% of companies that report sustainability information provide some level of assurance on it

63% of these assurance engagements were conducted by Audit or Audit-Affiliated Firms

88% of assurance engagements employing an Audit Firm made use of the International Standard on Assurance Engagements 3000 (Revised), while other service providers often rely on alternative assurance standards

83% of all assurance engagements result in limited assurance reports

There are significant differences across jurisdictions

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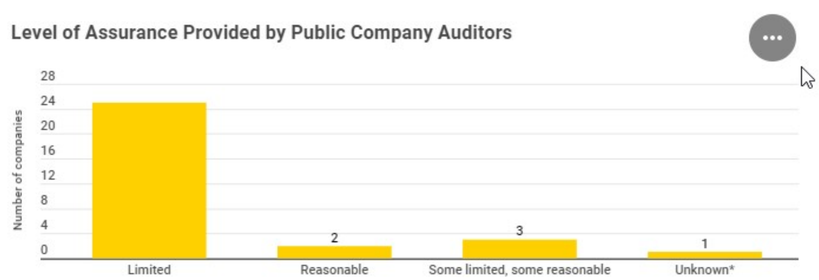
ESG REPORTING ATTESTATION

U.S. State of Play: S&P 500

- 95% of S&P make available sustainability information
- 51% have had some form of Assurance or verification over ESG metrics
- 6% had assurance from public company audit firm while 47% had assurance from engineering or consulting firm (non-CPA)

Source: Center for Audit Quality Review of S&P 500 ESG Reporting as of 6/18/2021

Level of Assurance: Of the companies that had assurance from public company auditors, most of them obtained limited levels of assurance over select information. Three companies obtained limited assurance over some metrics and reasonable assurance over other metrics and two companies obtained just reasonable assurance.



*Level of assurance could not be determined from the company's documentation of assurance in its ESG reporting.

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ESG REPORTING & ATTESTATION

The Auditor's Role

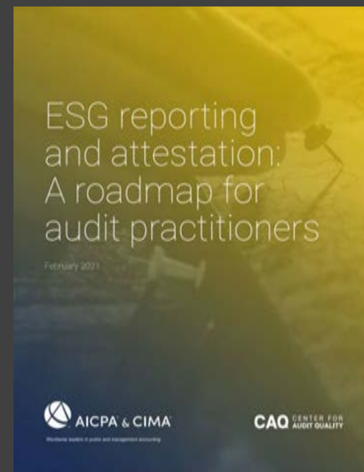
KEY CONSIDERATIONS

- Scope of subject matter
- Sufficient/appropriate evidence
- Reporting criteria to be measured against (e.g., ESG standards/frameworks; custom metrics)?
- Level of attestation – e.g., exam/review
- Where/how will ESG information and attestation report be disclosed/used
- Consistency, comparability, frequency of reporting
- Appropriate governance and controls over process
- Materiality
- Other rules/regulations

UNDERLYING ASSUMPTIONS

- The building blocks of reliable, comparable and relevant ESG information begin with quality reporting by management.
- 3rd-party assurance from an independent accounting firm can enhance the reliability of ESG information reported by companies, in a manner similar to the rigorous process that occurs with audits of F/S and ICFR.

Source: AICPA & CAQ *ESG Reporting and Attestation Roadmap*



Keeping ESG Reporting Clean

- Ensure policies, procedures and internal controls.
- Utilize relevant ESG ratings and reporting frameworks.
- Consistently represent ESG disclosures and claims.
  - Are we using unclear terms like "sustainable?"
  - Are our labels and logos from accredited organizations?
  - Is there easily accessible evidence provided to support ESG claims?
  - Is the frequency and timing of reporting appropriate, sufficient, consistent and comparable?
  - Is reported information factual or misleading; are standards and metrics "cherry picked?"
- Verify ongoing monitoring of methodologies and requirements.
- Compare to peers.

Board and Management Oversight

At a Glance – Role of the Board

- Establish the tone from the top with respect to ESG
- Define oversight responsibility and board committee structure
- Identify, monitor and oversee management of non-financial risks correctly
- Be alert to controls over data quality for more effective information management, decision-making and reporting
- Establish management accountability criteria and integration of ESG objectives into overall corporate strategy
- Ensure communication and reporting is reflective of prioritized ESG factors, related objectives and tracking of progress

Addressing Stakeholder Expectations of Boards

Stakeholder	Expectations of the Board
Investors	Oversee the integration of ESG into operations that support sustainable value creation strategies.
Proxy Advisors	Disclose the board's role in overseeing environmental, social and governance issues.
Rating Agencies	Ensure management provides up to date information on ESG policies, initiatives and performance.
Regulators	Ensure the organization discloses its material ESG risks and impact on the business, and how management is mitigating those risks.
Management Teams	Oversee the development and direction of the ESG strategy, goals and objectives to address related risks, including oversight of the controls, policies, processes, metrics, incentives and monitoring processes in executing the strategy.
Employees	Establish clear communication and tone of urgency from the top. Hold the management team accountable for carrying out the organization's mission, visions and values while encouraging innovation and ensuring the well-being of all employees.

CEO, Management Team and Board Considerations For Proactive & Evolving ESG Risk Management & Oversight

Identifying Business-Relevant ESG Issues
- Current process and assumptions
- Competitor analysis
- Integration into ERM

Prioritizing ESG Risks/Opportunities Based Upon:
- Materiality assessment/risk tolerance
- Stakeholder impacts/expectations - engagement
- Market impact, valuation
- Decision-useful information

Clearly Define Board Oversight:
- Identify full board/committee roles
- Update board charters
- Consider disclosure of oversight

Tying to Strategy and Value Creation:
- Establishing short-term and long-term targets, goals and metrics in line with business strategy
- Assessing resource needs internally/externally
- Establishing compensation incentives

Selecting Applicable Frameworks and Methodology
- Assess availability of data
- Process/internal controls for collecting/integrity of data

Defining Performance Accountability
- Tracking & monitoring mechanisms

Designing Reliable Reporting
- Selecting appropriate standards/frameworks
- Designing controls and processes over ESG data
- Identifying communication channels – sustainability reports, websites, filings
- Integrating within financial statements

Maintaining ESG as a Regular Board Agenda Item
- Defining and formalizing responsibilities among board/committees/management
- Ensuring continued education on ESG matters

Assessing Need for Third-Party Assurance
- Compliance
- Data integrity

US ESG EXECUTIVE LEADERSHIP TEAM

ESG Leadership Team

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2:05 – 3:35 p.m.

Crypto & Audit Implications: Trends & Applications for Accounting Practitioners

Dr. Sean Stein Smith, CPA, CMA, CFE, CGMA, *Assistant Professor, City University of New York - Lehman College*

Blockchain Systems: Audit of the Future

Dr. Sean Stein Smith
City University of New York – Lehman College
Founder – Institute For Blockchain & Cryptoasset Research

About me

- Dr. Sean Stein Smith, CPA, CMA, CGMA, CFE
- Assistant Professor, Lehman College, City University of New York
- Forbes Contributor – Crypto & Blockchain
- AICPA Outstanding CPA of the Year (2022)
- Accounting Today Top 100 Most Influential People in Accounting
- E.C. Harwood Visiting Research Follow – American Institute of Economic Research
- Board of Advisors – Wall Street Blockchain Alliance (WSBA)
- Chair, Accounting Working Group, WSBA
- Advisory Board Member – Gilded "Crypto Accounting Made Simple"
- Strategic Advisor – Crescent City Capital
- 40 under 40 in Accounting (2017-2021)
- NJCPA Trustee (2022 FY)

Quick crypto level-set

How is BTC different from fiat?

Bitcoin

- Fixed supply (21 million)
- Requires investment to create new units
- Not issued by a government or central oversight authority
- Borderless
- Cryptographically secured

USD

- Unlimited supply (printer go brrr)
- No investment required to increase supply
- Controlled entirely by central government or central bank
- Linked to specific nation-state
- No inherent security

Different cryptoassets (more than bitcoin)

Crypto-classes

- Decentralized cryptocurrencies
  - Bitcoin
- Semi-centralized cryptocurrencies
  - Stablecoins
- Centralized cryptocurrencies
  - Central bank digital currencies

Applications

- Smart contracts
  - Enable blockchains to talk to other technology
- Decentralized autonomous organizations
  - Organization governed by smart contracts
- DeFi
  - Banking without the banks

Crypto Market Update

Ethereum merge, recap.

- The Ethereum merge has successfully been completed (September 2022)
  - Ethereum blockchain has converted from Proof-of-Work consensus to Proof-of-Stake consensus
  - Energy consumption will decline by approximately 99% as a result
  - Opens the door for further pivoting away from BTC to ETH as crypto market leader
- Tax accounting has not changed
  - More on that later
- Financial accounting has not changed
  - Not yet at least

Is ether a security?

- Same day as ETH merge completing, SEC chair Gary Gensler offered testimony that staked crypto could qualify as securities
- Meet criteria of the Howey Test as an "investment contract"
- https://cointelegraph.com/news/ether-staking-could-trigger-securities-laws-gensler

ETHPoW Fork?

- Speculated to possibly cause some issues with regards to the appetite/market post-merge
- Appealed to PoW miners looking to remain in business
- Token crashed up to 75% at worst declines following the merge
  - (24-36 hours after)
- Is showing signs of gaining popularity with some non-U.S. mining pools, etc.
- https://cointelegraph.com/news/does-ethereum-s-new-ethpow-fork-stand-a-chance-ethw-price-falls-65-post-merge
- https://news.bitcoin.com/new-ethereum-pow-fork-gathers-60-terahash-from-well-known-pools-ethws-price-shudders-39-in-24-hours/
- https://decrypt.co/110023/ethereum-fork-ethpow-suffers-bridge-replay-exploit-token-tanks-37

SEC Crypto Asset Office – Sept 2022

- Office of Crypto Assets will join the seven (7) existing offices that handle corporate disclosure filings
- https://www.reuters.com/markets/us/us-sec-set-up-new-office-crypto-filings-2022-09-09/
- *Office of Crypto Assets*
- The Office of Crypto Assets will continue the work currently performed across the DRP to review filings involving crypto assets. Assigning companies and filings to one office will enable the DRP to better focus its resources and expertise to address the unique and evolving filing review issues related to crypto assets.
- https://www.sec.gov/news/press-release/2022-158

U.S. GAAP Primer

- U.S. Generally Accepted Accounting Principles are the rules that U.S. publicly traded firms must follow
  - U.S. domiciled and foreign firms trading on U.S. markets
- Determines how assets, liabilities, and equity instruments are reported on financial statement and for external financial reporting purposes
- The Financial Accounting Standards Board (FASB) is the group that writes, reviews, and codifies GAAP standards
- Up until 2021-2022, the FASB refused to consider crypto accounting rules at all

The GAAP problem

- What is the best way to describe crypto from an accounting perspective?
- Asset?
- Liability?
- Equity?
- In most cases it can be argued that crypto represents some sort of asset
- But what kind?
- Intangible
- So what’s the problem?

The GAAP problem, cont.

- Under U.S. GAAP
  - Intangible assets cannot be marked to market
  - Intangible assets must be tested for impairment
  - If impairment has occurred, these assets must be written down
  - After impairment has occurred, the value can never be restored
- These represent major issues for firms seeking to use/accept/hold cryptoassets
- Crypto remains a volatile asset class

FASB Takes Action

- More recently the FASB has taken action to try and resolve these accounting issues
  - December 2021 the FASB added a digital asset project to its research agenda
  - May 2022, the FASB added this project to its technical agenda
- All seemed to be moving in the right direction
- https://www.fasb.org/Page/ProjectPage?metadata=fasb-Accounting-for-and-Disclosure-of-Crypto-Assets
- Not quite as thorough as was previously hoped

August/September 2022 update

- The FASB has released a statement setting the criteria that will be used on this project
- NFTs are excluded
- Certain stablecoins are excluded
- No specific crypto named to be included or not


CoinDesk

Policy

FASB Crypto Accounting Review Won't Include NFTs, Certain Stablecoins: Report

The accounting standards body outlined its criteria for crypto assets that would be covered by a forthcoming rule regarding companies and their digital assets.

- https://www.coindesk.com/business/2022/10/13/fasb-mulls-fair-value-accounting-for-crypto-holdings-report/


CoinDesk

Business

FASB Mulls Fair-Value Accounting for Crypto Holdings: Report

Fair-value accounting for crypto will encourage companies to put bitcoin on their balance sheet, according to Michael Saylor.

By Oliver Knight Oct 13, 2022 at 5:48 a.m. EDT

Jarrett vs. United States

- Nothing has changed as a result of these headlines
- Staking rewards are still an ambiguous tax topic
  - Post-merge this will become more important
- No change to IRS guidance or FAQs
- No indication that policy changes are coming
- Conversation specific to the unique facts and circumstances of this case and complaints therein
- https://www.natlawreview.com/article/recent-tax-developments-concerning-staking-rewards
- https://news.bloombergtax.com/tax-insights-and-commentary/taxpayers-in-jarrett-case-still-seek-an-answer-on-crypto-staking

Bad news! Sept/Oct 2022

- Jarrett case has been dismissed
- Jarrett plans to file appeals with existing legal team
  - Includes the Proof of Stake Alliance
- As of right now, block rewards and staking rewards are taxable upon creation
- https://news.bloombergtax.com/daily-tax-report/crypto-staking-tax-lawsuit-ruled-moot-after-irs-issued-refund

Crypto Staking Tax Lawsuit Ruled Moot After IRS Issued Refund

Crypto hack – August 2021

- Over $600 million stolen in Poly hack
- Spans multiple blockchains, exchanges, and financial institutions
- Operates in the decentralized finance (DeFi) space
- https://www.reuters.com/technology/defi-platform-poly-network-reports-hacking-loses-estimated-600-million-2021-08-11/


Technology

Crypto platform Poly Network hacked in estimated $600 mln cyberheist

Alun John, Tom Westbrook, Tom Wilson

Crypto hack – the plot thickens

- Most funds were eventually returned..
- https://www.reuters.com/technology/over-half-crypto-tokens-stolen-610-mln-hack-now-returned-poly-network-says-2021-08-12/#:~:text=Poly%20Network%2C%20a%20platform%20that,are%20still%20outstanding%2C%20it%20said.


Technology

Over half of crypto tokens stolen in $610 mln hack now returned, Poly Network says

Tom Wilson

Phew…

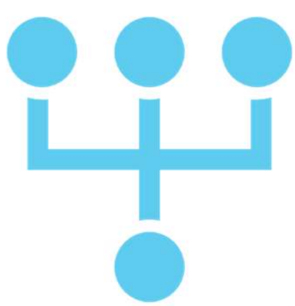
- Something you might be thinking is

Accounting Standards?

- Nothing authoritative from the FASB that is crypto-specific
- AICPA has issued several research and whitepapers
- Most recently
- Accounting for and Auditing of Digital Assets [Practice Aid]
- https://www.aicpa.org/interestareas/informationtechnology/resources/blockchain/digital-assets.html

Blockchain & Audit

Will blockchain destroy the audit?



- Are auditors going to become redundant?
- No!
- Automation is coming to the profession, but blockchain will not replace auditors or the audit process
- Let’s get to it?

Crypto Accounting

Let's remember

- Blockchain is NOT an accounting system
- Nothing to do with accounting
- It is called a "ledger" but it's not like ledgers we are used to discussing
- More specifics to remember as well

What blockchain doesn’t have

- No debits
- No credits
- No income statement
- No balance sheet
- No cash flows
- Blockchain is just a record of transactions at a certain date in time

UTXO model (Bitcoin)

- Bitcoin: Unspent transaction output (UTXO) model
- How the balance of BTC is tracked
- UTXO equals transfer of coins
- A transaction spends coins (UTXOs) and creates new coins (UTXOs).
- All inputs (UTXOs) must equal all outputs (UTXOs).

Account model (Ethereum)

- Ethereum: account based balance model.
- Entire record of the Ethereum is the current state of wallet balances
- The balance in an account (wallet) is the total number of coins, Ether (ETH).
- Uses debits (subtracts) and credits (add) to update account balances
- This is like a journal entry with a debit and credit of the same amount.

ethereum

Audit Implications

Big picture

- There are a few things ever audit or assurance professional needs to know about blockchain and audit
- No need to become computer programmers or coding experts overnight
- Need to be to articulate and communicate core items that clients and professionals need to know about

Core elements to keep in mind

- Every blockchain is different and needs to be monitored individually
- Controls will not become less important
- Data access and integrity are more important
- Audit will need to evolve and change
- Clients need to be a part of this conversation

Hard fork vs Soft fork

- Both a hard fork and soft fork are software upgrades for the underlying blockchain that drives and supports the various cryptocurrencies
- Hard forks are not backward compatible with previously existing code and cryptocurrencies
- Soft forks are backwards compatible with existing code and cryptocurrencies
- Wallets would have to be upgraded

Accounting considerations

- If a hard fork occurs, how should the issuance of new currencies be accounting for? (ETH and ETC)
- What about soft forks that “edit” the underlying blockchain code?
- Are the changes in price that result from forks shown as realized or unrealized gains/losses
- What about how these are shown on the P/L and B/S

Food for thought

- What if an investor or holder of cryptocurrencies does not want to receive the new versions of the cryptocurrency?
- What happens if an investor does not agree with the fork?
- Is there a process by which investors can redeem coins prior to the fork?

Audit Implications

- Anyone work on a SOC 1 engagement?
- What about a SOC 2 engagement?
- Section 404 of SOX
- What do those have to do with blockchain and cryptoassets?

SOC 1

The SOC 1 report

Also known as the Statement on Standards for Attestation Engagements (SSAE) 18, the SOC 1 report focuses on a service organization's controls that are likely to be relevant to an audit of a user entity's (customer's) financial statements. Control objectives are related to both business process and information technology. A SOC 1 – Type I audit report focuses on a description of a service organization's control and the suitability of how those controls are designed to achieve the control objectives as of a specified dates. A SOC 1 –Type II audit report contains the same opinions as a Type I, but it adds an opinion on the operating effectiveness to achieve related control objectives throughout a specified period. Learn more about SOC 1 Type I and Type II reports here. SOC 1 audit reports are restricted to the management of the services organization, user entities and user auditors.

SOC 2

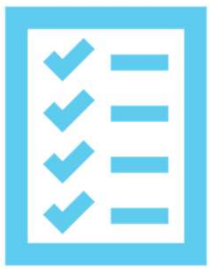
The SOC 2 report

The SOC 2 report addresses a service organization's controls that relate to operations and compliance, as outlined by the AICPA's Trust Services criteria in relation to availability, security, processing integrity, confidentiality and privacy. A service organization may choose a SOC 2 report that focuses on any one or all five Trust Service principles and may choose either a Type I or a Type II audit. A SOC 2 report includes a detailed description of the service auditor's test of controls and results. The use of this report is generally restricted.

Why was the SOC 2 report created?

The SOC 2 report was created in part because of the rise of cloud computing and business outsourcing of functions to service organizations. These are called user entities in the SOC reports. Liability concerns have caused a demand in assurance of confidentiality and privacy of information processed by the system.

Audit Implications, cont.



- Core components on blockchain redefine the audit
- 1) Traceability
- 2) Transparency
- 3) Consensus data approval
- 4) Tamper resistant
  - Not immutable!
- 5) Real time nature of data communication

Blockchain impact on audit

- Generates the following questions:
- 1) How do we avoid the black box of automation as processes are automated?
- 2) Are there processes in place to maintain appropriate authorization over the source code?
- 3) Do we have controls over smart contracts?
  - Smart contracts are what make blockchains “work” and interact with other technology systems?
- 4) Blockchain by itself will not verify the accuracy of information

Starting points

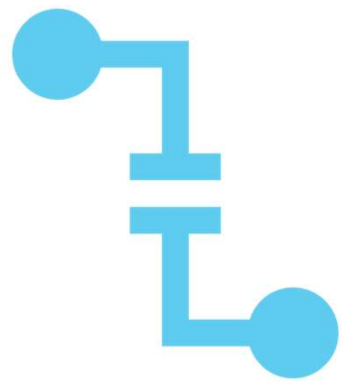
- Everywhere!
- Audits try to attest to
  - Value
  - Completeness
  - Accuracy
- Access to network level information can assist with all of these audit functions

Audit considerations

- Blockchain will change the workflows associated with internal processes at the both
  - Client
  - Audit and accounting firm
- Monitoring of data on-ramps and off-ramps will need to increase to accompany the change in data flows
- Auditors need to understand how the blockchain is functioning inside the client
  - And why!

Why controls matter

- Blockchain and crypto-space is littered with past failures
- Mt. Gox
- Quadriga
- Binance
- Tether, Crypto Capital, Bitfenex
- All connected to control and workflow failures
- Not blockchain problems!



Blockchain use case

- Why is the client considering, or implementing, a blockchain platform anyway?
- Are there cryptoassets involved, or non-financial data?
- Do all involved firms understand the industry specific industry laws that need to be taken into account
- Has interoperability been addressed?

Other audit considerations

- How is the blockchain updated?
- Are employees at the client educated and trained to use blockchain appropriately?
- Does the audit team understand how blockchain workflows and the need for controls?
- What is the status of GAAS updates and modifications to reflect blockchain-augmented audit?

Blockchain pitfalls

- Blockchain is <u>not</u> an accounting system
- Augments and supplements accounting systems, but it is NOT an accounting system
- Means that interoperability and accuracy of information is still the responsibility of auditors
- Controls are even more important in a blockchain environment
- Processes do need to change

Pain points

- According to an AICPA report, a transaction recorded in a blockchain may:
  - Be unauthorized, fraudulent, or illegal.
  - Be executed between related parties.
  - Be linked to a side agreement that is "off-chain."
  - Be incorrectly classified in the financial statements.
- Represents work opportunities for CPAs
- https://www.aicpa.org/content/dam/aicpa/interestareas/frc/assuranceadvisoryservices/downloadabledocuments/blockchain-technology-and-its-potential-impact-on-the-audit-and-assurance-profession.pdf

Where does the auditor fit?

- Where exactly does an accounting or audit firm fit in this conversation?
- Probably not as a full member — Unnecessary and could compromise independence
- Member with limited access
- Allowing access to financial data without violating industry specific data privacy laws

New job opportunities

- **Auditor of smart contracts.** Smart contracts may be embedded in a blockchain to automate business processes. Parties to smart contracts may be eager to engage a CPA to verify that smart contracts are implemented with the correct business logic.
- **Service auditor of consortium blockchains.** Potential users of private blockchain products may wish to engage a CPA to provide independent assurance on the stability and robustness of the system's architecture. Rather than each participant performing his or her own due diligence, it may be more efficient to hire a CPA to achieve these objectives. A trusted and independent third party may be needed to provide assurance as to the effectiveness of controls over the private blockchain.
- **Access-granting administrator.** A trusted, independent third-party CPA may be the perfect candidate to serve as the central access-granting administrator for a blockchain that requires permission to join.
- **Arbitrator.** CPA assurance providers may be among the qualified professionals in the future who would settle disputes among participants in a private blockchain.
- https://www.journalofaccountancy.com/news/2018/mar/how-blockchain-might-affect-audit-assurance-201818554.html

Smart contract auditor

- Smart contracts are what actually allow blockchains to speak to each other and interact with other blockchains
- CPAs and auditors can serve as an independent third party to
- 1) Check that the code language is up to date
- 2) Ensure the smart contracts actually operate as advertised
- 3) How is this engagement going to be structured?
- 4) How will access to counterparty systems be monitored?
- 5) What about internal controls around the smart contact audit?

Service auditor (consortium)

- Consortium blockchains seems to be moving to the forefront of enterprise blockchain conversation
- Who will help ensure these blockchains are operating as advertised?
- Might be simpler to hire a CPA firm to perform an assurance engagement over this?
- But, does this impact independence, i.e. who pays the CPA firm?

Access granting role?

- Consortium blockchains need different classes of access and authorization
- Actually the core value proposition of the consortium model
- Who grants, monitors, and updates these levels of access?
- CPA firm?
- What type of insurance is necessary in this case?

Arbitrator

- Who helps resolve problems when they arise?
- What if these problems are caused due to
  1) Outdated blockchain code
  2) Erroneous smart contract language
  3) Faulty business logic
- All potential opportunities for audit and attestation professionals

Blockchain insurance

- Errors and omissions coverage are well understood, but blockchain opens the door for additional insurance liability coverage
- Are there even products available out there for clients of accounting firms to purchase?
- If so, does the pricing of these policies hinder broader adoption going forward?

Market Examples & Resources

EY Blockchain Analyzer

- Recently launched Blockchain Analyzer 2.0 tool
- To be used for internal clients to date, but portions have been released to the public
- High profile example of commercial level application
- https://www.ey.com/en_gl/news/2019/04/multimillion-dollar-investment-in-ey-blockchain-analyzer-delivers-new-upgrades-for-blockchain-and-cryptocurrency-audit-and-tax-services

PwC Blockchain Audit Tool

- Recently launched and updated
- Main point of differentiation is that this tool allows auditors to verify crypto balances and transactions without needing private key information
- Critical to custody and provenance
- https://cointelegraph.com/news/will-pwcs-new-software-solve-the-cryptocurrency-auditing-problem

Microsoft Blockchain

- Powered by Azure to audit smart contracts running on the Ethereum blockchain
- Remember, smart contracts are what make blockchains do anything
- Ethereum forms the basis for most new smart contracts and applications
- https://thenextweb.com/hardfork/2019/06/04/microsoft-azure-blockchain-ethereum/

Where to learn more

- Wall Street Blockchain Alliance
- Association of International Certified Professional Accountants (AICPA)
- CPA.com
- Be sure to look for industry specific resources as well!

Thank you!

- Questions?
- Comments?
- Jokes?
- Email – drseansteinsmith@gmail.com
- Twitter - @seansteinsmith
- LinkedIn – Sean Stein Smith

3:50 – 4:40 p.m.

Hot Tax Practice Procedure & Ethical Issues

Michael Goller, J.D., *Shareholder & Tax Department Chair,*

Reinhart Boerner Van Deuren s.c.

HOT TAX ETHICS, PRACTICE AND PROCEDURAL ISSUES

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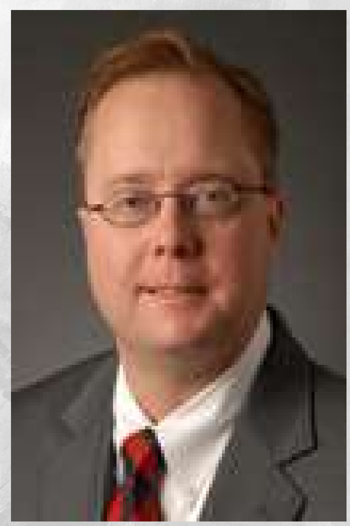
Michael G. Goller is a shareholder in Reinhart's Tax, Litigation and Business practices. He focuses on tax controversy and tax litigation, as well as tax and estate planning. His clients range from large public corporations to midsized, privately held businesses and their owners. Michael works on behalf of his clients in disputes with the IRS, the Department of Justice and various other taxing authorities.



Reinhart
Boerner Van Deuren s.c. Attorneys at Law

Table of Contents

PART I
Hot Practice and Procedure Issues

- The IRS is going to receive a lot of money. How will it be spent?
- What are the hot audit issues?

Hot Issues – Which Will Get Hotter

- Partnership Audits
- High Net Worth Audits
- Estate and Gift - Valuation Issues
- Net Operating Loss and Basis Issues
- Passive Losses and the Real Estate Professional
- Section 183 – "Hobby" Loss Cases
- Refund Claim Traps
- Employment Tax Audits
- Penalty Issues

PARTNERSHIP AUDITS

New Partnership Audit Program and related high net worth audit program are HOT in FY 2022, and beyond.

Source: Tax Notes (9/20/21)

Overview

The BBA, among other things, eliminates the so-called TEFRA Unified Partnership Audit Procedures[1] and the Audit Procedures for Electing Large Partnerships.[2] It also creates a more streamlined partnership audit approach, thus making it easier for the IRS to audit a partnership.

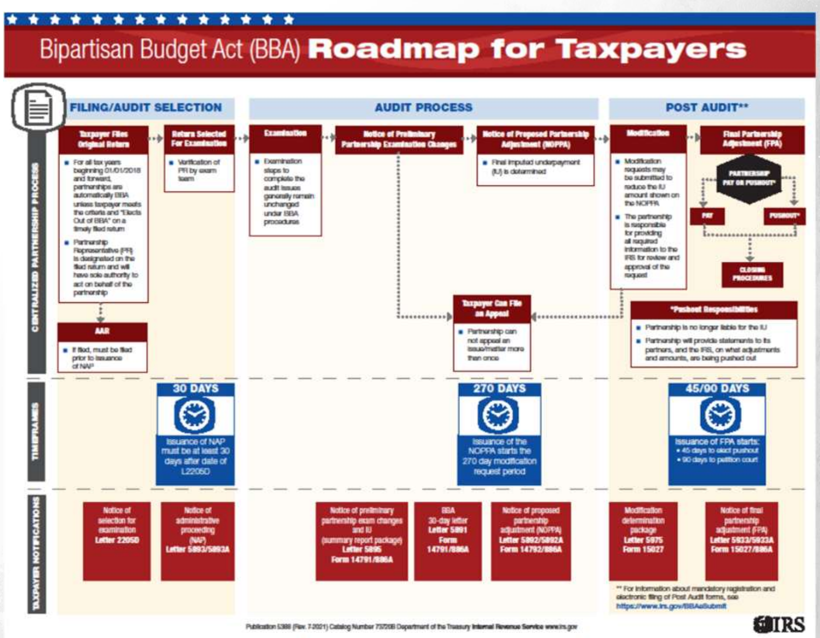
1 These were first created in the Tax Equity and Responsibility Act of 1982.

2 Created as part of the Taxpayer Relief Act of 1997.

Neutral Revenue Raiser

- The BBA was promoted as a "neutral" revenue raiser (*i.e.*, a revenue raiser in disguise); in that an increase in partnership audits will raise revenue without increasing taxes.
- It is expected that the new audit procedures and increased audits will yield $9.3 billion of additional revenue over ten years. As such, the law gained quick approval in Congress.

Partnership Audit Road Map



Current Status

- These audits seem to be off to a slow start
- IRS is asking for lengthy statute extensions

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Airplane Cases

- Partnership or corporate structure
  - Personal Entertainment v. Non-Personal Entertainment
- SIFL or §274-10(e)
- Schedule C Structure – CCA 202117012 (4/30/21)
- Depreciation and the Section 280F trap
- Entertainment Facility trap

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Auditing Net Operating Losses

- What are the rules of the road
- Many traps – the statute of limitations is an issue

Comment: The five year net operating loss carry back has made this very relevant

Statute of Limitations Issues

- A statute of limitations is a law that specifies the amount of time within which an act must be performed to be legally binding.
- Normally, the IRS must make any assessment of additional tax within three years of the time a return is filed.
- Assessment is nothing more than a bookkeeping entry made on the records of the Internal Revenue Service. Specifically, section 6203 provides that an "assessment shall be made by recording the liability of the taxpayer in the Office of the Secretary [of the Treasury] . . . ."
- A determination as to when the IRS made an assessment can be made by reviewing an IRS transcript of account.

Statute of Limitations Issues (cont.)

There are a few significant intricacies about the statute of limitations on assessment

A. A return filed prior to the due date is treated as filed on the due date
B. If the return is filed after the due date, then the actual date of filing is used
C. A return required to be filed return is deemed filed when it is postmarked, if the return is timely filed
D. If the return is not filed when due, then the filing date, for limitations purposes, is the date it is actually received by the IRS. When a return is filed with the wrong Service Center, the statute does not begin to run until the redirected return is received by the correct Service Center

Statute of Limitations Issues (cont.)

E. When calculating the 3-year period, the date that the return is actually filed is excluded
F. When the due date falls on a Saturday, Sunday, or legal holiday, the return is considered timely filed if it is filed on the next business day. In such an instance, the statute of limitations begins to run on the actual date of filing.
G. The statute of limitations on assessing estate tax cannot be extended. See § 6501(c)(4)(A)

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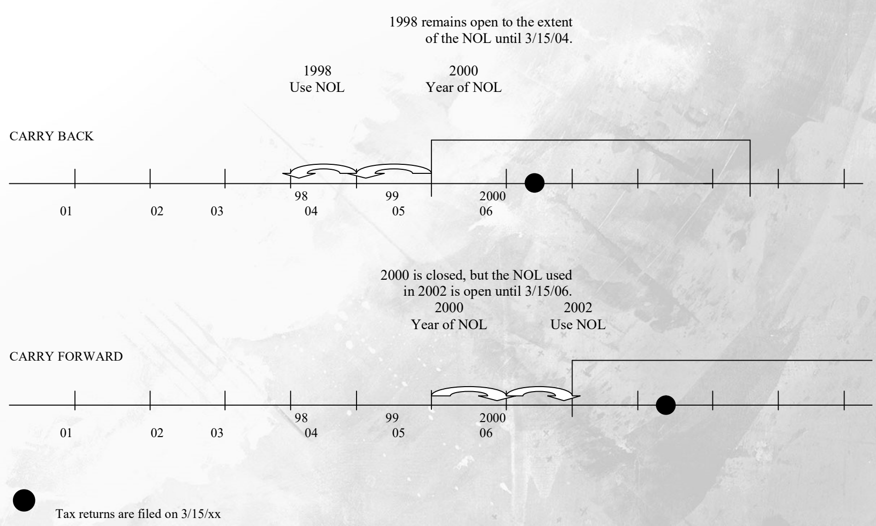
Exception to Three-Year Rule for Items Carried Forward or Back

A. A deficiency attributable to the carry-forward of a net operating loss, capital loss, or unused tax credit may be assessed within 3 years of the date of filing the return for the year the loss or credit is used, even though such date may be well beyond the normal statute of limitations for the year to which the loss or credit originally arose

B. The statute of limitations on a carryback runs from the year of the loss, not the year in which the benefit of the loss is put to use

Net Operating Losses and The Statute of Limitations on Assessment § 6501



IRS Attach on Cost Segregation Studies

- Publication 5653 (Rev. 6-2022) “Cost Segregation and Audit Technique Guide”
- Revisions were not large but whenever the IRS revises an audit manual, there will be audits

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Sample IDR

Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 006
To: [redacted]	Subject: Activity Log	
	Submitted to: [redacted]	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

1. Please complete and sign the attached log forms (Exhibit A for calendar year 2019 and Exhibit B for calendar year 2020) for each real estate activity for which Taxpayer claims to have materially participated.
   a. List all hours and services performed for the 2019 and 2020 calendar years. Provide detailed explanations of services or activities performed.
   b. Provide documents to support hours claimed. This can include, but is not limited to, calendars, diaries, or other documents that reflect services provided and hours attributable to those services.

Where documents exist in electronic format, please provide in original electronic format.

Draft Date: 9/16/2022
Due Date: 11/7/2022

Information Due By 11/7/22 At Next Appointment ☐ Mail In ☐

FROM	Name and Title of Requestor: Hwang, Yujin Internal Revenue Agent	Badge Number: 1003822997 Phone: 312-292-3152 Fax: 855-330-7359 Email: Yujin.hwang@irs.gov	Date: 9/16/2022
	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 1 of 1

Form 4564

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Passive Losses and the Real EstateProfessional

- Section 469
- Rental Real Estate
- Real Estate Professional
- Proving Material Participation
- Make a Grouping Election – watch limited partnership trap

Section 183 "Hobby" Loss Cases

- Section 183
- Recent case - Walters v. Comm'r, T.C. Memo 2022-17 "Green Home" was a for profit venture

PART II
The Very Hot Research Credit

The Section 41 Research Credit

- Background of the Research Credit
- Different types of Research Credits
  - Regular Credit--20% of current year's expenses over base period expenses. Must prove up fixed base percentage.
  - Alternative Simplified Credit–-credit ranges from 1.65% to 3.75% and is a function of three prior years' sales

The four tests:

- Elimination of Uncertainty for each New or Improved Business Component Test
- Technological in Nature Test--discover information that is technological
- Process of Experimentation Test--Experiment in the "scientific" sense
- Business Component Test--needs some level of functional improvement to a new or improved Business Component

Examples

- Software development
- Improving the manufacturing process
- New technology exploration
- A great deal of manufacturing can qualify, but look closely at the four tests

IRS Concerns

- A great deal of manufacturing can qualify, but look closely at the four tests
- IRS believes there is widespread abuse
- Discovery Requests- very broad
- A Second (or Third) Tour – very common
- Funded Research – a hot issue
- Base Period Substantiation-Traditional Credit
- IRS “Upping the Ante” by Amending the IRS’s Tax Court Answer to Disallow all QRE and Assert a Penalty
- New IRS policy on refund claims

Uncertainty Test

- “Activities intended to discover information that would eliminate uncertainty concerning the development of improvement of a product.”
- Uncertainty exists if the <u>information available to the taxpayer at the start</u> of the project does not establish the method of improving or designing the component.
- Uncertainty must be as to technical ability, not economic or business uncertainty.
- Focus is on activities being conducted to address the uncertainty.

Technological in Nature Test

- "Activities undertaken for the purpose of discovering information which is *technological in nature*."
  - Technological in Nature
    - Relies on the principles of hard sciences, such as engineering and physical, biological, or computer sciences.
    - May apply existing technologies or principles to eliminate uncertainty.
    - Patent safe harbor- rebuttable presumption that test is met if there is a patent.

Process of Experimentation Test

- Substantially all (i.e. 80%) of the activities constitute a process of experimentation.
- Hypothesis, Test, Retest
  - Factors indicating experimentation:
    - Testing and analyzing alternative hypotheses
    - Significant scientific testing, and
    - Evaluation of numerous of complex technical tests

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Business Component Test

- Development of a product and/or process
- A business component is “a product, process, computer software, technique, formula, or invention” that is held for sale, lease or license or is used by the taxpayer in a trade or business.
- Section 41(d)(2)(B)
- Research relating to process improvements must qualify separately from the research relating to the product produced
- There must be some level of functional improvement
- Shrink Back Rule
  - If an entire product or process does not meet the test, the components of the product or process may be considered and some of the costs may qualify.

IRS Exam, Appeals and Litigation Process

- Involvement of the examination function at appeals is now common
- IRS "engineer"--often not an engineer
- Hazards of litigation
- Document IRS concessions (i.e., the "engineer" agrees an item has been documented)
- IRS attorney will often try to raise a "New Issue“ (i.e., a penalty, funded research, disallow all QRE, look closer at the “Substantially All” test

The IRS "Engineer"

- May not be an engineer
- Often "drives the bus"

Good Credit Study

- Allocate costs by New or Improved Business Component
- Avoid repeated "boiler plate" language
- Study should summarize findings, not repeat statements (hearsay issue)
- The author of the credit study summarizes his or her investigation and then opines that:
  - The four tests are met
  - None of the exclusions apply (e.g., funded research or undocumented contract research)

IRS Standard Information Document Request ("IDR") Traps

- The IRS typically issues a "standard" IDR in all research credit cases. Think about these questions before the return is filed.
- Traps to watch for
- Don't confuse "Projects" with "New or Improved Business Components"
  - Each New or Improved Business Component must meet the four tests
- Each question is a potential trap/admission

The IRS Tour

- Usually a Fishing Expedition
- IRS Insists on These in Most Cases
- Manage the Interview – witness prep is key

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Witness Tips-Research Credit Cases

<u>Explain the Following to the Witness</u>

- To qualify for the R&D credit, activities must meet all of the following four tests.
  - **Elimination of Technical Uncertainty** – The research is intended to **eliminate technical uncertainty** as it relates to any of the following:
    - Capability uncertainty – can we do what is asked?
    - Methodology uncertainty – how will we do what is asked?
    - Design uncertainty – can we design the actual solution?

Witness Tips-Research Credit Cases (cont.)

- **Technological in Nature** – The research must be designated to discover information that is **"technological in nature"**. The research activities must rely on the **principals of science, such as engineering, physical, biological, or computer science**.

- **Process of Experimentation** – The research must involve a process of **experimentation** intended to eliminate the technical uncertainty (**hypothesis**, test, retest).

Witness Tips-Research Credit Cases (cont.)

- **New or Improved Business Component** – The research must be intended to develop or improve the **performance, function, quality, or reliability of a product, process or system** (i.e. new of **improved business component**).

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Common Interview Questions/Themes

General

- What is your educational/technical background?
- What was your role on the project? The IRS is looking to disqualify wages not related to the research activities (e.g., sales, day-to-day operational support, management activities).
- How did you calculate the research expenses (e.g., time tracking system, calendar meetings, other records)?
- Do you contract with third parties who perform research?
- Maintenance activities can be research activities-but you may need to explain this.

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Common Interview Questions/Themes (cont.)

- Business Component (i.e., project) specific questions:
  - What was the goal of the project?
  - What were the specific research activities?
  - What were the steps in the development of the new or improved product, process, or system?
  - Why was there uncertainty
  - When did research cease (i.e., when was the technical uncertainty eliminated?)?
  - Wasn't this just "pure math"

Common Interview Questions/Themes (cont.)

- What risk of loss existed when you undertook this research
- What rights did you retain in your research (be prepared to address language in a contract)

Tips for Answering Questions

- **Don't minimize your involvement in research projects.** This is not a time for humility.
- **Provide specific examples of your technical involvement in research projects.**
- Avoid words and phrases like "**tweak**," "**refigure**," "**modify**," "**we know we could do it**"
- Mention specific challenges, problems, obstacles, uncertainties, and failures (**failure is a good thing for purposes of the credit**) and the steps undertaken to try to arrive at a solution (e.g., hypothesis, testing, retesting, prototyping, modeling).

Tips for Answering Questions (cont.)

- Mention the risk of loss you faced
- Words and phrases like "**scientific**," "**uncertainty**," "**test and retest**," "**measure data**," "**solution**," "**new or improved product**," "**new or improved process**," "**new or improved system**" are helpful
- It's OK to say "I don't know, we will get back to you"
- Be honest
- Avoid going off topic

IRS Acknowledgement IDR-- Happens at the end of the audit

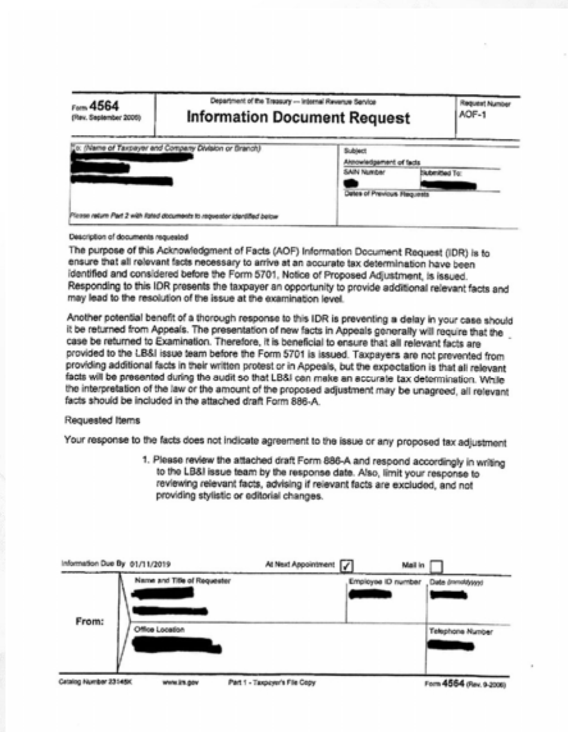
- IRS issues to most LB&I taxpayers an IDR that attempts to box the taxpayer into certain facts
- How to respond to the IDR?
- Why noncompliance is not an option:
  - Burden of proof issues
  - Rule of evidence issues (must make info available to opponent)
  - Penalty issues--arguing reasonable cause
  - IRS appeals uses a nonresponse as a basis for not appealing
  - Qualified Offer issues

Cooperation Issues

- Consider if you are eligible to switch the burden of proof to the IRS
  - Cooperation is important
  - Adequate records are important
- Noncooperation leads to admissions (e.g., statements or inferences that are later used against you)

Acknowledgement IDR

- Use the acknowledgement IDR to support your case



Form 4564 (Rev. September 2006) | Department of the Treasury — Internal Revenue Service | **Information Document Request** | Request Number AOF-1

To: (Name of Taxpayer and Company Division or Branch)
[redacted]

Please return Part 2 with listed documents to requester identified below

Subject: Acknowledgement of facts
SAIN Number: [redacted]
Submitted To: [redacted]
Dates of Previous Requests

Description of documents requested

The purpose of this Acknowledgment of Facts (AOF) Information Document Request (IDR) is to ensure that all relevant facts necessary to arrive at an accurate tax determination have been identified and considered before the Form 5701, Notice of Proposed Adjustment, is issued. Responding to this IDR presents the taxpayer an opportunity to provide additional relevant facts and may lead to the resolution of the issue at the examination level.

Another potential benefit of a thorough response to this IDR is preventing a delay in your case should it be returned from Appeals. The presentation of new facts in Appeals generally will require that the case be returned to Examination. Therefore, it is beneficial to ensure that all relevant facts are provided to the LB&I issue team before the Form 5701 is issued. Taxpayers are not prevented from providing additional facts in their written protest or in Appeals, but the expectation is that all relevant facts will be presented during the audit so that LB&I can make an accurate tax determination. While the interpretation of the law or the amount of the proposed adjustment may be unagreed, all relevant facts should be included in the attached draft Form 886-A.

Requested Items

Your response to the facts does not indicate agreement to the issue or any proposed tax adjustment

1. Please review the attached draft Form 886-A and respond accordingly in writing to the LB&I issue team by the response date. Also, limit your response to reviewing relevant facts, advising if relevant facts are excluded, and not providing stylistic or editorial changes.

Information Due By 01/11/2019 | At Next Appointment ☑ | Mail in ☐

From:
Name and Title of Requester: [redacted]
Employee ID number: [redacted]
Date (mm/dd/yyyy): [redacted]
Office Location: [redacted]
Telephone Number: [redacted]

Catalog Number 23145K | www.irs.gov | Part 1 - Taxpayer's File Copy | Form 4564 (Rev. 9-2006)

Form **4564** (Rev. September 2006) | Department of the Treasury — Internal Revenue Service | **Information Document Request** | Request Number AOF-1

2. Please check the box(es) that apply:

a. ☐ The taxpayer agrees that all relevant facts are documented in the attached draft Form 886-A.

b. ☐The taxpayer does not agree with specific facts documented in the draft Form 886-A. The taxpayer will identify the specific facts that are in dispute, and will provide documents to support those specific facts by the response date of this IDR that will permit the issue team to make an accurate tax determination.

c. ☐ The taxpayer does not agree that all relevant facts are documented in the draft Form 886-A. The taxpayer will identify all omitted relevant facts, will provide the documents upon which the taxpayer relied to support those additional facts that will permit the issue team to make an accurate tax determination, and will provide the additional facts by the response date of this IDR.

d. ☐ Other, please explain.

Information Due By 01/11/2019 At Next Appointment ☑ Mail In ☐

From: Name and Title of Requester [redacted] Internal Revenue Agent | Employee ID number [redacted] | Date (mmddyyyy) [redacted]

Office Location [redacted] | Telephone Number [redacted]

Catalog Number 23145K www.irs.gov Part 1 - Taxpayer's File Copy Form **4564** (Rev. 9-2006)

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Form **886-A** | **Explanation of Items** | Page 1 of 9 / Issue No.

Name of Taxpayer [redacted] | Tax Identification Number [redacted] | Year/Period Ended 201612-201712

IRC §41 – Credit for Increased Research Activities

A taxpayer may claim credit for certain increased research or experimental activities in connection with its trade or business. Research or experimental expenditures are expenditures incurred in the taxpayer's trade or business which represent research and development costs in the experimental or laboratory sense (for activities intended to discover information that would eliminate uncertainty concerning the development or improvement of a product). The computation of the Research Credit ("RC") is based upon Qualified Research Expenditures ("QREs"), specifically defined as wages, supplies, and contract research incurred in the research process.

Issue

In tax years 201612 - 201712 for [redacted] were the expenses used to compute the Research Credit, and the Credit amount correct and in accordance with IRC §41?

No. The correct Research Credit amounts for increasing research activities are reflected in the following table.

	2016	2017
Credit per Return	$ [redacted]	$ [redacted]
per IRS Audit	$ -	$ -
Adjustments to Credit	$ [redacted]	$ [redacted]

Please note the above credit amounts were determined using the Alternative Simplified Credit. The IRC § 280c reduced credit election was made in both years.

I, [redacted], IRS Engineer, wrote this report.

Form **886-A** Department of the Treasury - Internal Revenue Service

Reinhart Boerner Van Deuren s.c. Attorneys at Law

Form 886-A	Explanation of Items	Page 2 of 9 Issue No.
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

Facts

[redacted] was founded in [redacted] designs and manufactures [redacted]

When this case was first assigned as a consultation the focus was on 201612. As the audit progressed the IRS audit team decided to add the 201712 tax year as well. For the tax years 201612 and 201712, [redacted] prepared the [redacted] returns, conducted a Research Credit study and aided in the credit computations.

On September 21, 2018, [redacted] provided a tour of their facility [redacted] WI to gain a better understanding of its operations and the extent of research conducted. In addition, we interviewed [redacted] to understand how jobs/projects are taken from order receipt to passing the necessary components along to the construction contractor for installation at the customer site.

[redacted] does not track QREs by project, instead [redacted] determines qualified wages on an employee-by-employee basis. [redacted] evaluate projects, activities and costs to make determinations on the what percentage is appropriate given the law under IRC Section 41.

The following table summarizes the recent QRE history of [redacted]

	2013	2014	2015	2016	2017
Wages	[redacted]			[redacted]	
Supplies	-	-	-	-	-
Contract Research	[redacted]			[redacted]	
Total QREs	[redacted]			[redacted]	

Form 886-A   Department of the Treasury - Internal Revenue Service

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Form 886-A	Explanation of Items	Page 3 of 9 Issue No.
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

Applicable Law

Section 41(b)(1) provides that the term "qualified research expenses" means the sum of the following amounts which are paid or incurred by the taxpayer during the taxable year in carrying on any trade or business of the taxpayer: (A) in-house research expenses; and (B) contract research expenses.

Section 41(b)(2) provides, in relevant part, that in-house research expenses include any wages paid or incurred to an employee for "qualified services" performed by such employee, and any amount paid or incurred for supplies used in the conduct of qualified research.

Section 41(b)(2)(B) provides that qualified services means, for purposes of both in-house and contract expenses, (i) engaging in qualified research, or (ii) engaging in the direct supervision or direct support of research activities which constitute qualified research.

Treas. Reg. §1.41-2(c)(1) provides that engaging in qualified research for purposes of performing qualified services means the actual conduct of qualified research (as in the case of a scientist conducting laboratory experiments).

Treas. Reg. §1.41-2(c)(2) provides that direct supervision for purposes of performing qualified services means the immediate supervision (first-line management) of qualified research (as in the case of a research scientist who directly supervises laboratory experiments, but who may not actually perform experiments). Direct supervision does

Form 886-A   Department of the Treasury - Internal Revenue Service

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Form 886-A	Explanation of Items	Page 4 of 9 Issue No.
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

not include supervision by a higher-level manager to whom first-line managers report, even if that manager is a qualified research scientist.

Treas. Reg. §1.41-2(c)(3) provides that direct support for purposes of performing qualified services means services in the direct support of either (i) persons engaging in actual conduct of qualified research, or (ii) persons who are directly supervising persons engaging in the actual conduct of qualified research.

Under Treas. Reg. §1.41-2(c)(3)(ii), however, direct support of research activities does not include general administrative services, or other services only indirectly of benefit to research activities.

Section 41(d)(1) defines the term "qualified research" as research,

(A) with respect to which expenditures may be treated as expenses under section 174,

(B) which is undertaken for the purpose of discovering information—

(i) which is technological in nature, and

(ii) the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and

(C) substantially all of the activities of which constitute elements of a process of experimentation for a purpose related to a new or improved function, performance, or reliability or quality, and not for a purpose related to style, taste, cosmetic, or seasonal design factors.

Form 886-A Department of the Treasury - Internal Revenue Service

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Form 886-A	Explanation of Items	Page 5 of 9 Issue No.
Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

Section 41(d)(4), includes specific exclusions, or activities that are not allowable under the Research Credit. This includes internal-use software.

The application of qualified research is intended to be useful in the development of a new or improved business component of the taxpayer. I.R.C. §41(d)(1(B)(ii). The business component is defined as any product, process, computer software, technique, formula, or invention held for sale, lease or license, or used by the taxpayer in its trade or business. I.R.C. §41(d)(2)(B).

Taxpayer's Position

As of the date of this draft report, [redacted] has not had discussions with the IRS regarding the conclusions of the report.

Argument

During the interview process [redacted] provided an overview of how a project progresses from start to finish. Typically, [redacted] is contacted by a customer who is need of [redacted] This customer may or may not have their own drawings of what the end product will look like. For the sake of this example I will refer to it as an [redacted] The customer knows they need a [redacted] to span over and around their process equipment. The customer provides detailed drawings of the installation location (including location of columns, utilities, etc.), along with the size and location of their process equipment. [redacted] then embarks on designing the [redacted] to fit the application, utilizing computer software to both lay out the design and components dimensionally but also can test stresses. The software package to test

Form 886-A Department of the Treasury - Internal Revenue Service

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Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

stresses is not always utilized. Mainly an Excel spreadsheet is consulted based upon prior knowledge of the materials and components [redacted] uses in its projects. This spreadsheet aids in the analysis of each connection.

As the project progresses [redacted] discusses the design of the [redacted] with the customer and the customer provides feedback. This feedback can be in the form of approval, changes in the design due to communication issues, change in customer requirements, or changes in the design due to a change in their own installation/design of the manufacturing process this [redacted] will fit in. The customer will provide head and width clearances, along with any loads the structure will need to bear. There is roughly a 20% scope creep on 95% of the projects.

One of the specific examples discussed was a project for [redacted] This project involved creating a structure around a large machine, in a location on a fault line. Therefore, additional bracing needed to be added. The customer took care of the floor and footings for the machine. The challenges discussed were the weight of the machine, access for machine set-up, site conditions and the phasing of the project. Again, [redacted] tested the loading in software and utilized the Excel spreadsheet to verify spans and loads were safe. When asked, it was mentioned experience plays a large factor in the design of their structures. Then, [redacted] tests and validates.

During the IRS audit process concern has arisen the information provided thus far does not demonstrate the activities described pass the four-part test of IRC Section 41. In IDR 5, as part of question 7, the IRS requested "what activities are being conducted that constitute research activities?" In response, [redacted] stated that qualified research occurred through all four phases of their development work: Sales/Quotation,

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Conceptual Design, Detailed Design and Installation. In the following paragraphs each phase will be analysed.

Sales/Quotation – [redacted] argues each of their projects is unique and they must work through vague/conceptual customer information during this phase. This forces [redacted] to have a series of meetings with the customer to better define project specifications. Engineering and sales work together to prepare the quotation. Refining the design with a specific customer is not inherently qualified for the research credit. Furthermore, because engineers and technical discussions were involved with the customer does not by default mean the activities qualify. More specifically, these activities do not describe or indicate a process of experimentation was required. For purposes of Section 41(d), a process of experimentation is a process designed to evaluate one or more alternatives to achieve a result where the capability or the method of achieving that result, or the appropriate design of that result, is uncertain as of the beginning of the taxpayer's research activities. Given [redacted] capabilities of designing such [redacted] there is no evidence of uncertainty in their capability of designing custom structures for other customers.

Conceptual Design – [redacted] argues each structure is custom designed and engineered to the customer's needs. Further, they argue the technical variables are unique to each project. Yet, an Excel spreadsheet, based upon prior knowledge and design, is consulted to determine proper spans and stress levels on each structure. It is my opinion that, based on the facts provided thus far, [redacted] adapts its business components to each customer's unique needs. According to IRC Section 41(d)(4)(B) adaptation of an existing business competent, namely these steel structures, is specifically disallowed by law. Furthermore, many of the problems described are merely business risks, not technological risks, such as phasing of the project.

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Detailed Design – [redacted] argues the CAD, drawing work, structural detail work in a 3D environment are qualified activities per Section 41. Furthermore, [redacted] argues validation of design to ensure buildability and potential revisions would also be qualified. However, none of these activities are inherently qualified. It is important to remember that iterations alone do not qualify activities for the credit. Just because a Taxpayer revised drawings and changes its designs does not mean a process of experimentation has occurred to arrive at the revisions. During the interviews, and reviewing Taxpayer information provided, no factual evidence has been provided to show problems or technical uncertainties existed that required a true process of experimentation to resolve. [redacted] simply moves hole locations or beams to allow access, provide support, or fit within the construction envelope.

Installation – [redacted] states: "During the Installation Phase, installation drawings are created and drawings are back checked (a routine quality control function at this point). The Engineering department is not involved at this stage of the project unless there are installation issues. Any revisions made in the field are completed by the drafters." This statement encapsulates the fact that revisions alone do not require a process of experimentation per IRC Section 41.

Therefore, as of this draft report, no facts have been provided to demonstrate a process of experimentation has occurred, as per IRC Section 41. Furthermore, given [redacted] utilizes their expertise in designing and developing [redacted] to adapt to each customer's specific needs, IRC Section 41(d)(4)(B) adaptation of an existing business competent would be applicable. In other words, IRC Section 41 specifically disallows the activities described by [redacted]. As a result, no expenses related to the activities presented will be allowed.

Form 886-A Department of the Treasury - Internal Revenue Service

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Form 886-A	Explanation of Items	Page 9 of 9
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Name of Taxpayer [redacted]	Tax Identification Number [redacted]	Year/Period Ended 201612-201712

Conclusion

After touring [redacted] facility in [redacted] interviewing two employees who qualified employee wages, and reviewing documentation provided to substantiate the activities as qualified I do not find enough evidence to demonstrate the activities required a process of experimentation. In addition, the activities engaged by [redacted] appear to be specifically disallowed per IRC Section 41(d)(4)(B) or adaptation of an existing business competent.

The table below summarizes my conclusions:

	2016	2017
Credit per Return	$ [redacted]	$ [redacted]
per IRS Audit	$ -	$ -
Adjustments to Credit	$ [redacted]	$ [redacted]

Form 886-A Department of the Treasury - Internal Revenue Service

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The Appeals Office and the Research Credit

- Ex Parte Rule – Not really
- IRS Engineer is present
- Which projects to discuss – can you limit the scope
- Do I extend the assessment statue or refuse to extend, docket the case in Tax Court and then go to Appeals

Getting to Appeals

- 30 day letter
- Protest – Skinny or fat – pros and cons
- Do an FOIA request
- Exam's "T-letter"

Settling the Case at Appeals

- Hazards of litigation
- Does the IRS have uniform settlement guidelines?
- What to do if you hit a "brick wall"?

Which Court to go to

- U.S. Tax Court
- Federal District Court (refund)
- U.S. Court of Federal Claims (refund)
- Issues to consider
    - Precedent
    - Discovery issues and cost
- IRS v. DOJ

The Current IRS Litigation Position

- Centralized handling of research credit cases
  - Taxpayer loses the advantage of a full Tax Court calendar
- Settlement options
- Common "hot" items--funded research; contract research; Internal Revenue Code section 6662 penalty; proof of the fixed base percentage, the process of experimentation test is always key

IRS Attorneys Requests for Information

- IRS attorneys have a set of standard questions
- Need to be able to address these questions in a cost-effective manner
- Trap - the failure to respond can lead to formal discovery or deemed admissions

Research Credit Branerton Letter

OFFICE OF THE CHIEF COUNSEL

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
OFFICE OF DIVISION COUNSEL
LARGE BUSINESS & INTERNATIONAL
[redacted]

March 5, 2019

[redacted]

<u>VIA OVERNIGHT MAIL</u>

Michael G. Goller
Reinhart Boerner Van Deuren
Suite 1700
1000 North Water Street
Milwaukee, WI 53202

In re: [redacted]

Dear Mr. Goller:

This letter concerns your clients' case in the United States Tax Court. As you are aware, I am the attorney assigned to represent the Internal Revenue Service in your clients' case.

The Tax Court rules, which can be found on the court's webpage at <u>www.ustaxcourt.gov</u> are designed to make trials proceed as smoothly as possible. Tax Court Rule 91 requires the parties to advise the court about all facts that are not in dispute that we would like the court to consider in resolving this case. The court also expects the parties to agree on all documents and papers that we would like the court to consider. We, therefore, must agree on those facts and documents that are not in dispute, and submit them to the court in advance of the trial as a "Stipulation of Facts".

The court has found that the stipulation process works best when the parties discuss the case and voluntarily exchange necessary facts, documents and other data. <u>See</u> T.C. Rule 70(a). In accordance with <u>Branerton Corp. v. Commissioner</u>, 61 T.C. 691 (1974), we request the following information with respect to the above-referenced case. Please return any responses to the matters discussed below and any responsive documents to me by March 29, 2019. Further, we would like to schedule a conference in my office on April 9, 2019, at 10 A.M.

EXHIBIT
C

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TL-20815-18 2

<u>Definitions</u>:

"Petitioners" mean [redacted]

Unless otherwise specified, the requests concern the taxable years ending December 31, 2012 and December 31, 2013 for Petitioners, and the taxable years ending September 30, 2012 and September 30, 2013 for [redacted]

"Entity" means a corporation, partnership, limited liability company, trust, estate, or any other body recognized under domestic law, including those disregarded for Federal income tax purposes, and any equivalent body recognized under foreign law.

"Person" means an individual and any Entity.

<u>Requests</u>

General:

1. Provide copies of Petitioners' Forms 1040 for the tax years ending 12/31/2012 and 12/31/2013 and the Forms 1120S for the tax years ending 9/30/2012 and 9/30/2013 for [redacted]
2. Please provide Petitioners' books and records for the tax year ending December 31, 2012 and December 31, 2013 for both financial accounting and tax purposes, including audited financial statements, any unaudited financial statements, the trial balance, balance sheet, cash flow statement, the general ledger, the certified income statement, the uncertified income statement, and the reconciliation of book to tax.
3. Please provide [redacted] books and records for the tax year ending September 30, 2012 and September 30, 2013 for both financial accounting and tax purposes, including audited financial statements, any unaudited financial statements, the trial balance, balance sheet, cash flow statement, the general ledger, the certified income statement, the uncertified income statement, and the reconciliation of book to tax.
4. Please identify, by name, address, and telephone number, the name of the individual(s) and or firm that audited all and/or any portion of petitioner's and [redacted] financial statements for years at issue;
5. Please identify Petitioners' and [redacted] bookkeeper(s) for the years at issue
6. The following questions relate to adjustments made to Petitioners' distributive share of income based on Respondent's adjustments to [redacted] Forms 1120S;

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[redacted] 3

a. [redacted]

b. [redacted]

c. [redacted]

d. [redacted]

e. [redacted]

f. [redacted]

g. [redacted]

h. [redacted]

Research Credit:

7. Please separately list each entity in which Petitioners held an interest, that paid or incurred qualified research expenses pursuant to I.R.C. § 41 for the tax years ending December 31, 2012 and December 31, 2013.

8. Please confirm that [redacted] is the only entity whose expenses are included for purposes of the qualified research credit, which Petitioners are claiming qualified research credit.

9. Please identify the individual(s) and/or firm by name, address and telephone number, upon whom Petitioners and/or [redacted] relied when claiming the qualified research credit on its Form 1120s and Form 1040 for the relevant tax years.

[redacted] 4

10. Provide all documents, including memoranda, from any individual(s) or firm that advised Petitioners and/or [redacted] regarding its claimed qualified research credit for the tax years at issue.

Computation and qualification of research credit:

11. Please provide all documents showing how [redacted] calculated its research credit for the taxable years at issue.

12. If [redacted] undertook sampling to compute any portion of the research credit, please state what sampling technique was used.

13. Please provide a list of projects or activities for which Petitioners claim [redacted] incurred qualified research expenses.

14. For each project or activity identified above in question 13, please list the business component(s) for which Petitioners claim section 41 is applicable.

15. Please confirm that Petitioners are claiming [redacted] only incurred in-house research expenses as qualified research expenses for purposes of calculating the section 41 research credit.

16. For each business component for which Petitioners claim [redacted] incurred qualified research expenses, please provide all documents that support Petitioners' position that [redacted] undertook qualified research during the taxable years at issue.

17. This request pertains to each business component for which Petitioners claim [redacted] incurred qualified research expenses. Please organize your response by business component.

a. All contracts between [redacted] and the customer, including:

i. Bid packages;

ii. Change orders;

iii. Amendments and modifications;

iv. Contract drafts;

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v. A complete copy the contract, grant or other agreement, including, but not limited to, the contract, attachments or exhibits to the contract, all related prime contract(s), and change orders;

vi. The project/contract name and client name;

vii. The dollar amount and date of the contract;

viii. Identification of the specific terms, clauses, conditions and/or laws relied upon in determining that the project was not funded by another person or entity within the meaning of I.R.C. § 41 including, but not limited to:

1. Payment terms, clauses, conditions and/or laws;
2. Inspection terms, clauses, conditions and/or laws;
3. Acceptance terms, clauses, conditions and/or laws;
4. Terms, clauses, conditions and/or laws addressing changes or modifications to the contract, grant or agreement ;
5. Warranty terms, clauses, conditions and/or laws;
6. Termination terms, clauses, conditions and/or laws;
7. Standard of care terms, clauses, conditions and/or laws; and
8. Property rights terms, clauses, conditions and/or laws.

b. For each business component, please identify the individual(s) who negotiated the contract(s) on behalf of [redacted] as well as the customer.

c. Please provide copies of documentation showing the receipt of all payments for each job, including invoices, receipts, cancelled checks, wire transfers, etc.

d. With respect to each business component:

i. Identify the request/parameters provided to [redacted] by the customers and provide any supporting documentation;

ii. Identify the individual(s) that determined the product specifications;

[redacted] 6

iii. Identify each area of technical uncertainty for which qualified research was necessary;

iv. Identify the individual(s) that identified the areas of technical uncertainty;

v. Identify the individual(s) and/or entities that designed the equipment. If someone other than an employee of [redacted] provided a design (even if that design was ultimately modified or rejected), please identify that individual;

vi. Please provide copies of all design specifications, draft specifications, and documents of a similar nature created with respect to this job and identify the individual(s) responsible for their creation;

vii. Please identify the individual(s) responsible for resolving these areas of uncertainty and describe with specificity the actions taken;

viii. Please provide any employee records/logs to support the resolution of uncertainty (if any) and the actions taken with respect to the uncertainty

ix. To the extent that the individual(s) engaged in modeling, simulation, systematic trial and error to resolve areas of uncertainty, please describe the steps taken by the employee and identify any software used; and

x. For each area of uncertainty, please identify the hypothesis and/or alternatives to be tested or evaluated, records/notes showing the results of each of those tests, and describe the individual(s) conclusions regarding the best and/or viable alternative(s).

e. For each business component Petitioners claim [redacted] incurred qualified research expenses, please identify each employee of [redacted] that performed "qualified services" pursuant to I.R.C. § 41(b)(2)(B) on the job.

i. For each of the employees identified, please provide documentation to show the wages that each received during the years at issue;

[redacted] 7

ii. Please explain the compensation agreement for each employee (for example, whether the employee is salaried or received hourly wages);

iii. Please provide the job title and the job description maintained internally for each employee at the time of hiring or, if the employee was promoted after hiring, at the time of the employee's most recent promotion;

iv. Identify how many hours each employee spent working each job during the relevant years, and provide all substantiating documentation (employee logs, records, timecards, etc.);

1. Of those hours spent working each job, please identify how many hours were spent on "qualified services" pursuant to I.R.C. § 41(b)(2)(B);

2. Describe the activities that comprise the "qualified services" pursuant to I.R.C. § 41(b)(2)(B) that were performed by each employee for each job;

v. Identify how many hours each employee spent performing services for [redacted] generally during the relevant tax years;

18. For each business component for which Petitioners claim [redacted] incurred qualified research expenses, please provide all documents supporting the amounts paid or incurred by [redacted] for supplies, if any, used in the conduct of qualified research during the years at issue.

Base Years:

19. Please identify the first taxable year of [redacted] in which the [redacted] had qualified research expenses pursuant to I.R.C. § 41.

20. Please identify the first taxable year in which [redacted] had gross receipts.

21. Please identify all taxable years in which [redacted] had both gross receipts and qualified research expenses pursuant to I.R.C. § 41.

22. Please identify the gross receipts of [redacted] for tax years ending 9/30/08, 9/30/09, 9/30/10 and 9/30/11, and provide documentation to support those figures.

Instructions:

[redacted] 8

Please see the enclosed Internal Revenue Service Production Specifications for Electronically Stored Information and Hard Copy Documents. Petitioner's responses to our requests should comply with those specifications.

Petitioners should regard these requests as continuing in nature and supplement its responses as required under Tax Court Rule 102.

If any portion of any document is withheld on the grounds of privilege, please state, with respect to each portion withheld:

(a) Name and title of the document;

(b) Individual and institutional author(s);

(c) Date of the document;

(d) Names, titles, and addresses of all recipients of the documents and/or copies thereof;

(e) Subject matter of the document;

(f) Privilege claimed; and

(g) Number of the request(s) to which the production of the document would otherwise be responsive.

If you have any questions, or, if the suggested conference date or time is inconvenient, please write or call me at [redacted]

Sincerely,

[redacted]

Attorney
(Large Business & International)

Contract and Funded Research (Opposite Sides of the Same Coin)

- In cases of research, where the taxpayer does the research but does not have the risk of loss (i.e., funded research)--does not qualify for the credit. Treas. Reg. § 41(d)(4)(H).
- In cases of contract research where the taxpayer pays for the research, need to be able to show that payment is not contingent on the result. Treas. Reg. § 1.41-2(e)(2).
  - **Have a contract and make it part of the audit record**

Funded Research

- Watch out for funded research
  - Who is really at risk--amounts paid for the product or the success of the research are not treated as funding research. Treas. Reg. § 1.41-4A(d)(1).
    - **Documentation is often difficult in the context of manufacturing. IRS regulations state all "agreements" between the taxpayer and other persons are to be considered when determining if research is funded. Treas. Reg. § 1.41-4A(d).**
  - Who keeps the right to the research? Treas. Reg. § 1.41-4A(d)(2).

Funded Research (cont.)

- Purchase Order/Terms and Conditions/Master Purchase Agreement "Trap".
  - Possible Solution
    - A taxpayer retains the right to use the research results without making payments to the payer (the U.S. Government) who obtained the right to use and disclose the technical data from the taxpayers research. Lockheed Martin Corp. v. U.S., 210 F.2d 1338 (Fed. Cir. 2008)

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CASES OF INTEREST

- Populous Holdings v. Comm'r, T.C. Dkt No. 405-17 (2/5/21)
  - Fixed fee contract has an inherent risk of loss
- Meyer, Borgman & Johnson, Inc. v. Comm'r, Dkt No. 7805-16 (unpublished order, 11/19/20, Judge Holmes). A Motion for Reconsideration is pending.
- Little Sandy Coal v. Comm'r, T.C. Memo 2021-5. Appeal pending. Substantially all test (80% of research activity must be a process of experimentation, excludes direct support in the numerator).
- Perficent, Inc. v. Comm'r, DKTs 5467-17, 7600-18 (T.C. 2002). Partial Motion for Summary Judgement is pending: IRS is arguing that contracts were for the purchase of research services (i.e., Funded Research). Taxpayer is arguing that the contracts were for the purchase of products. **IRS is also arguing that warranty provisions in the contracts are not sufficient to the taxpayer has a risk of loss.**

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IRS Likes to Add a Section 6662 In Research Credit Cases

- If there is a low income or a loss year, the math is very pro-IRS

Penalty Avoidance Matrix

	Reasonable Basis §1.6662-3(b)(3)	Reasonable Cause §6664 §1.6664-4(b)	Disclosure §6662(d)(2)(B) §1.6662-3(a)	Substantial Authority §1.6662-4(d)
Negligence	Yes	Yes	No[1]	Yes[2]
Disregard of the Rules or Regulations	Yes[4]	Yes	Yes[3]	Yes[5]
Substantial Understatement of Income Tax	No	Yes	Yes[6]	Yes
Substantial Valuation Misstatement (Income)	No	Yes[7]	No	No
Substantial Valuation Misstatement (E&G)	No	Yes	No	No
Gross Valuation Misstatement (Income)	No	No[7]	No	No
Gross Valuation Misstatement (E&G)	No	Yes	No	No

1. § 1.6662-7(b).
2. There must also be a reasonable basis for the position, adequate records must be kept and the position must be properly substantiated. §1.6662-3(c). In a case where there is substantial authority for a position, since this standard is higher than the reasonable basis standard (which negates negligence), there is no negligence. §1.6662-3(b)(3).
3. There must be reasonable basis and the taxpayer must keep adequate books, records and substantiation. § 1.6662-3(c)(1).
4. The disregard can be careless, reckless or intentional. § 1.6662-3(b)(2). The first two (careless and reckless) are for all practical purposes, the same as negligence, meaning reasonable basis would negate these two triggers. Further, however, if a position is intentionally contrary to a rule or regulation, reasonable basis would not be enough. However, see the disclosure election.
5. A position that is contrary to a Revenue Ruling or Notice is not treated as disregarding the ruling or notice if the contrary position has a realistic possibility of being sustained (a standard that is lower than substantial authority § 1.6662-3(b)(2). It is technically possible to have substantial authority that is contrary to a Treasury Regulation, which means the penalty could apply. In this case the taxpayer should be sure to make a disclosure.
6. There must also be a reasonable basis for the tax treatment of the disclosed item. §6662(d)(2)(B)(ii).
7. There is no reasonable cause exception for a gross valuation misstatement with respect to charitable deduction property and the exception only applies to a substantial valuation statement when there is a qualified appraisal and the taxpayer made a good faith investigation of the value of the property. § 6664(c)(3).

What is a Substantial Understatement of Income Tax?

- What is an Understatement of Tax?
  - Excess of the amount required to be shown on the return. Section 6662(d)(2)(A)
- Non-corporate taxpayer
  - Exceeds the greater of 10% of the tax required to be shown on the return or $5,000
- Corporation other than S Corporation or Personal Holding Company
  - Exceeds the lesser of one of the following:
    - 10% of the tax required to be shown on the return (or if greater, $10,000); or
    - $10 Million §6662(d)(1)

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What is a Substantial Understatement of Income Tax (cont.)

- Thus, for a corporation, there in no S.U. penalty if the understatement is under $10,000.
- If 10% of the amount required to be shown on the return excludes $10,000 there is a S.U.
- However, once the understatement exceeds $10,000,000, there is always an S.U., even if $10,000,000 is less than 10% of the amount required to be shown on the return (e.g. amount reported is $102,000,000, amount omitted is 9.9%, $12,870,000). This is not a 10% omission, but there is still a S.U. penalty.

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Research Credit Refund Claims

- Treas. Reg. 301.6402-2(b)(1) – a Claim for Refund "must set forth in detail each ground upon which a … refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof."
- Premier Tech v. U.S., 2021-2 U.S. Tax Case (CCH), 2021 WL 2982064 (D. Utah 2021) year 2014, Form 1120X, Taxpayer win

Research Credit Refund Claims (cont.)

- FAA 20214101F (10/15/21)
  - Huge amount of detail required
  - Transitional Relieve until 2024 (45 days to supplement "incomplete" refund claims)
  - Refund Claims made while under audit are reviewed by the Exam team. Other claims go to the Utah Service Center and subject matter "experts."

Research Credit Take Aways

- Handling the Audit, Appeals and Litigation
- Funded Research
- Section 6662 Accuracy Related Penalty

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State Credit Issues Example - Wisconsin

- Wisconsin credit for research--looks to the federal credit requirements
- Wisconsin sales and use tax exemption for qualified research. Wis. Stats. § 77.54(57d)(b).

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PART III
Ethics

Partnership Ethical Concerns

- Conflicts of Interest
  - Who is my client
  - Need a good engagement letter
  - Do I opt-out if I can
  - Do I push out
  - The modification process
  - What does the operating agreement say

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Ethical Obligation to Talk About Penalty Avoidance

- Under IRS Circular 230, practitioners must advise the client of any penalties that are reasonably likely to apply and the practitioner must discuss the possibility of penalty avoidance via disclosure. §10.34(c)

The Office of Professional Responsibility

- There is often a tendency to assume that the Department of the Treasury's Circular No. 230 (Circular 230) pertains solely to preparing tax returns, tax opinions or dealings with the IRS
- The conventional wisdom is that a violation Of Circular 230 must mean a practitioner has engaged in some sort of outrageous behavior
- The reach of this ethical code is far greater than one might think
- A violation can (and does) occur in many more situations than practitioners might otherwise expect

A Violation of Circular 230 Is a Serious Matter

- Public discipline for violating Circular 230 usually involves obvious misconduct such as one's own failure to file or pay tax, or the conviction of a criminal offense
- We have been seeing more cases that pertain to alleged "bad tax practice," such as a lack of due diligence, failure to give sound tax advice, conflicts of interest or other issues that indicate a tax practitioner's lack of fitness to practice before the IRS

Who Is Subject to Circular 230? Section 10.3 (Revised June 9, 2014)

- Circular 230 applies to those who "practice before the IRS"
- "Practice before the IRS" comprehends all matters connected with a practitioner's presentation to the IRS with respect to a taxpayer's rights, privileges or liabilities under the tax law, including
  - Preparing or filing documents, correspondence and communicating with the IRS
  - Rendering written advice with respect to an entity plan or arrangement that has a potential for tax avoidance or evasion
  - Representing a client at IRS conferences and hearings

Who Is Subject to Circular 230? Section 10.3 (Revised June 9, 2014)

- Attorneys and CPAs (including in-house practitioners) who are not under suspension or disbarment from practice before the IRS may file a Power of Attorney (POA) (Form 2848)
  - This permits them to and practice before the IRS and makes them subject to Circular 230
- One need not file a POA to provide written tax advice, however, providing written tax advice constitutes practice before the IRS
  - *i.e.*, makes the individual subject to Circular 230

When Is Conduct Sanctionable?

- Generally, a practitioner may be sanctioned if the practitioner:
  - Is incompetent or disreputable;
  - Intentionally misleads a client so as to defraud that client; or
  - Is acting with a specific mental state or competency standard (*i.e.*, willful, reckless or gross incompetence), fails to comply with key provisions of Circular 230

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AICPA Rules

- Statements on Standards for Tax Services

Statement on Standards for Tax Services No. 1, *Tax Return Positions*

  - Interpretation No. 1-1, Reporting and Disclosures
  - Interpretation No. 1-2, Tax Planning

Statement on Standards for Tax Services No. 2, *Answers to Questions on Returns*

AICPA Rules

Statement on Standards for Tax Services No. 3, *Certain Procedural Aspects of Preparing Returns*

Statement on Standards for Tax Services No. 4, *Use of Estimates*

Statement on Standards for Tax Services No. 5, *Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision*

AICPA Rules

Statement on Standards for Tax Services No. 6, *Knowledge of Error: Return Preparation and Administrative Proceedings*

Statement on Standards for Tax Services No. 7, *Form and Content of Advice to Taxpayers*

ABA Model Rules of Professional Conduct

- Some Version of the MRPC has been adopted in almost all states.
- Rules are mandatory.
- Comments to the rules are aspirational (not mandatory).

Traps for the Tax Practitioner

- Other traps for the unwary practitioner
  - malpractice claims
  - breach of fiduciary duty
  - breach of contract
  - rules of evidence-waiver of the attorney/client privilege
  - disqualification to practice, suspension-disbarment by the State Bar or the Internal Revenue Service
  - reasonableness of fees
  - regulation on advertising
  - invalidation of estate plan
  - violation of rules relating to signing and non-signing tax preparers

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Concerns for the Tax Planner

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Who is My Client?

- Related Issues
  - What is my duty to my client?
  - What are my possible conflicts of interest?
  - Multiple Client Issues
    - Representing spouses
    - Representing a closely-held business
    - Representing fiduciaries (*i.e.*, the trustee or personal representative)

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What Are the Scopes of the Services to Be Performed?

- Importance of a Good Engagement Letter
- Conflict Waivers
- Relationship Between Scope of Services and Diligence and Care Required from the Practitioner

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Is My Client Competent?

- Realities of Modern Life –
- Babyboomers' parents are in their 80s or 90s
- Older babyboomers are in their 70s
- Due to an increase in divorce, more families have step-parents. This can give rise to tension between surviving spouses and stepchildren.
- More people own their own retirement accounts as opposed pensions which are not transferable to the next generation. Thus, a conflict can arise over the disposition of those funds.
- Life expectancies are increasing. Providing adequate health care and concerns over making sure a client has the funds necessary to cover expenses becomes far more difficult to plan for.
- Diseases like Alzheimer's are expected to increase dramatically in the upcoming years
- The interplay between dementia, lack of capacity and susceptibility to undue influence is a potential "perfect storm" for litigation.

Is My Client Competent? (cont.)

- When does a person have capacity to execute a will or estate planning document?
  - "The testator must have mental capacity to comprehend the nature, the extent and the state of affairs of his property. The central idea is that the testator must have a general, meaningful understanding of the nature, state and the scope of his property, but does not need to have in his mind a detailed itemization of every asset; nor does he need to know the exact value of his property. A perfect memory is not an element of a testamentary capacity. The testator must know and understand his relationship to persons who are or who might naturally or reasonably be expected to become the objects of his bounty for which he must be able to make a rational selection of his beneficiaries. He must understand the scope and general effect of the provisions of his will in relation to his legatees and devisees. Finally, the testator must be able to contemplate these elements together for a sufficient length of time, without prompting, to form a rational judgment in relation to them, the result of which is expressed in the will."

    O'Brien v. Lumphrey, 50 Wis. 2d 143, 183 NW. 2d 133 (1971)
  - Practical comments.

Role of the Tax Advisor when Dealing with a Client of Potentially Diminished Capacity

- Document that what you are drafting is valid and defensible
- Make sure there are witnesses to the execution of documents
- Confirm that the client consents to disclosure of the contents of the document, however, if there is something unusual it is often a good idea to confirm that item in the presence of the witness (*i.e.*, confirm in front of the witness that a child is being disinherited)

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Role of the Tax Advisor when Dealing with a Client of Potentially Diminished Capacity

- Prepare a contemporaneous memorandum to the client's file
- Consider a video recording or a verbatim transcript in cases where a will contest is expected
- Ask your client about his or her health before executing the testamentary documents. Document this discussion

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Sources of Authority

- ABA Model Rules of Professional Conduct 1.2 scope of representation
- ACTEC Commentary on Model Rule 1.2
- Relationship to Model Rule 1.6 Confidentiality
- Fiduciary Exemption to Rule 1.6, not in existence in every state

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Exculpatory Clauses

- What is an exculpatory clause?
- Model Rule 1.8(h)(i) cannot limit an attorney's liability unless the client is represented when executing the limiting document
- Seeking a release of claims in a proper manner

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Representing Fiduciaries

- ABA Formal Opinion 94-30
- ACTEC Commentary to MRPC 1.2
- Real life examples
  - Residual Beneficiaries versus specific beneficiaries—a trap for the unwary

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Conflicts

- Conflicts of Interest with Current or Former Clients and Obtaining Waivers – Conflict Traps for the Unwary

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Who is My Client?

- Model Rule 1.18, Duties to Prospective Client
  - A person will be considered a prospective client if the person discusses with the lawyer "the possibility of forming a client/lawyer relationship." ABA Model Rule 1.18(a)
  - If the relationship does not come to fruition, the lawyer must still treat the person as a former client for conflict purposes. ABA Model 1.18(b)
  - A problem may arise if the lawyer seeks to represent one party first and then looks to represent another party. A lawyer may not represent an adversary in the same or substantially related matter if "the lawyer receives information from the prospective client that could be significantly harmful to that person in the matter." ABA Model Rule 1.18(c)

Define Who Will Be The Client

- ABA Model Rule 1.7 (CMT No. [27]) notes that:
  - Conflict questions may arise in estate planning and estate administration. A lawyer may be called upon to prepare wills for several family members, such as husband and wife, and depending on the circumstances, a conflict of interest may be present . . . . In order to comply with conflict of interest rules, the lawyer should make clear the lawyer's relationship between the parties. *Id.*
  - Need a Good Engagement Letter

Defining the End of the Client Relationship

- Does retention of documents make what would otherwise be a former client, a current client?
  - The ACTEC Commentaries recognize a concept of "dormant representation." The rules provide:
    - The execution of estate planning documents and the completion of related matters, such as changes in beneficiary designations and the transfer of assets to the trustee of a trust, normally ends the period during which the estate planning lawyer actively represents an estate planning client. At that time, unless the representation is terminated by the lawyer or client, the representation becomes dormant, awaiting activation by the client. (See ACTEC Commentary on MRCP 1.7 Conflicts of Interest: Current Clients.)

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Defining the End of the Client Relationship (cont.)

- The ACTEC Commentaries explain as follows:
  - The retention of the client's original estate planning documents does not itself make the client an "active" client or impose any obligation on the lawyer to take steps to remain informed regarding the client's management of property and family status. Similarly, sending a client periodic letters encourages the client to review the sufficiency of the client's estate planning or calling the client's attention to supplemental legal developments does not increase the lawyer's obligations to the client. ACTEC Commentary on MRCP 1.4 (Communication)
- Comment:
  - The ACTEC Commentaries do not seem to go as far as calling the client a former client, but rather "a dormant client." While many commentators would treat such client as a former client, may be, especially, with older estate planning clients, that they will have the expectation that "You were my lawyer," even if they haven't spoken to you for some time.

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Joint Representations

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Circular 230 Conflicts of Interest Section 10.29

- A major cause of malpractice claims, especially for Estate Planners

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A Conflict of Interest Exists If

- The representation of one client will be directly adverse to another client; or,
- There is a significant risk that the representation of one or more clients will be materially limited by the practitioner's responsibilities to another client, a former client or third person, or by the personal interest of the practitioner.

Comment: Rule is very similar to Model Rule 1.7

Other Authority

- ACTEC Commentary to Model Rule 1.7

Conflict Waivers – Circular 230 10.29

- The client must provide a written consent waiving the conflict within 30 days of giving verbal consent.
- The written waiver must be retained for at least three years after the conclusion of the representation of any affected client.

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Obtain a Waiver

- Where a conflict exists, a practitioner may still handle the matter if the practitioner reasonably believes that he/she will be able to provide competent and diligent representation to each affected client, the representation will not otherwise violate the law and each affected client waives the conflict in an informed consent at the time the conflict is discovered by the practitioner.

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Traps for the Unwary

- Representing spouses
- Personal interest of the lawyers
  - penalty issues
  - lawyer as a fiduciary
- Lawyer paid by a third party
- Innocent spouse relief issues

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Tax Court Rule 24(g)

- The Rule goes beyond the normal conflict definition and states that if Counsel of Record was involved in planning or promoting a transaction at issue before the Court, that attorney must either obtain a consent or withdraw from the case.
  - This is a trap for the unwary.

Comment: More cases are becoming docketed in Tax Court due to the IRS insistence that a year or more remain on the assessment statute. The estate tax statute on assessment cannot be extended. Thus, the application of Rule 24(g) will come up more often in estate tax cases.

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Why are more and more estate planners finding it necessary to docket a case in Tax Court?

- Two reasons
  - IRS budget cuts
  - Section 6501(c)(4)(A) provides that the statute of limitations on assessment can be extended with regard to "any tax imposed by this title, except *the estate tax* . . ." (emphasis added)
  - Practical Comments

Additional Trap for the Unwary

- Tax Court Petition is due before an executor is appointed (presumably an income tax issue that pertains to a pre-death year).
- Petition is filed in the name of Joe Smith, Deceased.
- Under Rule 60, must ratify Petition or the case may be dismissed.
- Dismissal of your Tax Court Petition means the IRS assessment stands.

Comment: If the estate has multiple beneficiaries, does the estate and a surviving spouse have a conflict?

More Conflict Traps for the Unwary

The Practitioner's Own Interest

- A common conflict, which is often overlooked, is the situation where a practitioner prepares a tax return, either as a signing or nonsigning preparer, and then handles the subsequent tax audit or appeal.
- In this situation, there may be a conflict if the practitioner has a personal interest that conflicts with the client's interest.
- For example, if the IRS asserts an accuracy-related penalty, will the practitioner be hesitant to argue that the penalty should not apply because of the taxpayer's good-faith reliance on the practitioner's tax advice?

Comment: The estate and gift tax valuation penalties are mathematical triggers. Thus, if value is too low the trigger (and thus a possible conflict) could arise without much warning.

More Conflict Traps for the Unwary (cont.)

Representing Both Spouses

- Another common conflict exists when the practitioner represents both a husband and wife, and the two spouses' interests become adverse.
- In such a situation, the practitioner may be unable to represent either spouse.
- Example – clients divorce and there is a pending Tax Court case. Does one spouse have a claim for relief under Section 6015 (i.e., innocent spouse and similar relief)?

OBTAINING A "GOOD" VALUATION REPORT – The Do's and Don'ts
Obtaining a "Good" Report

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- How to retain an expert
  - Kovel letter
- Does my expert understand the tax law?
  - Section 2703
  - Tax affecting earnings
  - Use of a weighted average when there are multiple valuation methods
- Reliance
- Privilege waiver
- Tax Court Requirements – T.C. Rule 143(g)
- Ethically – What can I tell my experts?

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Switching the Burden of Proof to the IRS

- Burden of proof can be important in valuation cases.
- This is especially so if the IRS does not obtain a good valuation report.
- Thus, failure to shift the burden can be a significant malpractice issue.

Comment: Given IRS budget issues, it is more difficult for the IRS to obtain a solid valuation report.

Make Sure During the Audit That the Burden of Proof Will Switch at Trial

- Burden to IRS
  - In most civil controversies, a rebuttable presumption existed that the IRS's determination of tax liability is correct
    - *i.e.*, the taxpayer has the burden of proving the IRS is wrong
  - Section 7491 switched the burden to the government in any non-criminal court proceedings, regarding a factual issue, if the taxpayer introduces credible evidence, which is relevant to determination of its liability.

Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- Qualification
  - Code Section 7491, which switches the burden of proof to the IRS, applies only to litigation in the courts between the taxpayer and the IRS;
  - In order to obtain a shift in the burden of proof, the taxpayer must first comply with all requirements of the code section;
  - Comply with substantiation requirements contained in the Code and Regulations;
  - Cooperate fully with the IRS;
  - Exhaust all administrative remedies available to the taxpayer, such as going to the IRS Appeals office; and
  - Produce credible evidence at trial.

Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- The requirement to prove credible evidence means that the burden technically starts out on the taxpayer, but shifts to the government unless the taxpayer produces evidence that would enable the court to find in favor of the taxpayer, absent any contrary evidence being produced by the IRS and ignoring the judicial presumption of IRS correctness.

Make Sure During the Audit That the Burden of Proof Will Switch at Trial (cont.)

- Finally, the shift in the burden of proof applies to all income, gift, estate, generation-skipping, taxes and all penalties in addition to tax
  - However, it does not apply to corporations, partnerships or trusts with the net worth exceeding $7 million (book value)

Can a Taxpayer 'Up the Ante' in a Valuation Case

- Can the taxpayer argue that the value was different from the amount reported on the tax return?
- Yes, a taxpayer can, however, the return position is an admission against interest, and the taxpayer is required to produce "cogent proof" that the value on the return is wrong.
- See *Estate of Gallagher v. Commissioner*, T.C. Memo 2011-148

Ethical Traps that Arise When the IRS Attempts to Collect Tax Due

- Collection issues are not common in the estate and gift tax context
- <u>Lien and Levy</u>
  - Lien - The invisible lien
    - Who is liable for the estate tax
    - Gift tax - the Section 6324(b) lien and secondary donee liability
  - Levy
    - Beware of frivolous collection due process appeals

Intake

- Is this a good client?
- Consider Conflicts of Interest
- What is scope of the engagement?
- Am I competent? Do I need help?

Reliance on Others

- Subordinates – care in hiring and delegating
- Experts – care in hiring
  - Is reliance reasonable?
- Protecting client confidentiality – how to retain an expert

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Document Drafting

- Written tax advice
- Delegation to a subordinate
- Due Diligence
- Stay up on changes in the law – draft what the client wants – Listen

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Return Preparation

- Client communication
- Do I disclose?
- Penalty discussions

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Privilege Waiver Issues

- Preparing a tax return
- Valuation experts
  - Is this a good valuation report?
  - Consider penalty thresholds when planning
- Other experts

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Common Tax Planning Traps

- Failure to know who is the client.
- Failure to clarify the scope of services.
- Not asking all the right questions – gather as much information as you can.
- Draft what the client wants.
- Know your limits.
- Ask is the client competent.

  - Remember the due care, due diligence, and competency

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Obligations of the CPA Firm If There Is a Data Breach

- CPA Firms Need to Collect Data

Tax

- Statement on Standards for Tax Services ("SSTS") No. 3, Certain Procedural Aspects of Preparing Returns
  - "Even though there is no requirement to examine underlying documentation, a member [CPA] should encourage the taxpayer to provide supporting data where appropriate"

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Obligations of the CPA Firm If There Is a Data Breach (cont.)

- New AICPA Rule
  - Code of Professional Conduct Rule 1.700.001, and Interpretation 1.700.005 provide that "a member would be considered in violation of the Confidential Client Information Rule [1.700.001] if the member cannot demonstrate that safeguards were applied that limited or reduced significant threats to an acceptable level"

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How Could This Happen to Me?

- The theft of an unencrypted laptop
- The loss of an unencrypted thumb drive
- Theft by a disgruntled employee
- E-mail to the wrong e-mail address
- Data breach at a cloud-based provider
- Hacker attack on a firm
- Failure to shred old client records

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Obligations of the CPA Firm If There Is a Data Breach (cont.)

- State Laws – most states have laws and regulations which require notification in the case of a data breach
- If you possess client medical data, HIPAA becomes relevant
- Notify clients

Failure to Obtain PTIN Section 10.8(a)

- Any individual who, for compensation, prepares or assists in the preparation of all or substantially all of a tax return or claim for refund must have a PTIN
- Generally, one must be a licensed attorney, certified public accountant, enrolled agent or registered return preparer to obtain a PTIN

Need both a PTIN and a Data Security Plan

IRS

Return Preparer Office — September 24, 2019

Resources:

IRS.gov

Frequently Asked Questions

Annual Filing Season Program

Enrolled Agent Information

Pay.gov System

Online PTIN System

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Dear Tax Professional,

Summer is over, and it won't be long until you're sitting down at your computer to renew your preparer tax identification number (PTIN) for 2020. In mid-October when renewal season begins, you will notice a *data security responsibilities* statement has been added to the PTIN renewal process. It serves as a reminder of your legal responsibility to have a data security plan and to provide data and system security protections for all taxpayer information. When completing your PTIN renewal, a checkbox will be available to confirm your awareness of these data security responsibilities.

Data security continues to be a hot topic. That's because tax professionals remain a top target of identity thieves and data breaches continue to affect tax professionals at an alarming rate. Cybercriminals use sophisticated and ever evolving techniques to gain access to your systems. These criminals steal sensitive taxpayer data to file fraudulent tax returns and create financial havoc for your clients. There are simple steps you can incorporate in your daily operations to minimize your vulnerability and protect client data, including:

- Protect email accounts with strong passwords and two-factor authentication if available.
- Install an anti-phishing tool bar to help identify known phishing sites.
- Use anti-phishing tools that are included in security software products.
- Use security software to help protect systems from malware and scan emails for viruses.
- Never open or download attachments from unknown senders, including potential clients. They should instead make contact first by phone.
- Send only password-protected and encrypted documents when files must be shared with clients over email.
- Never respond to suspicious or unknown emails.
- Back up sensitive data to a safe and secure external source.
- Properly dispose of old computer hard drives that contain sensitive data.

You should also make sure to have a written data security plan in accordance with the Federal Trade Commission's Safeguard Rule. Remember, protecting your clients is not only good for business, it's also the law. While the hope is that you're never the victim of a data breach, preparation and education will go a long way in helping to protect your clients and yourself.

More information:
Publication 4557, Safeguarding Taxpayer Data

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Publication 5293, Data Security Resource Guide for Tax Professionals
Identity Theft Information for Tax Professionals

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Firm Management Procedures to Ensure Circular 230 Compliance Section 10.36 (Revised June 10, 2014)

- The IRS appears to be attempting to create a “culture of compliance”
- Practitioners in a position of authority must do more than ensure their own compliance with Circular 230
- Supervising practitioners must ensure that all individuals they supervise comply with Circular 230 as it pertains to the preparation of returns, claims for refund or other documents submitted to the IRS

Section 10.36

- A practitioner responsible for implementation of Circular 230 compliance procedures will be subject to disciplinary action if:
  1(a) The responsible practitioner, through willfulness, recklessness or gross incompetence, does not take reasonable steps to ensure that the firm has adequate procedures to comply with Circular 230; and
  1(b) One or more individuals who are members of, associated with, or employed by the firm are, or have engaged in a practice in connection with their practice with the firm of failing to comply with Circular 230;

Section 10.36

2(a) The responsible practitioner, through willfulness, recklessness or gross incompetence, does not take reasonable steps to ensure that firm procedures in effect are properly followed; and

2(b) One or more individuals who are members of, associate with, or are employed by the firm or have engaged in a pattern or practice, in connection with their practice with the firm of failing to comply with Circular 230; or

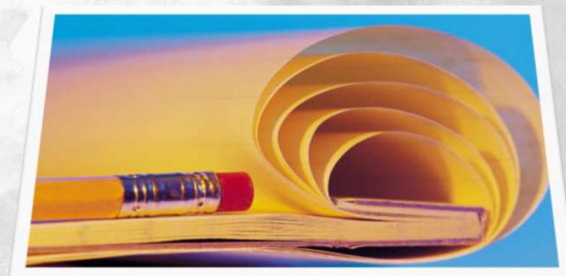
Section 10.36

3(a) The responsible practitioner knows or should know that one or more individuals who are a member of, associated with, or employed by the firm are, or have engaged in a pattern or practice in connection with their practice with the firm that does not comply with Circular 230, as applicable; and

3(b) The responsible practitioner, through willfulness, recklessness or gross incompetence, fails to take prompt action to correct the noncompliance.

Written Tax Advice Form Section 10.35 and Section 10.37(a) Revised June 9, 2012

- The Covered Opinion Rules (Former §10.35)
  - These have gone away – Proposed regulations were issued on September 14, 2012
  - Final regulations were issued June 9, 2014 and became effective on June 12, 2014



Old Rules

- Certain burdensome requirements existed if one issued one of the following:
  - A listed transaction opinion;
  - Principal purpose opinion is tax avoidance; or
  - Significant purpose to avoid tax opinion PLUS the opinion is one of the following opinions
    - Reliance Opinion
    - Marketed Opinion
    - Opinion subject to conditions of confidentiality
    - Opinion subject to contractual protection

Ramifications of the Withdrawal of the Covered Opinion Rules

- No more legends on our e-mails
- Issuing a tax opinion may be more complex than before
- It is clear under the new rules that government submissions on matters of general policy and continuing education presentations are not considered written tax advice

Requirements for Written Tax Advice Section 10.37(a) (Revised June 9, 2014)

- The Practitioner must
  - Base written advice on reasonable factual and legal assumption
    - Including assumptions as to future events
  - Reasonably consider all relevant facts and circumstances the practitioner knows or reasonably should know
  - Use reasonable efforts to identify and ascertain the facts relevant to written advice on each federal tax matter

Requirements for Written Tax Advice Section 10.37(a) (Revised June 9, 2014)

- Not rely upon representations, statements, findings or agreements (including projections, financial forecasts, or appraisals) of the taxpayer or any other person if reliance upon them would be unreasonable
- Relate applicable law and authorities to the facts; and not, in evaluating a federal tax matter, take into account the possibility that a tax return will not be audited or that a matter will not be raised on audit

Further, reliance upon a representation, statement, finding or agreement is specifically unreasonable if the practitioner knows or reasonably should know that one or more representations or assumptions on which any representation is based is incorrect, incomplete or inconsistent

Reliance on Others Section 10.37(b) Revised June 9, 2014

- The practitioner may only rely on the advice of another person if the advice was reasonable and the reliance is in good faith considering all the facts and circumstances
- Reliance is specifically not reasonable when
  - The practitioner knows or reasonably should know that the opinion of the other person should not be relied upon;
  - The practitioner knows or reasonably should know that the other person is not competent or lacks the necessary qualifications to provide the advice; or
  - The practitioner knows or reasonably should know that the other person has a conflict of interest in violation with Circular 230
    - *e.g.*, the conflict has not been properly waived

Standard of Review
Have I Complied with the Rule?

- In evaluating whether a practitioner's written tax advice complies with Section 10.37, the IRS will apply a "reasonable practitioner" standard, considering all facts and circumstances, including, but not limited to the scope of the engagement and the type and specificity of the advice sought by the client

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Standard of Review
Have I Complied with the Rule?

- In the case of an opinion the practitioner knows or has reason to know will be used or referred to by a person other than the practitioner in promoting, marketing or recommending a transaction, a significant purpose of which is the avoidance or evasion of tax, the IRS will apply an elevated "reasonable practitioner" standard. Emphasis will be given to the additional risk, caused by the practitioner's lack of knowledge of the specific taxpayer's particular circumstances **(*i.e.*, when tax advice is going to be used to promote a transaction to a third party, the IRS will apply an elevated standard of care).**

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Due Diligence
Section 10.22 (Revised June 9, 2014)

- Practitioner Must Exercise Due Diligence
  - Every practitioner must exercise due diligence when practicing before the IRS
    - This includes exercising diligence in preparing documents relating to IRS matters and verifying the correctness of oral and written presentations made to both the IRS and one's client with regard to any matter administered by the IRS
    - A practitioner's duty to be diligent is a very broad concept
    - A lack of diligence would seem to exist in most instances of deficient practice-related conduct

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Due Diligence
Section 10.22 (Revised June 9, 2014)

  - The concept of diligence seems to require more than the mere belief that a presentation is correct the moment it is submitted to the IRS or a client
    - The implied approval of past incorrect statements would seem to be a violation of Section 10.22
    - If a practitioner fails to correct an incorrect statement made to the IRS or a client, knowing full well that the recipient continues to rely on that statement
    - A failure to correct the error is inconsistent with the practitioner's obligation to be diligent

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Reliance on Others

A practitioner will be presumed to have exercised due care if the practitioner relies on the work product of another person so long as the practitioner used reasonable care in engaging, supervising, training, and evaluating the person, taking into account the nature of the relationship between the practitioner and the other person

Diligence as to Accuracy §10.22

- Trap for the unwary – FBAR (FinCin 114) and foreign bank accounts

Use of Estimates

- AICPA Statement on Standards for Tax Services No. 4, Use of Estimates
  - Unless prohibited by statute or by some other rule, a CPA may use the taxpayer's estimates in the preparation of a tax return if it is not practical to obtain exact data and if the CPA determines that the estimates are reasonable based on the facts and circumstances known to the CPA
    - The taxpayer's estimate should be presented in a manner that does not imply greater accuracy than exists

Am I Bound by the Prior Audit or Court Case?

- AICPA Statement on Standards for Tax Services No. 5, Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision
  - A conclusion in an audit or court proceeding does not restrict a CPA from recommending a different position in a later year unless a taxpayer is bound to a specified treatment by a formal closing agreement or some other method
    - However, the CPA must still satisfy the normal standards for preparing a tax return. See SSTS No. 1, Tax Return Positions.

Am I Bound by the Audit or Prior Court Case?

- Thus generally, the result of the audit or court case will indicate how to treat the item in a later year
  - There could be exceptions, for example
    - If the prior decision was due to nothing more than a lack of documentation;
    - If the taxpayer yielded in an administrative proceeding for settlement purposes, but has a legitimate basis for not adopting the position; or,
    - New court decisions, rulings or other authorities have been promulgated since the prior proceeding.

Preparer Penalty Standards Under I.R.C. Section 6694(a)

Standard	Preparer Duty
Frivolous[1]	Cannot prepare tax return
Reasonable basis[2]	Can prepare tax return with disclosure[3]
Substantial authority[4]	Need not disclose unless a tax shelter or a Section 6662A Reportable Transaction[5]
Reasonably believe more likely than not (i.e., more than 50%)	Need not disclose

[1] The percentage of comfort is perhaps 5% or less
[2] Reasonable basis is defined in Section 1.6662-3(b)(3); the percentage of comfort is perhaps 20%
[3] Use Form 8275 or 8275R, or disclose pursuant to annual revenue procedure (e.g., Rev. Proc. 2015-16)
[4] "Substantial authority" is defined in Section 1.6662-4(d). It is a comfort level of perhaps 40% or more
[5] A tax shelter is an arrangement that has a significant purpose of avoidance or evasion of income tax. Section 6662(d)(2)(C)(iii). See Notice 2009-5 for how, in limited situations, to lower the standard to substantial authority for a tax shelter (basically educate the taxpayer about penalty exposure and document this fact)

Competence – Section 10.35 (Revised June 9, 2014)

- A practitioner must possess the necessary competence to engage in practice before the IRS
- Competent practice requires knowledge, skill, thoroughness and the preparation necessary for the matter at issue
- A practitioner may become competent through various methods such as consulting with experts or studying the relevant law

Comment: Sections 10.35 and 10.36 together mean that managers have a duty to ensure that their subordinates have the requisite knowledge and skill and that they appropriately use that knowledge and skill

AICPA Rules

- AICPA Code of Professional Conduct, Section 50, Article V, Due Care
- "... Members should be diligent in discharging responsibilities to clients, employers and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards ..."

MRPC -1.3

- A lawyer shall act with reasonable diligence and promptness in representing a client

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Prompt Disposition of Matters and Responses to Requests for Information §10.20 and §10.23

- If the IRS makes a proper request for records or information, a practitioner must promptly respond to the request unless the practitioner reasonably has the good-faith belief that the information is privileged
- A practitioner may not unreasonably delay the prompt disposition of any matter before the IRS

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Prompt Disposition of Matters and Responses to Requests for Information §10.20 and §10.23

- The practitioner must make a reasonable inquiry of the practitioner's client as to who has possession or control of the requested information
  - However, a practitioner need not make inquiry of any other persons or verify information provided by the client

Comment: Consider these rules when responding to a "wealth squad" IDR, a detailed LB&I IDR or a very broad discovery request.

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Prompt Disposition of Matters and Responses to Requests for Information §§10.20 and 10.23

- Where the documents or information requested by the IRS are not in the possession of the practitioner or client, the practitioner must promptly provide the IRS employee seeking the information with any information the practitioner has about who has possession or control of the requested information

Comment: This rule certainly seems to raise Section 7525 and attorney-client concerns

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What Are the Scopes of the Services to Be Performed?

- Importance of a Good Engagement Letter
- Conflict Waivers
- Relationship Between Scope of Services and Diligence and Care Required from the Practitioner

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Privilege Waiver Issues

- Preparing a tax return
- Valuation experts
  - Is this a good valuation report?
  - Consider penalty thresholds when planning
- Other experts

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Privileges In a Tax Setting

- Federal Rules of Evidence – Rule 501- Privileges in General
  - Rule 501 provides that common law governs a claim of privilege unless provided otherwise by the Constitution, a federal statute, or rules prescribed by the Supreme Court. In a civil case, state law governs.
- There are a Number of Relevant Privileges
  - Attorney-Client
  - Accountant-client or practitioner privilege
  - Work Product Doctrine
    - Each can be waived
    - There are exceptions to each Recent case law
  - Spousal Privilege

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Attorney-Client Privilege (cont.)

<u>The Kovel Letter</u>

- The Privilege Can Extend Communications with the Attorney's Agents
- So long as a client's communication is made to an agent of an attorney (*i.e.*, a CPA that has been retained by the attorney) in confidence, for the purpose of obtaining Legal Advice from the lawyer, it is privileged. *United States v. Schwimmer*, 892 F.2d 237, 243 (2d Cir. 1989).
- What is a *Kovel* Letter?
- This rule, generally known as the *Kovel* rule. The application of the *Kovel* rule can be difficult in situations where non-legal services, such as preparing a tax return, are provided with legal services because it is difficult to distinguish between communications made for the preparation of a tax return and those made for the provision of legal services. Because the *Kovel* rule rests on the attorney-client privilege, the protection of the *Kovel* rule is lost anytime the attorney-client privilege is lost.
- When to use a *Kovel* Letter.

<u>Comment</u>: The key is the facilitation of communication between the lawyer and client

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PART IV
High Net Worth And Family Off Issues

- FY 2022 Audit Campaign Issue
- High-income taxpayers will continue to receive audit attention (the audit rate is approximately 9% for those reporting income of $1 Million to $5 Million)
  - These taxpayers often have income and losses from flow-through entities
  - Thus, the audit of an individual will often lead to the examination of various related entities

High Net Worth Issues (cont.)

- The audit process involves a review of not only the taxpayer's personal income tax return, but also related partnership tax returns, fiduciary income tax returns, and estate and gift tax returns
- The audit is a complete review of the taxpayer(s) (*i.e.*, the IRS uses LB&I Audit Methods and Techniques)

High Net Worth Issues (cont.)

- Responding to Information Document Requests can be very burdensome, with a number of practical and <u>ethical</u> concerns
- IRS Counsel is often involved through the audit
- Often if information is not produced by the IDR deadline the IRS will issue a pre-summons letter and then an IRS summons

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High Net Worth Issues (cont.)

Some examples of the broad scope of high net worth audits include

- Estate and Gift tax issues
- **Valuation issues**
- Executive Compensation
- C corporation and S corporation issues
- Noncash charitable contributions
- **Partnership and LLC issues**
- Passive activity losses
- Foreign Trusts
- Foreign Bank Account reporting
- Basis and At-Risk issues
- Transfer Pricing Issues
- **Private airplane issues**

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Department of the Treasury
Internal Revenue Service
LB&I:ECPA:NorthCentral:1721
230 South Dearborn M/S 4172
Chicago, IL 60604

[redacted]

Date:
10/08/2021

[redacted] ID number (last 4 digits):

Form:
1040

Tax periods:
201912

:t:

[redacted] number:

[redacted]r:

[redacted] ber:

Dear Mr. [redacted] and Mrs [redacted] :

Your federal return for the period(s) shown above was selected for examination.

What you need to do
Please call me on or before October 29, 2021. You may contact me from 8:00am to 3:00pm at the telephone number provided above.

During our telephone conversation, we'll talk about the items I'll be examining on your return, the types of documents I'll ask you to provide, the examination process, and any concerns or questions you may have. We'll also set the date, time, and agenda for our first meeting.

Someone may represent you
You may have someone represent you during any part of this examination. If you decide you want representation, the representative you authorize will need a completed Form(s) 2848, *Power of Attorney and Declaration of Representative*, before we can discuss any of your tax matters.

If you choose to have someone represent you, please provide a completed Form 2848 by our first appointment. You can mail or fax the form to me or have your representative provide it at the first appointment, if you won't be present. You can obtain Form 2848 from our office, from our web site, www.irs.gov or by calling (800) 829-3676.

If you filed a joint return, you and your spouse may attend the examination. If you and/or your spouse choose not to attend with your representative, you must provide completed Form(s) 2848. You should provide a separate Form 2848 for each spouse if you filed jointly even if you use the same representative.

Your rights as a taxpayer
We have enclosed Publication 1, *Your Rights as a Taxpayer* and Notice 609, *Privacy Act Notice*. The Declaration of Taxpayer Rights found in Publication 1 discusses general rules and procedures we follow in examinations. It explains what happens before, during, and after an examination, and provides additional sources of information.

Letter 2205 (Rev. 1-2017)
Catalog Number 63744P

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A video presentation, "Your Guide to an IRS Audit," is available at http://www.irsvideos.gov/audit. The video explains the examination process and will assist you in preparing for your audit.

Thank you for your cooperation and I look forward to hearing from you by [date]

Sincerely,

[redacted]
Internal Revenue Agent

Enclosures:
Publication 1
Notice 609

Letter 2205 (Rev. 1-2017)
Catalog Number 63744P

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Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 001
To: and	Subject: Initial IDR - Form 1040 – 201912	
	Submitted to:	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

The purpose of this Information Document Request (IDR) is to obtain information relevant to your Form 1040 filed for the tax year ending December 31, 2019.

Please provide the following documentation:

1. Copies of any amended Forms 1040 (including all schedules/attachments) filed for the tax year ending December 31, 2018, December 31, 2019, and December 31, 2020.
2. Copies of any correspondence from the Internal Revenue Service concerning Form 1040 for the tax year ending December 31, 2019 excluding the Letter 2205 (initial contact letter) sent by .
3. Copies of all audit reports issued by any federal or state agency for tax year ending December 31, 2019.
4. Personal net wealth and/or financial statement(s) as of December 31, 2019, if available. This should include the method of accounting used to compile them, net worth computations or other financial data regarding your assets, liabilities, net worth, income and losses, and cash flows from all sources within and without the United States, including all underlying documents and any applicable exhibits and/or footnotes associated therewith, and if not apparent, please identify the preparer of such documents. If not available, provide a negative written response.
5. A brief summary of your business and investment activities, including items reported on the Form 1040, Schedule E. For activities identified as non-passive, elaborate on your involvement and day-to-day role with each entity.
6. Provide a copy of the worldwide legal organization chart as of January 1, 2019 and December 31, 2019 including all domestic and foreign affiliates, places and dates of incorporation and their relationship to the reporting partnership/LLC for the entities you have greater than 50% control of through the rules of attribution. This chart should include all entities to which the Taxpayer is related within the meaning of Section 267.

Information Due By 11/05/21 At Next Appointment ☐ Mail In ☐

FROM	Name and Title of Requestor: Internal Revenue Agent	Badge Number: Phone: Fax: Email:	Date: 10/8/2021
	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 1 of 3

Form 4564

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Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 001
To: [redacted] and [redacted] [redacted]	Subject: Initial IDR - Form 1040 – 201912	
	Submitted to:	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

The following should be included in the chart:
a. Name of each entity,
b. Employer Identification Number,
c. Ownership percentage in each entity,
d. U.S. tax treatment of entity,
e. Country in which the entity was created or organized,
f. Country in which the entity operates, and
g. Business activity of the entity.

If there is a difference in entities reported at January 1, 2019 and December 31, 2019, please provide an explanation.

7. Tax return workpapers and reconciliation schedules used to prepare the Form 1040 (original and amended, if applicable) for the tax year ending December 31, 2019.
8. For all disregarded entities with activities reported on the Taxpayer's (each spouse) individual tax returns for the tax year ending December 31, 2019, please provide:
   a. Detail General Ledger Transaction file (Lowest level transaction detail that can be reconciled to the Year-end Trial Balance amounts),
   b. Year-end Trial Balance file showing beginning of the tax period balances and end of the tax period balances,
   c. Chart of Accounts (GL Account Number, GL Account Name, Account Type),
   d. LLC Operating Agreements,
   e. Check-the-box elections (Form 8832), and
   f. Reconciliation of the Profit and Loss records to the Form 1040 tax return.
9. Provide all Schedule K-1s issued to , , and its disregarded entity/entities (flowing into Form 1040) for tax year ending December 31, 2019. Provide any Schedule K-1 workpapers and reconciliation to the 2019 tax return.

Information Due By 11/05/21 At Next Appointment ☐ ☐

FROM	...e of Requestor: Internal Revenue Agent	Badge N... Phone: Fax: Email:	Date: 10/8/2021
	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 2 of 3

Form 4564

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Form 4564	Department of the Treasury Internal Revenue Service Information Document Request	Request Number 001
To: [redacted] and	Subject: Initial IDR - Form 1040 – 201912	
	Submitted to:	
	Dates of Previous Requests: N/A	

Description of Documents Requested:

10. Any other tax returns filed for the tax years ending December 31, 2019, including Excise Tax, 1099, 1096, W-2, 940, 941, Schedule H, and Gift or Estate Tax returns.

11. Copies of any gift or estate tax returns filed for the tax year ending December 31, 2019.

12. Did you make gifts in excess of $15,000 during the tax year ending December 31, 2019? If yes, specify the amount of the gift, when it was made, and the name(s) of the recipient(s).

When responding to this IDR, please identify each response to each item requested in this IDR by labeling each response with the corresponding number or letter listed in the IDR. This will help facilitate an efficient review of the information provided and decrease the likelihood of additional follow up questions. Where documents exist in electronic format, please provide in original electronic format.

Due Date: 11/05/2021

Information Due By 11/05/21 At Next Appointment ☐ Mail In ☐

FROM	le of Requestor: Internal Revenue Agent	Badge I Phon Fax: Email:	Date: 10/8/2021
	Office Location: Internal Revenue Service; Mail Stop 4171 LB&I:ECPA:1113; 230 S. Dearborn; Chicago, IL 60604		Page 3 of 3

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Lender Mgmt LLC V. Comm’r, T.C. Memo 2017-25

- Family office takes a profits interests in investments and is treated as a trade or business.

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PART IV

Employment Tax Issues

- New Audit Program
- Three Main Issues -
  - Employee/Independent Contractor
  - Fringe benefit issues
  - Deduction issues

October 1, 2021 – A very interesting day

Fringe Benefit Issues

- Executive compensation issues in general
- Vehicle and tool *per diem* issues
- IRS is looking at the issue of whether employees are attempting to turn "wages" into taxable *per diem* allowances
  - Carefully scrutinize what expenses can be included in a *per diem*
- Comment: Contractors who have a large amount of unreimbursed business expenses are asking for increased per diems due to the nondeductability of these expenses.

Section 530 of the Revenue Act of 1978

- Generally allows taxpayer to treat worker as not being an employee for employment tax, but not income tax or other purposes
- Must have reasonable basis and meet certain requirements

Section 530 of the Revenue Act of 1978 (cont.)

- *Reasonable basis* for treating a worker as an independent contractor exists if the taxpayer reasonably relied on

1. Past IRS audit practice with respect to the taxpayer, or
2. Published rulings or judicial precedent, or
3. Long-standing recognized practice in the industry of which the taxpayer is a member, or
4. If the taxpayer has any "other reasonable basis" for treating a worker as an independent contractor.

Section 530 of the Revenue Act of 1978 (cont.)

Comment: When section 530 relief is at issue, the IRS is supposed to consider the application of this relief before determining if an employment relationship existed.

Section 530 of the Revenue Act of 1978 (cont.)

- Additional requirements
  1. The taxpayer must not have treated the worker as an employee for any period
  2. All federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor
  3. The taxpayer (or a predecessor) must treat all workers holding substantially similar positions consistently for purposes of employment taxes
     - The "similar worker consistency requirement"

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Statute of Limitations in Employment Tax Cases

Section 6513 governs when a return is deemed to be filed for purposes of Section 6511 (i.e., for purposes of whether a claim for refund is timely filed). Subsection (c) pertains to Social Security Taxes and Income Tax Withholding (i.e., the taxes reported on a Form 941). Section 6513(c) provides that:

> If a **return** for any period ending with or within a calendar year **is filed before April 15** of the succeeding calendar year, such return shall be considered filed on April 15 of such succeeding calendar year. § 6513(c)(1). (Emphasis added.)

Thus, when a Form 941 for a period is filed before April 15 of the following period, the tax return is considered filed on April 15 of that following year.

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Interest-Free Adjustments

- Generally, for employment tax (i.e., Form 941 obligations), if the adjustment to the Form 941 (i.e., the tax deficiency) is
  - paid on or before the due date of the 941 for the period in which the error is "ascertained,"
  - the amount of the underpayment shall be paid without interest being charged.
- An error is ascertained when resolved at examination or with appeals.

Interest-Free Adjustments (cont.)

- If, however, the case is not resolved at Appeals and the taxpayer receives a notice and demand for payment from the IRS, the adjustment will not be interest free.
- In addition, the taxpayer will not be allowed an interest free adjustment where a prior audit found that additional tax was due with respect to the same issue.

Valuation Issues

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Traps for the Unwary When Obtaining Valuation/ Appraisal Reports

- *Exelon v. Comm'r*, 906 F.3d 513 (7th Cir. 2018)
  - SILO tax shelter
  - Appraisal of power plant found to lack credibility because the attorney interfered with the integrity and independence of the appraiser by providing wording and conclusions the lawyer expected to see so that the lawyer could issue a tax opinion
  - Loss on (1) valuation issue; and (2) reasonable cause defense to a penalty
- Need an appraiser who understands the process
- Be careful about "educating" an appraiser
- Assume whatever is sent to the expert will be made available to the IRS

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Valuation Checklist

- The Cover Letter – Summary
  - Who is the retaining party and other intended users?
  - Use the Correct Definition of Fair Market Value ("FMV"), FMV for a gift, Treas. Reg. Section 25.2512-1 defines fair market value as
    - **[T]he price at which property would change hands between a willing buyer and a willing seller, Neither being under any compulsion to buy or sell and both having reasonable knowledge of the Relevant facts**

Valuation Checklist (cont.)

- **The "as of" or date**
- **Purpose of the valuation and intended use (e.g. estate and gift tax purposes)**
- Type of asset and interest being valued (i.e. a minority interest . . .)
- Control Rights - in any
- Access to Liquidity
- The Scope of Work
- Information Considered
- Methodologies Utilized
- Fair Market Value Conclusion

Valuation Checklist (cont.)

- The Report- Body
  - Standard of value – Define FMV again
  - Purpose of the valuation
  - What is being valued?
  - Prior transactions if any
  - What interest is being valued
  - Economic overview / market conditions
  - Company specific information
  - Methodologies used to determine FMV (Holding Company v. Active Business).

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Valuation Checklist (cont.)

- Discounts. Do not rely only on case law. Berg Estate v. Comm'r, T.C. Memo 1991-279
- Explain the weight given to each methodology used. Otherwise if one methodology is rejected, the whole report any fail. True Estate v. Comm'r T.C.Memo 2001-167 aff'd., 390 F.3d 1210 (10th Cir 2004)
- Tax Affecting Earnings if an S Corp. or Partnership. Calculation both ways. Recent Cases, Kress, Estate of Jones. If do not tax affect, can the marketability discount be increased.

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Reliance and Reasonable Cause

- Ordinary business care and prudence
- Three part test when relying on a professional advisor.
  1. The advisor was competent and had sufficient expertise;
  2. The taxpayer provided the necessary and adequate information to the advisor; and
  3. The taxpayer relied in good faith on the advisor.

Neonatology Assocs., P. A. v. Comm'r, 115 T.C. 43 (2000)

Valuation Penalties

- The determination whether a penalty applies is made on a property by property basis
  - Thus, different penalties could apply to different pieces of property
  - See *Estate of True v. Commissioner*, T.C. Memo 2001-67, aff'd, 390 F.3d 1210 (10th Cir. 2004)

Valuation Penalties (cont.)

- Four Penalties - two in the gift tax context and two in the income tax context. These "triggers" are mathematical:
  - Substantial Valuation Misstatement (income tax)[1]
  - Substantial Estate or Gift Tax Valuation Understatement[2]
  - Gross Valuation Misstatement (income tax)[3]
  - Gross Estate or Gift Tax Valuation Understatement[4]

1. Return value is 150% or more of the correct value - 20% penalty.
2. Return value is 65% or less of the correct value - 20% penalty.
3. Return value is 200% or more of the correct value - 40% penalty.
4. Return value is 40% or less of the correct value - 40% penalty.

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Taxpayer Valuation Penalties

- Estate and Gift Tax Understatement of Value
  - Substantial Valuation Misstatement
  - There is a 20% penalty of the portion of the underpayment of tax attributed to undervaluation if the value on the estate or gift tax return is 65% or less of the amount determined to be correct
    - Section 6662(a), (b)(5), (g)
- Gross Valuation Misstatement
  - There is 40% of the tax attributable to the undervaluation if the amount reported on the estate or gift tax return is 40% less of the value determined to be correct
    - Section 6662(h)(1), (2)(C)
  - There is no penalty if the underpayment of tax is $5,000 or less
    - Section 6662(g)(2)

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Disclosure

- There is no disclosure exception for any of the valuation misstatement penalties
- Comment
  - A disclosure exception would be "too good to be true"
  - The penalty would rarely apply (*i.e.*, I am disclosing the fact that the value on a form is likely wrong)
- Reasonable cause exception can apply

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Reasonable Cause

- A showing of reasonable cause and good faith avoids the estate and gift tax penalties
  - Section 6664(c)(1)

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Income Tax Overstatement of Value e.g., a Charitable Contribution

- Substantial Valuation Misstatement
  - There is a 20% penalty applicable to any underpayment attributable to a Substantial Valuation Misstatement
    - Section 6662(b)(3)
  - A substantial valuation misstatement occurs if the value (or adjusted basis) of any property claimed on a return claimed income is 150% or more of the correct amount
    - Section 6662(e)
  - The penalty is not imposed unless the misstatement results in an underpayment of greater than $5,000 ($10,000 for a C-corporation)
    - Section 6662(b)(2)

Gross Valuation Misstatement

- There is a 40% penalty in the case of a Gross Valuation Misstatement.
- A Gross Valuation Misstatement occurs if the value of the property is 200% or more of the correct value section.
- The standard is automatically met if the correct value is zero.
  - Treas. Reg. Section 1.6662-5(g).
- Example
  - Donor claims a deduction under Section 170 for the donation of property to a qualified charity

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Reasonable Cause and the Income Tax Valuation Penalties

- A reasonable cause exception under Section 6664 can apply when the underpayment is attributable to a substantial (but not a Gross) understatement with regard to a charitable contribution if the following occurs:
  - The claimed value of the property is based upon a qualified appraisal by a qualified appraiser;
  - The taxpayer also made a good faith investigation of the value of the contributed property; and
  - The taxpayer acted with reasonable cause and in good faith
    - Section 6664(c)(3)

Comment: Review the definitions of a qualified appraiser and appraisal in Treas. Reg. Section 1.170A-13(c)(3) and (5)

Penalty for Erroneous Refund Claims — Section 6676

Penalty for Erroneous Refund Claims (Section 6676)

- Penalty equal to 20% of the excessive amount claimed unless:
  - It is shown that there is reasonable cause for the claim for the excessive amount.
  - Assume reasonable cause is the same as under Section 6664.

Comment: Reasonable cause is a defense.

CONCLUSION