FOUNDATIONS OF FIDUCIARY ACCOUNTING: A BEGINNER'S GUIDE FOR CPAS

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I. FOUNDATIONS OF FIDUCIARY ACCOUNTING: BEGINNER'S GUIDE FOR CPAS

A. The Attorney–CPA Partnership in Administration

1. Division of Responsibilities

a. Estate Attorney

i. Interprets the trust instrument or will.

ii. Advises on applicable state law and probate procedures.

iii. Addresses fiduciary duties, beneficiary rights, and legal compliance.

iv. Prepares or reviews legal releases and settlement documents.

b. CPA

i. Maintains accurate financial records and transaction histories.

ii. Classifies receipts and disbursements.

iii. Prepares fiduciary accounting schedules and tax returns.

iv. Supports distributions, reconciliations, and documentation.

2. **Shared Goal:** Protect the fiduciary, promote transparency, and minimize disputes among beneficiaries.

II. THE FIDUCIARY DUTY TO ACCOUNT

A. Sources of the Duty

1. Common-law fiduciary principles.

2. Applicable state statutes and probate rules.

   a. Uniform Trust Code provisions, where adopted.

   b. Trust instrument or will requirements.

3. Beneficiary rights to information and financial reporting.

4. **CPA Practice Point:** Determine the governing jurisdiction and review the actual governing document before preparing an accounting.

B. Statutes of Limitations and Beneficiary Objections

1. Formal accountings may provide a mechanism for limiting the time to bring certain claims.

2. Applicable requirements vary by state and type of proceeding.

3. Notice, disclosure, delivery, and objection periods may be governed by specific statutory rules.

4. An accounting alone does not automatically eliminate fiduciary liability.

5. **CPA Practice Point:** Coordinate with the attorney to determine whether the accounting and accompanying notices satisfy applicable legal requirements.

C. Consequences of Inadequate Accounting

1. Potential consequences include:

a. Court-ordered repayment or surcharge.

b. Reduction or denial of fiduciary compensation.

c. Removal of the fiduciary.

d. Payment of attorneys' fees and litigation costs.

e. Increased scrutiny of transactions and missing documentation.

2. **CPA Practice Point:** Maintain supporting records for every material receipt, disbursement, asset transfer, and distribution.

D. Trustee Compensation

1. Compensation may be governed by:

a. The trust instrument.

b. Applicable state statutes.

c. Court orders.

d. A reasonable-compensation standard, where applicable.

2. Documentation should identify:

a. Compensation as a separate line item.

b. The calculation method and applicable authority.

c. Time records or other supporting documentation, as appropriate.

d. Reimbursements and other administrative expenses separately.

III. TRUST ACCOUNTING CONCEPTS

A. Governing Document and State Law

1. Review the governing instrument for:

    a. Definitions of income and principal.

    b. Distribution provisions.

    c. Allocation of receipts and expenses.

    d. Trustee powers and discretion.

    e. Special accounting or reporting requirements.

2. Applicable state law supplies rules where the governing instrument does not control, subject to mandatory legal requirements.

3. **CPA Practice Point:** Do not assume that tax accounting rules or ordinary financial accounting conventions determine fiduciary allocations.

B. Principal and Income Allocation

1. Fiduciary accounting distinguishes between:

    a. Principal

        i. Assets held in the trust.

        ii. Contributions and certain capital transactions.

        iii. Allocations designated to principal under the governing instrument and applicable law.

b. Income

i. Receipts allocated to income under the governing instrument and applicable law.

ii. Amounts potentially available for distribution to income beneficiaries.

iii. Allocation rules affect the economic interests of current and remainder beneficiaries.

C. Impartiality and Equitable Adjustments

1. Trustees may need to balance the interests of income beneficiaries and remainder beneficiaries.

2. Relevant considerations include:

a. Income generation versus long-term growth.

b. Preservation of principal.

c. Allocation of expenses and depreciation.

d. Statutory adjustment mechanisms, where authorized.

e. Treatment of non-income-producing assets and asset sales.

3. **CPA Practice Point:** Identify unusual or potentially inequitable allocations and refer legal questions to the attorney before making adjustments.

D. Fiduciary Accounting Income (FAI) vs. Distributable Net Income (DNI)

Fiduciary Accounting Income (FAI)	Distributable Net Income (DNI)
Primarily a fiduciary-law concept	A federal income tax concept
Helps determine amounts distributable as income under the governing instrument and applicable law	Helps determine the income distribution deduction and beneficiary taxation under Subchapter J
Depends on fiduciary allocation rules	Calculated under federal tax rules
Does not necessarily equal taxable income	Does not necessarily equal cash available for distribution

1. **Important Distinction:** Capital gains may be taxable for fiduciary income tax purposes without being classified as fiduciary accounting income. Their treatment depends on applicable tax rules, the governing instrument, state law, and the circumstances.

2. **CPA Practice Point:** A Form 1041 and its Schedule K-1s do not replace the fiduciary's separate accounting and reporting obligations.

E. Discretionary Distributions and the HEMS Standard

1. HEMS stands for:

   a. **H**ealth

   b. **E**ducation

   c. **M**aintenance

   d. **S**upport

2. When applicable, the HEMS standard limits the exercise of distribution discretion.

3. Accounting documentation should identify:

a. The beneficiary receiving the distribution.

b. The amount and date.

c. The stated purpose.

d. Supporting invoices, receipts, or other records, where appropriate.

e. The relevant trust provision or authorization, when useful.

4. **CPA Practice Point:** Vague descriptions of substantial distributions can create questions about compliance and impartiality.

IV. FIDUCIARY ACCOUNTING FORMS AND REPORTS

A. The Accounting

1. An accounting reconciles the assets for which the fiduciary is responsible with their disposition and the assets remaining.

a. Receipts may include:

i. Initial inventory or opening assets.

ii. Subsequent receipts.

iii. Other amounts chargeable to the fiduciary under the applicable accounting format.

b. Disbursements may include:

i. Authorized expenses.

ii. Taxes and fiduciary compensation.

iii. Beneficiary distributions.

iv. Other properly documented dispositions.

v. The accounting should reconcile to the assets remaining on hand, with appropriate treatment of gains, losses, transfers, and other adjustments.

2. **CPA Practice Point:** Confirm that the report balances and that the supporting schedules explain material changes in asset values and holdings.

B. Supporting Schedules

1. A well-organized accounting may include:

a. **Opening inventory:** Assets and applicable valuation date.

b. **Receipts:** Income, contributions, proceeds, and other receipts.

c. **Disbursements:** Expenses, taxes, fees, and other payments.

d. **Distributions:** Payments or transfers to beneficiaries.

e. **Closing assets:** Property remaining at the end of the accounting period.

2. Schedule names and letter designations vary by jurisdiction and reporting format. Follow the applicable court rules or agreed reporting structure.

C. Court Accounting vs. Informal Accounting

1. Court Accounting

a. Follows applicable court rules and prescribed forms.

b. May require specific schedules, supporting documentation, and notice procedures.

c. Is subject to court review and approval where required.

2. **Informal Accounting**

a. Is commonly used in privately administered trusts and estates.

b. May allow flexibility in presentation.

c. Should clearly identify assets, transactions, distributions, and ending balances.

d. Should provide sufficient detail for beneficiaries to evaluate the fiduciary's administration.

3. **Legal Releases**

a. A common nonjudicial resolution process may involve:

i. Preparing a comprehensive accounting.

ii. Having the attorney review applicable disclosure and release requirements.

iii. Delivering the accounting and proposed release to the appropriate beneficiaries.

iv. Providing an opportunity for review and questions.

v. Obtaining informed written approval or releases, where legally effective.

vi. Documenting final distributions and retaining the completed records.

b. **Important:** A release does not automatically extinguish every potential claim. Its enforceability and scope depend on applicable law, adequate disclosure, execution requirements, and the circumstances.

V. CPA PRACTICE CHECKLIST

A. Before finalizing a fiduciary accounting, consider the following:

1. Obtain and review the trust instrument or will.
2. Confirm the applicable jurisdiction and accounting period.
3. Reconcile opening assets to prior records or the initial inventory.
4. Verify receipts, disbursements, and transfers against source documents.
5. Classify principal and income under the governing rules.
6. Separately identify trustee compensation and reimbursements.
7. Review beneficiary distributions and retain appropriate support.
8. Reconcile realized gains, losses, and ending assets.
9. Compare fiduciary accounting treatment with Form 1041 and Schedule K-1 reporting.
10. Identify unresolved legal or allocation questions for attorney review.
11. Confirm required delivery, notice, and approval procedures with counsel.
12. Retain workpapers and supporting documentation.

VI. KEY TAKEAWAYS

A. **Documentation protects the fiduciary.** Accurate, complete records help demonstrate responsible administration.

B. **The governing instrument matters.** Review it alongside applicable state law before allocating receipts and expenses.

C. **Tax accounting and fiduciary accounting serve different purposes.** Reconcile them, but do not treat them as interchangeable.

D. **Classification and disclosure matter.** Principal, income, compensation, expenses, and distributions should be clearly identified.

E. **Coordinate with counsel.** Legal questions about beneficiary rights, limitations periods, allocation authority, and releases should be resolved before finalizing the accounting.