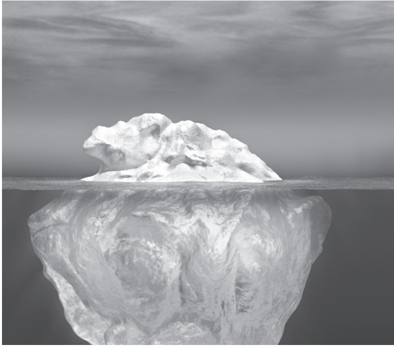


MODULE B

Professional Ethics

Auditors must approach their jobs with independence and skepticism. How do we instill those necessary traits in auditors? This may be the most important auditing question of our time.

James R. Doty, PCAOB Chairman, in remarks made at SEC Reporting Conference, June 2, 2011

To educate a person in mind and not in morals is to educate a menace to society.

Theodore Roosevelt, 26th President of the United States (1858–1919)

Always do right—this will gratify some and astonish the rest.

Mark Twain, (pseudonym of Samuel L. Clemens), famous American writer (1835–1910)

Professional Standards References

Topic	AU/ISA Section	PCAOB Reference*
Overall Objectives of the Independent Auditor	200	AU 110, AU 150,AU 201, AU 220, AU 230
Quality Control for an Audit Engagement	220	*AS 7*
Responsibility Not to Knowingly or Recklessly Contribute to Violations		Rule 3502
Auditor Independence		Rule 3520
Contingent Fees		Rule 3521
Tax Transactions		Rule 3522
Tax Services for Persons in Financial Reporting Oversight Roles		Rule 3523
Audit Committee Preapproval of Certain Tax Services		Rule 3524
Audit Committee Preapproval of Nonaudit Services Related to Internal Control over Financial Reporting		Rule 3525
Communication with Audit Committees Concerning Independence		Rule 3526
	ET Section†	
Members in Public Practice	ET 1.000 - 1.800	
Members in Business	ET 2.000-2.400	
Other Members	ET 3.000-3.400	
AICPA Council Resolution Designating Bodies to Promulgate Technical Standards	ET Appendix A	
AICPA Council Resolution Concerning Form of Organization and Name (Rule 505)	ET Appendix B	
AICPA Code of Conduct Revision History Table	ET Appendix C	
AICPA Code of Conduct Mapping Document	ET Appendix D	

* AU references represent standards issued by the ASB prior to April 16, 2003, that have not been superseded or amended by the PCAOB.

† ET references represent sections in the AICPA Code of Professional Conduct.

LEARNING OBJECTIVES

As described in Chapter 2, the responsibilities principle identifies three specific responsibilities. Two of the responsibilities, (1) having appropriate competence and capabilities to perform the audit and (2) maintaining professional skepticism and exercising professional judgment throughout the planning and performance of the audit, have been focused on in other chapters of this book. This module focuses on the third responsibility, complying with relevant ethical requirements. In this spirit, this module is designed to teach you about the AICPA Code of Professional Conduct and demonstrate why it is so important to your success as a professional accountant. As you will soon learn, regulation of the profession, including any discipline for violations, depends on the prevailing published codes of ethics and enforcement practices. As a result, we believe this module is essential to your success.

Your objectives are to be able to:

LO B-1 Understand general ethics and a series of steps for making ethical decisions.

LO B-2 Reason through an ethical decision problem using the imperative, utilitarian, and virtue theories of moral philosophy.

LO B-3 Identify the different entities that make ethics rules for CPAs and public accounting firms.

LO B-4 With reference to American Institute of Certified Public Accounting (AICPA), Government Accountability Office (GAO), Public Company Accounting Oversight Board (PCAOB), and Securities and Exchange Commission (SEC) rules, analyze factual situations and decide whether an accountant's conduct does or does not impair independence.

LO B-5 With reference to AICPA rules on topics other than independence, analyze factual situations and decide whether an accountant's conduct does or does not conform to the AICPA Code of Professional Conduct.

LO B-6 Explain the types of penalties that can be imposed on accountants.

INTRODUCTION

Scott London seemed to have it all. One of three sons of a Los Angeles certified public accountant, he followed his father into the accounting business. He graduated in 1984 from California State University, Northridge, and soon landed a job at a firm that later became part of **KPMG.** From an outsider's perspective, London appeared to have an ideal personal life. He and his wife Michele had two children and lived in an expensive home at the end of a cul-de-sac in a Los Angeles suburb known as the gateway to the Santa Monica Mountains. Professionally, as the KPMG partner in charge of the firm's Pacific Southwest Audit practice, he had more than 50 partners and 500 employees reporting to him. After 29 years with the firm, he seemed to be set financially. However, with all this going for him, he plead guilty to passing confidential client information to a golf buddy who then traded on the information to make more than $1 million in illegal gains. Although the information was initially passed "innocently" in casual conversation on the golf course, London began accepting payments of cash and jewelry in exchange for the tips. Bryan Shaw, the recipient of the information who profited from the illegal trades, cooperated with authorities, including agreeing to wear a wire to gain evidence against his benefactor. In return for the confidential information, London received more than $50,000 in cash and gifts, including a $12,000 Rolex watch; however, the amount of these "gifts" are seemingly immaterial given London's estimated seven-figure annual salary.

The sting operation that nabbed London was the result of a joint investigation by the FBI, SEC, and

Department of Justice. When first notified of the allegations, KPMG acted immediately and decisively, firing London, who the firm said "violated the firm's rigorous policies and protections, betrayed the trust of clients as well as colleagues, and acted with deliberate disregard for KPMG's long-standing culture of professionalism and integrity." The firm also took legal action against London. Due to independence concerns, the firm resigned as auditor of **Skechers** and **Herbalife,** companies whose audits London oversaw. KPMG also announced that it would reassess its quality control standards, which include employee training, monitoring key employees' personal investments, and a whistle-blowing hot line.

In addition to losing his job and being sued by his former employer, London ended up serving 14 months in prison and paying $100,000 in fines. He is still on probation and performing community service. He has openly confessed to his misconduct and has expressed his remorse: "I cannot begin to apologize for my incredibly stupid actions. There is no excuse for my wrongful conduct." However, even in hindsight, London has trouble explaining his behavior: "I felt guilt about it regularly—I can't explain it to be honest with you. . . . I look back at when this started and I can't explain it . . . . I guess [the] best way to describe it is that humans make mistakes."[1]

We may never know the true motives behind his actions, but we do know that London made a conscious decision to betray his employer, his clients, and his profession, violating a number of rules from the AICPA Code of Professional Conduct in the process. In this module, we discuss the AICPA Code of Professional Conduct and many of the rules that London violated when sharing stock tips on the golf course.

GENERAL ETHICS

LO B-1

Understand general ethics and a series of steps for making ethical decisions.

What is ethics? Wheelwright defined *ethics* as "that branch of philosophy which is the systematic study of reflective choice, of the standards of right and wrong by which it is to be guided, and of the goods toward which it may ultimately be directed."[2] In this definition, you can detect three key elements: ethics (1) involves questions requiring reflective choice (*decision problems*), (2) involves guides of right and wrong (*moral principles*), and (3) is concerned with the consequences (*good or bad*) of decisions.

What is an ethical problem? A *problem situation* exists when an individual must make a choice among alternative actions and the right choice is not absolutely clear. An *ethical problem situation* may be described as one in which the choice of alternative actions affects the well-being of other persons. Although these are technical definitions of ethical dilemmas, we are often faced with situations in which what we want to do conflicts with what we know is the right course of action. Ethicists may argue that these are not ethical dilemmas, but that fact does not make the decisions any easier.

What is *ethical behavior?* You can find three standard philosophical answers to this question: ethical behavior is that which (1) produces the greatest good, and/or (2) conforms to moral rules and principles, and/or (3) best demonstrates the virtues you value most. The most difficult problem situations arise when two or more rules conflict or when a rule and the criterion of "greatest good" conflict. However, as a professional auditor, you must always conform to the code of ethical behavior that applies to your jurisdiction or face the possibility of being formally sanctioned by the profession.

Why does an individual or group need a code of ethical conduct? A *code* makes explicit some of the criteria for conduct unique to the profession. *Codes of professional ethics* provide guidance in addressing

[1] "Insider Trader Is Identified," *The Wall Street Journal,* April 11, 2013, p. C1.

[2] Philip Wheelwright, *A Critical Introduction to Ethics,* 3rd ed. (Indianapolis, IN: Odyssey Press, 1959).

situations that may not be specifically available in general ethics theories. An individual is better able to know what the profession expects. From the viewpoint of the organized profession, a *code* is a public declaration of principled conduct and a means of facilitating *enforcement* of standards of conduct. Once again, you can see the value of ethical behavior. Remember that accounting is the only business discipline that is considered a profession similar to those of doctors and lawyers. As a student of auditing, you must commit yourself to knowing and understanding the AICPA *Code of Professional Conduct.* Understanding the Code of Professional Conduct will allow you to better prepared to handle difficult situations like the one posed in Ethical Example 1.

ETHICAL EXAMPLE 1

In a famous experiment conducted by Stanley Milgram (a psychologist at Yale University), subjects were told to ask questions of an individual in another room. If the individual answered incorrectly, the subjects were told to inflict an electric shock as punishment. In reality, no shock was actually administered; however, the subjects believed they were administering one and could hear shouts, cries, and appeals to stop emanating from the next room. The experimenter ordered the subjects to continue to apply the shocks at ever increasing amounts. Many subjects increased the voltage to intensities labeled as dangerous and continued even after the individual in the next room asked for a doctor. Why do you think the subjects continued to apply shocks? What would you have done in this circumstance? Many have used the Milgram study result as an explanation for how good people often get caught up in wide-reaching frauds such as **Enron** and **WorldCom,** by subordinating their judgments to authority figures.

AN ETHICAL DECISION PROCESS

LO B-2

Reason through an ethical decision problem using the imperative, utilitarian, and virtue theories of moral philosophy.

When considering general ethics, your primary goal is to arrive at a personal framework for making ethical decisions. Consequently, an understanding of some of the general principles of ethics can provide background for a detailed consideration of standards for professional conduct.

In the earlier definition of ethics, one of the key elements was *reflective choice.* This involves engaging in an important sequence of events beginning with the recognition of a decision problem. Collection of evidence, in the ethics context, refers to thinking about rules of behavior and outcomes of alternative actions. The process ends with analyzing the situation and taking an action. Ethical decision problems almost always involve projecting yourself into the future to live with your decisions. Professional ethics decisions usually turn on these questions: “What written and unwritten rules govern my behavior?” and “What are the possible consequences of my choices—whom will my decision affect?” *Principles of ethics* can help you think about these two questions in real situations.

A good way to approach ethical decision problems is to think through several steps:

1. Define all facts and circumstances known at the time you need to make the decision. They are the “who, what, where, when, and how” dimensions of the situation. Identify the actor who needs to decide what to do.
    a. Because ethical decision problems are defined in terms of their effects on people, identify the people involved in the situation or affected by it. These are the “stakeholders”; be careful not to expand the number of stakeholders beyond the bounds of reasonable analysis.

b. Identify and describe the stakeholders' rights and responsibilities in general and to each other.

2. Specify the actor's major alternative decision actions and their consequences (good, bad, short-run, long-run).
3. The actor must choose among the alternative actions.

Let's apply the preceding ethical framework to Ethical Example 2.

ETHICAL EXAMPLE 2

Step 1: Kathy Ellis (the chief financial officer) ordered Jorge Santos (a staff accountant) to "enhance" the financial statements in a loan application to Spring National Bank by understating the allowance for uncollectible accounts receivable saying, "It's an estimate anyway and we need the loan for a short time to keep from laying off loyal employees." What should Santos do?

Step 1a: The stakeholders include the direct participants—Ellis, Santos, and Luis Perez (Spring National Bank's loan officer)—and some indirect participants—bank stockholders and loyal employees. Other people may be affected— Santos's mother, citizens who depend on the solvency of the banking system as a whole, taxpayers who may eventually need to bail out the insolvent banking system, and others—but identifying them probably will not improve the analysis.

Step 1b: *Responsibilities:* Ellis and Santos should act with integrity, and Ellis should not pressure Santos to cut corners with financial statements. Perez should make careful loan approval decisions. *Rights:* Santos should not be subject to pressures to cut corners with "enhanced financial statements." Perez should receive information that is not materially misstated or manipulated. (Some rights of employees and bank stockholders also could be identified.)

Step 2: (a) Santos can follow orders: Ellis is happy, he keeps his job, Perez gets fooled and approves the loan, the employees keep their jobs, the company fails, the bank is unable to collect the loan, the employees are laid off anyway, and Ellis and Santos are prosecuted and convicted of making false statements to a federal institution and go to federal prison. (2) Santos can refuse to "enhance" the financial statements: Ellis is not happy, Santos is fired, Ellis prepares the financial statements herself, and so on. (3) Santos persuades Ellis of the potential problems and Perez refuses the loan, and the company must find another way to survive, or Perez approves the loan anyway and the bank takes the risk; or Ellis does not agree, and Santos must again face alternatives (1) and (2) anyway.

In addition to weighing the consequences, Santos also should consider general and professional rules. If he is a CPA, some of the relevant professional rules relate to maintaining integrity (AICPA Rule 102), application of accounting standards (AICPA Rule 203), and the prohibition of discreditable acts (AICPA Rule 501). Santos needs to decide whether to follow rules or balance the expected consequences in the particular situation.

Step 3: As the actor, Santos must choose one of the alternative actions and justify it by presenting a convincing argument for its superiority. He can base the argument on rules, consequences, or a combination of both.

PHILOSOPHICAL PRINCIPLES IN ETHICS

We could skip a discussion of ethical theories if we were willing to accept a simple rule: "Let your *conscience* be your guide." Such a rule is appealing because it calls on an individual's own judgment, which may be based on wisdom, insight, adherence to custom, or an authoritative code. However, it also might be based on caprice, immaturity, ignorance, stubbornness, or misunderstanding. Often, as in the Milgram experiments (see Ethical Example 1), undue pressures might cause us to act in a way that we will

later regret. The problem with using conscience as a guide is that it tells you about a wrong decision *after* you act!

In a similar manner, reliance on the opinions of others or on the weight of opinions of a particular social group is not always enough. Another person or a group of persons may perpetuate a custom or habit that is wrong. To adhere blindly to custom or to group habits is to abdicate individual responsibility. Titus and Keeton summarized this point succinctly: "Each person capable of making moral decisions is responsible for making his own decisions. The ultimate locus of moral responsibility is in the individual."[3] This does not mean you should not consult with friends, colleagues, or family members when facing a dilemma, but that only *you* have the final responsibility.

Thus, the function of *ethical principles* is not to provide a simple and sure rule but to provide some guides for your individual decisions and actions. Of course, as a professional auditor, you are required to follow the code of professional conduct. So, in that sense, professional auditors must always first apply the imperative principle. However, because many decisions go beyond the code, the principle of utilitarianism and the generalization argument are also considered. Finally, the decision must align with your own character (or virtue).

The Imperative Principle

The *imperative principle* directs a decision maker to act according to the requirements of an ethical rule. Strict versions of imperative ethics maintain that a decision should be made without trying to predict whether an action will create the greatest balance of good over evil. Ethics in the *imperative* sense is a function of moral rules and principles and does not involve a situation-specific calculation of the consequences.[4]

The philosopher Immanuel Kant (1724–1804) was perhaps the foremost advocate of the imperative school. Kant maintained that *reason* and the strict *duty to be consistent* should govern our actions. He believed that individuals should act only as they think everyone should act all of the time. This law of conduct (in moral philosophy) is known as Kant's **categorical imperative,** meaning that it specifies an *unconditional obligation.* One such maxim (rule), for example, is "Lying is wrong."

Suppose you believe that Santos (from Ethical Example 2) should agree with Ellis and do everything she asked for "enhancing the financial statements," thus participating in a lie (knowingly misrepresenting the facts about the allowance for uncollectible accounts receivable). The Kantian test of the morality of such a lie is this: Can this maxim be a moral rule that should be followed without exception by all persons who have the opportunity to fool a bank loan officer for a good cause? If Santos refuses to manipulate the financial statements and the loan is refused, the result may be economic hardship and employee layoffs. Kant maintained that motive and duty alone define a moral act, not the consequences of the act. This reasoning places the highest value on the duty to be consistent and a lower value on the consequences, in this case the fate of the employees.

The general objection to the imperative principle is the belief that so-called universal rules always turn out to have exceptions. The general response to this objection is that if the rule is stated properly to include the exceptional cases, the principle is still valid. The problem with this response, however, is that human experience is complicated, and extremely complex universal rules would have to be constructed to try to cover all possible cases.[5]

[3] H. H. Titus and M. Keeton, *Ethics for Today,* 4th ed. (New York: American Book–Stratford Press, 1966), p. 131.

[4] I. Kant, *Foundations of the Metaphysics of Morals,* trans. Lewis W. Beck (Indianapolis, IN: Bobbs-Merrill, 1959; originally published in 1785).

[5] Several rules in the AICPA Code of Professional Conduct are explicitly phrased to provide for exceptions to the general rules, notably Rules 203 and 301. Imperative rules also seem to generate borderline cases, so the AICPA Ethics Division issues interpretations and rulings to explain the applicability of the rules.

Most professional codes of ethics have characteristics of the imperative type of theory. As a general matter, professionals are expected to act in a manner in conformity with the rules. As it relates to your work as an audit professional, this principle would lead you to follow the code of professional conduct to the letter of the law. This, of course, is what you must do to avoid being sanctioned by the profession. However, society frequently questions not only conduct itself but also the rules on which conduct is based. Thus, a dogmatic imperative approach to ethical decisions may not be completely sufficient for the maintenance of professional standards. Society may question the rules, and conflicts among them are always possible. A means of estimating the consequences of alternative actions may be useful; see Ethical Example 3.

ETHICAL EXAMPLE 3

Consolidata Inc. was a tax client of **Alexander Grant & Company, CPAs** (AG). Consolidata prepared payrolls for 38 customers, received the customers' money, and then paid the payrolls. AG learned that Consolidata was in serious financial difficulty and advised the company to inform its customers, but company officials did not do so. When AG learned that the company's officers and directors had resigned, AG telephoned 12 Consolidata customers who were also AG clients, told them of the situation, and advised them not to entrust further payroll funds to Consolidata. The 12 were spared the risk of losing their money when Consolidata went out of business one month later.

Consolidata accused AG of breach of contract for breaking an obligation of confidentiality required by the AICPA Code of Professional Conduct (discussed later in this module). One SEC attorney said she thought AG should have alerted all 38 customers, not just the 12 AG clients. Accountants and SEC officials viewed the situation as a balancing of confidentiality (AICPA rule) against the public interest (Consolidata customers who needed a warning). Ethicists would view this dilemma as a conflict between an imperative principle (client confidentiality) and utilitarianism (what action benefits the most parties).

The Principle of Utilitarianism

The *principle of utilitarianism* emphasizes examining the *consequences* of action rather than following some rules. The criterion of producing the greater good is made an explicit part of the decision process. The *principle* is very useful, but be sure to notice that it does not specify the *values* that enable you to determine the good or evil of an action. In **act-utilitarianism,** the center of attention is the *individual act* as it is affected by the specific circumstances of a situation. The general difficulty with act-utilitarianism is that it seems to permit too many exceptions to well-established rules. By focusing attention on individual acts, the long-run effect of setting examples for other people appears to be ignored. If an act-utilitarian decision is to break a moral rule, the decision's success usually depends on everyone else's adherence to the rule, which is highly unlikely in auditing.

Rule-utilitarianism, on the other hand, emphasizes the centrality *of rules for ethical behavior* while still maintaining the criterion of the greatest universal good. This kind of utilitarianism means that decision makers must first determine the rules that will promote the greatest general good for the largest number of people. The initial question is not which *action* has the greatest utility but which *rule.*

The generalization argument may be considered a judicious combination of the imperative and utilitarian principles. Basically, the **generalization argument** considers the consequences of a decision made by similar persons acting under similar circumstances.[6] A more everyday expression of the argument is this question: "What would happen if everyone acted in that certain way?" If the answer to the question is that the consequences would be undesirable, the conclusion, according to the generalization test, is that the way of acting is unethical and should not be done.

[6] M. G. Singer, *Generalization in Ethics* (New York: Atheneum, 1961, 1971), esp. pp. 5, 10–11, 61, 63, 73, 81, 105–122.

In Ethical Example 2, Santos's problem as a professional accountant and as an employee arose when Ellis asked him to "enhance the financial statements" and he saw the enhancement as a lie. His generalization question may be something like this: "What if all accountants fudged financial statements and fooled loan officers when their companies needed to obtain loans?" Most people will see an easy answer: The result would be undesirable (because it might succeed often and cause considerable losses to banks along with other undesirable personal consequences for the actors in addition to the problem of having broken a rule that requires truth telling). Another kind of conflict subject to the generalization test is illustrated by a public accounting firm's desire for service and need for independence (see the Auditing Insight "Service versus Independence").

Virtue Ethics

Virtue ethics can be traced not only to the Greek philosophers Aristotle and Plato (his *Republic* discusses the Four Cardinal Virtues: wisdom, justice, fortitude, and temperance), but also to Buddhist ethical tradition. Rather than a focus on following rules or weighing outcomes, virtue ethics emphasize the role of one's character in the decision-making process. Questions that may be asked include "What action will help me become my ideal self?" or "What action would I be the proudest of?"

To contrast the different approaches, consider the example of cheating on a class assignment. A utilitarian approach might weigh the potential positive outcome of cheating ("I need to pass this class") against the negatives ones (hurting others' grades, possibly getting caught). Under Kant's categorical imperative approach, cheating is always wrong, no matter what positive outcomes may come from it. Under the Aristotelian virtue ethics approach, one would consider whether cheating was most aligned with the person the student aspired to be.

AUDITING INSIGHT

Service versus Independence

For many years, a national public accounting firm encouraged its professionals to become active members of the boards of directors of corporations. The purpose was to provide expertise to businesses in the metropolitan area and to enable the public accounting firm to become well known and well respected. The public accounting firm changed its policy to prohibit such service after it had to refuse the opportunity to obtain some of these corporations as audit clients because of independence concerns. The public accounting firm's audit independence was considered impaired when a member of the firm had served in a director or management capacity during the period covered by the financial statements the corporations wanted the firm to audit. The generalization test was this: If members of the firm serve on the boards of directors of all corporations that may become audit clients, none of these corporations can be accepted as audit clients—a result that is undesirable.

This brief review of ethical principles provides some important background to the ways that many people approach difficult ethical decision problems. As a professional auditor, you are required to adhere to the prevailing code of conduct in all your duties. However, there will be times in your career when the code does not go far enough. In those situations, it is important to consider the three major approaches to ethical decision making—the categorical imperative's focus on rules, consequentialism's focus on outcomes, and virtue ethics' focus on character—and apply them to decisions. Deciding how you will behave (i.e., what ethical principle you will follow) *before* you find yourself in an ethical dilemma can inoculate you from the kind of pressures the Milgram subjects and our hypothetical Santos experienced and allow you to make decisions of which you will be proud.

REVIEW CHECKPOINTS

B.1 What roles must a professional accountant be prepared to perform in regard to ethical decision problems?

B.2 When might the rule "Let your conscience be your guide" *not* be a sufficient basis for (a) your personal ethical decisions and (b) your professional ethical decisions?

B.3 Assume that you accept the following ethical rule: "Failure to tell the whole truth is wrong." In the textbook illustration about Santos's problem with Ellis's instructions, (a) what would this rule require Santos to do and (b) why is an unalterable rule such as this classified as an element of imperative ethical theory?

B.4 How do utilitarian ethics differ from imperative ethics?

ETHICAL CODES OF CONDUCT

LO B-3

Identify the different entities that make ethics rules for CPAs and public accounting firms.

Independence, professionalism, and integrity have long been concerns of the accounting profession, but the accounting scandals of Enron, WorldCom, and the financial crisis have brought renewed cries and placed additional emphasis on these issues. The PCAOB was created, in part, to help bring a new level of independence and integrity to the profession. In that spirit, the PCAOB has issued a number of rules that apply to auditors that serve clients that are public entities. Furthermore, public accounting firms and CPAs also must follow rules set forth by the SEC and the AICPA Professional Ethics Executive Committee (PEEC). Public accounting firms and CPAs completing multinational audits also must comply with the International Federation of Accountants (IFAC) Code of Ethics for Professional Accountants. If you are an internal auditor, you will be expected to observe the rules of conduct of the Institute of Internal Auditors (IIA). As a management accountant, the standards of ethical conduct for management accountants of the Institute of Management Accountants (IMA) will apply to you. Certified fraud examiners are expected to observe the Association of Certified Fraud Examiners (ACFE) Code of Ethics. If you find this "alphabet soup" of ethics rule makers confusing, imagine those CPAs who have to deal with complex and often conflicting rules on a daily basis. As a CPA, you will be expected to observe rules of conduct published in several codes of ethics, depending on the jurisdiction. In summary, if you join the AICPA and a state society of CPAs and practice before the U.S. Securities and Exchange Commission (SEC) on a multinational audit client, you will be subject to the following:

Source of Rules of Conduct	Applicable to
U.S. Securities and Exchange Commission (SEC)	Persons who practice before the SEC as accountants and auditors for SEC-registered companies
Public Company Oversight Accounting Board (PCAOB)	Registered firms and individuals who perform audits of companies under the jurisdiction of the PCAOB
International Federation of Accountants (IFAC)	Public accounting firms and CPAs performing audits of multinational companies
American Institute of CPAs (AICPA)	AICPA members
Applicable state society of CPAs	Members of a state society of CPAs
Applicable state board of accountancy	Persons licensed by the state to practice accounting

AUDITING INSIGHT

Fraud Auditor Expelled for Committing Fraud

A trial board of the ACFE found that a member had wrongfully represented himself as a *certified internal auditor* when in fact he did not hold the CIA designation. Such conduct is in violation of Article 1.A.4 of the Certified Fraud Examiners Code of Professional Ethics, and the member was summarily expelled from the organization.

L. Jackson Shockey, CFE, CPA, CISA, chairperson of the board of regents, said: "We are saddened that a member has been expelled for such conduct. However, in order to maintain the integrity of the CFE program, the trial board vigorously investigates violations of the Code of Professional Ethics. When appropriate, the board of regents will not hesitate to take necessary action."

Source: *CFE News.*

U.S. Securities and Exchange Commission (SEC)

The SEC has federal statutory authority to regulate the public accounting profession for the purposes of (1) protecting the reliability and integrity of the financial statements of public companies and (2) promoting investor confidence in financial statements and the securities markets. The SEC's jurisdiction covers only public companies that are required by federal securities laws to file financial statements audited by independent accountants. In addition to the duties outlined earlier, the passage of the Sarbanes–Oxley Act in 2002 requires the SEC to oversee the PCAOB.

The Public Company Accounting Oversight Board (PCAOB)

The PCAOB has been given the responsibility to set standards for public accounting firms and to oversee quality control, ethics, and independence issues for accounting professionals who audit financial statements of public companies. Students are urged to review the PCAOB website (www.pcaobus.org) to review the latest standards and rules issued by the PCAOB.

Although the PCAOB has almost the same level of authority as the SEC, the SEC must approve all PCAOB proposed rules before they are final. Also, even though the PCAOB has authority over the audits of only public entities, it would be a mistake to believe that the PCAOB's influence ends there. Indeed, several states (e.g., California) have passed legislation that incorporates PCAOB rules into state law applicable to audits of all companies, both public and private.

The International Federation of Accountants (IFAC)

For audits of multinational companies, auditors must follow the guidelines promulgated by the IFAC. IFAC's International Ethics Standards Board for Accountants is responsible for the Code of Ethics for Professional Accountants (IESBA Code), which is the code of conduct that governs the audits of multinational companies.[7] Although there are differences between the IESBA Code and the AICPA Code of Professional Conduct used to govern the audits of U.S. companies (which will be described later in this module), the codes are actually quite similar. In general, a CPA should always comply with the more restrictive standard that is applicable on a particular audit engagement. Not surprisingly, with the dramatic increase in audits of multinational companies by public accounting firms from the United States, the importance of the IESBA Code has increased. Indeed, the AICPA has just completed a convergence and codification project designed to align the AICPA and IESBA codes and simplify the overall structure of the AICPA Code.

[7] The most recent edition of the IESBA Code of Ethics was published on June 3, 2013, and is available at www.ifac.org/publications-resources/2013-handbook-code-ethics-professional-accountants.

The Professional Ethics Executive Committee (PEEC) of the American Institute of CPAs (AICPA)

The PEEC is the AICPA committee that makes and enforces all rules of conduct for CPAs (i.e., the AICPA Code of Professional Conduct) who are AICPA members. You might think that if you were not in public accounting and not a member of the AICPA, the rules would not apply. However, state and federal court proceedings and disciplinary bodies have consistently upheld that CPAs must adhere to professional ethical standards even if they are not members of the AICPA. Furthermore, most states incorporate the AICPA Code of Professional Conduct into their own accounting statutes.

As mentioned earlier, the PEEC has recently undertaken a project to recodify the AICPA's ethics standards to increase its accessibility and usefulness to members. The new Code (http://pub.aicpa.org/codeofconduct), effective as of December 15, 2014, is structured into topical areas and has been revised to reflect more of a conceptual framework approach. Importantly, the new recodified standards closely follow the IESBA ethical standards. The revised AICPA Code of Professional Conduct contains four parts. The first section, referred to as the Preface, includes a discussion of the Principles of Professional Conduct, a set of six positive essays expressing the profession's high ideals:

I. *Responsibilities.* In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all of their activities.

II. *The public interest.* Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

III. *Integrity.* To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

IV. *Objectivity and independence.* A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.

V. *Due care.* A member should observe the profession's technical and ethical standards, strive continually to improve competence and quality of services, and discharge professional responsibility to the best of the member's ability.

VI. *Scope and nature of services.* A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

The responsibility to the public interest clearly sets accountants apart from other business professionals. It is the reason that accounting is considered a profession even beyond other professionals such as doctors and lawyers whose primary responsibility is to their patients/clients. However, this *responsibility to the public interest* demands that CPAs' work must reflect high levels of moral judgment, true commitment to the public interest, and excellent performance. The *scope and nature of services* refer to the issue of balancing public accounting firms' commitment to clients (giving business advice and consulting) and commitment to the public (giving opinions on financial statements).

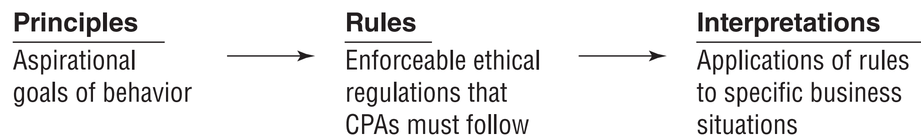
Although the first section of the AICPA Code of Professional Conduct embodies principles to which CPAs should adhere, they are very general in nature, and thus are difficult, if not impossible, to enforce on their own. The three remaining parts contain enforceable rules that were derived from the six Principles of Professional Conduct. Part 1 applies to members practicing public accounting; Part 2 does the same for those CPAs working in business; and Part 3 applies to all other members, including those who are retired or are between jobs.

AICPA CODE OF PROFESSIONAL CONDUCT

AICPA Code of Professional Conduct	
Preface: Applicable to All Members	
0.100	Overview of the Code of Professional Conduct
0.200	Structure and Application of the AICPA Code
0.300	Principles of Professional Conduct
0.400	Definitions
0.500	Non-authoritative Guidance
0.600	New, Revised and Pending Interpretations and Other Guidance
0.700	Deleted Interpretations and Other Guidance
Part 1 – Members in Public Practice	
1.000	Introduction
1.100	Integrity and Objectivity
1.200	Independence
1.300	General Standards
1.310	Compliance with Standards
1.320	Accounting Principles
1.400	Acts Discreditable
1.500	Fees and Other Types of Remuneration
1.600	Advertising and Other Forms of Solicitation
1.700	Confidential Information
1.800	Form of Organization and Name
Part 2 – Members in Business	
2.000	Introduction
2.100	Integrity and Objectivity
2.300	General Standards
2.310	Compliance with Standards
2.320	Accounting Principles
2.400	Acts Discreditable
Part 3 – Other Members	
3.000	Introduction
3.400	Acts Discreditable

The PEEC also publishes interpretations of the Code of Professional Conduct, which are detailed explanations of specific rules necessary to help members understand particular applications. Finally, the

PEEC also publishes "rulings" on the applicability of rules in specific situations.[8]



REVIEW CHECKPOINTS

B.5 In regard to ethics rules, what are the jurisdictions of the (a) AICPA PEEC, (b) SEC, (c) PCAOB, and (d) IFAC?

B.6 What organizations and agencies have rules of conduct that you must observe when you practice (a) public accounting, (b) internal auditing, (c) management accounting, and (d) fraud examination?

AN EMPHASIS ON INDEPENDENCE

LO B-4

With reference to American Institute of Certified Public Accounting (AICPA), Government Accountability Office (GAO), Public Company Accounting Oversight Board (PCAOB), and Securities and Exchange Commission (SEC) rules, analyze factual situations and decide whether an accountant's conduct does or does not impair independence.

At the time the U.S. Senate passed the Sarbanes–Oxley Act in July 2002 (by a vote of 99–0), the investing public was outraged by the magnitude of the financial statement frauds at both Enron and WorldCom (among many other frauds). The audacity of these frauds is mind boggling. Consider that in 2000, Enron was the seventh largest company on the Fortune 500 with reported assets of $65 billion and sales revenues of $100 billion. However, just a year later, Enron filed for bankruptcy, and billions of shareholder dollars were lost. In June 2002, WorldCom announced that it would be restating its financial statements due to improper accounting that took two major forms: the overstatement of revenue by at least $958 million and the understatement of line costs, its largest category of expenses, by more than $7 billion. The passage of Sarbanes–Oxley was a direct response to these financial statement frauds. Indeed, a number of the sections of the act are specifically targeted to prevent the threats to auditor independence that existed on both the Enron and WorldCom audit engagements. For example, Section 201 of Sarbanes–Oxley makes it unlawful for a public accounting firm to provide most consulting type services to its audit clients, including information systems design and implementation (e.g., SAP) and internal audit outsourcing. This regulation was clearly designed to prevent the type of relationship that existed between Enron and **Arthur Andersen** (Andersen). In 2000, Enron paid Andersen $25 million for financial statement audit services and $27 million for consulting and other services, such as internal audit services. The significant amount of revenue generated on consulting services was considered a threat to independence by many, especially considering that the compensation of audit partners at Andersen depended, in part, on consulting sales to its audit clients.

As you will soon learn, the AICPA Code of Professional Conduct (the Code) is crystal clear about the importance of independence. The responsibilities principle requires auditors to maintain independence *in*

[8] The full text of the interpretations and rules are available on the AICPA website (www.aicpa.org).

mental attitude; that is, auditors are expected to be unbiased and impartial with respect to all professional judgments and to the financial statements they audit. This "state of mind" is often referred to as the auditor's possessing independence in fact. It is important for auditors not only to be unbiased but also to appear to be unbiased. *Independence in appearance* relates to financial statement users' perceptions of auditors' independence. For example, even if the auditors do not have any direct or indirect financial interest or obligation with the audit client, they must ensure that no part of their behavior or actions appears to affect their independence in the opinion of the public. Simply stated, audit quality and the value of the profession depend on independence. If an auditor's independence is doubted, users of audited financial statements are likely to question the motives of the public accounting firm in completing the audit, greatly diminishing the value of the audit. As a result of its importance, public accounting firms now spend a substantial amount of time making sure they maintain their independence at all times.

American Institute of Certified Public Accountants[9]

The PEEC makes independence rules for CPAs that are applicable not only for audits of public companies but also for all other audits (audits of nonpublic companies, not-for-profit organizations, and government units) and attestation engagements. Independence is required for audit as well as attestation engagements, including reviews of financial statements. However, attestation engagements are governed by *Statements on Standards for Attestation Engagements* (*SSAEs*) dealing with assertions other than financial statements in which some form of assurance is provided. The Independence Rule is derived from the AICPA Code of Professional Conduct's objectivity and independence principle:

Independence Rule

> A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council. (1.200.001)[10]

The Independence Rule itself has very little substantive content. Instead, it incorporates PEEC interpretations that are explained in the following paragraphs. Exhibit B.1 summarizes the PEEC interpretations and other independence matters. The fundamental thrust of these interpretations is that auditors preserve **independence,** the mental attitude and appearance that auditors are not influenced by others in making judgments and decisions, by (1) avoiding financial connections that make it appear that the auditor's wealth depends on the outcome of the audit and (2) avoiding managerial connections that make it appear that the auditors are involved in management decisions for the audit client (thus auditing their own work).

EXHIBIT B.1 Summary of Independence Rule Interpretations

A covered member cannot

- Have a direct financial interest in a client.
- Have a material indirect financial interest in a client.
- Be a trustee or administrator of an estate that has a direct or material indirect financial interest in a client.
- Have a joint investment with a client that is material to the covered member.
- Have a loan to or from a client, any officer of the client, or any individual owning more than 10 percent of the client (except as specifically described in *Interpretation 101-5).*
- Participate on an attest engagement if she or he was formally employed by the client in a position to influence the audit or acted as an officer, director, promoter, underwriter, or trustee of a pension or profit-sharing trust of the client.

(Continued)

[9] The AICPA annually publishes a "Plain English Guide to Independence," which is designed to increase understanding of the complex independence rules. The guide can be downloaded from the AICPA website, www.aicpa.org/interestareas/professionalethics/resources/tools/downloadabledocuments/plain%20english%20guide.pdf.

[10] The "bodies designated by Council" refers to the PEEC.

A covered member's immediate family cannot • Have a direct financial interest in a client. • Have a material indirect financial interest in a client. • Have vested retirement benefits at a client.
A covered member's close relatives cannot • Have a key management level position with a client. • Have a material financial interest in a client that is known to the covered member. • Have a financial interest in a client that allows the relative to have significant influence in a client. • Be in a position to influence the audit.
A partner or a professional employee cannot • Be associated with a client as a director, officer, employee, promoter, underwriter, voting trustee, or trustee of a pension or profit-sharing trust of the client.

Essentially, **covered members** are prohibited from having any financial interest in clients that could affect their audit judgment (*independence in fact*) or would appear to others to have an influence on their judgment (*independence in appearance*). In addition, immediate family members are under the same restrictions as the auditor. Again, the appearance of independence would be jeopardized if the auditor's child owned stock in a client. Similarly, if a close relative or immediate family member worked for a client in a position that could influence the audit (e.g., a controller), independence in appearance, if not in fact, is impaired. Exhibit B.2 provides important definitions (both AICPA and SEC) used in delineating these issues.

So, what do all of the definitions presented in Exhibit B.2 mean for applying the independence rules? For most practical purposes, the people who are prohibited from having financial and managerial relationships with the client are the audit engagement team, the people in the chain of command, the covered persons in the public accounting firm, their close family members, and immediate family members.

EXHIBIT B.2 Comparison of SEC and AICPA Selected Definitions

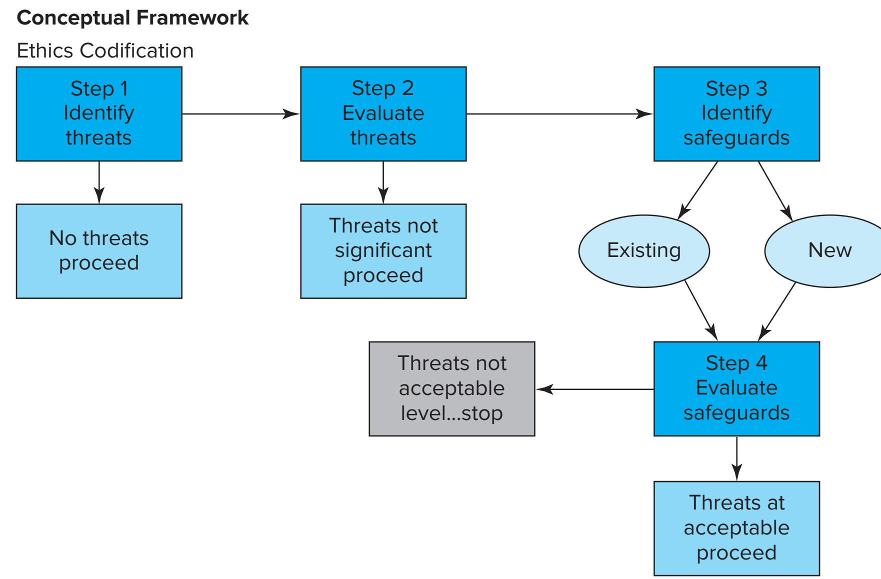
	AICPA Definition	SEC Definition
Engagement Team	Individuals participating in the audit or attest engagement, including those who perform reviews. The audit or attest engagement team includes all employees and contractors who participate in the audit or attest engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). The audit or attest engagement team excludes specialists and individuals who perform only routine clerical functions.	All partners, principals, shareholders, and professional employees participating in an audit, review, or attestation engagement of an audit client, including those conducting reviews and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.
Chain of Command	**Partner:** A proprietor, shareholder, equity or nonequity partner, or any individual who assumes the risks and benefits of firm ownership or who is held out by the firm to be the equivalent of an owner or partner. **Manager:** A professional employee of the firm who has either of the following responsibilities: 1. Continuing responsibility for the overall planning and supervision of engagements for specified clients. 2. Authority to determine that an engagement is complete subject to final partner approval.	All persons who (1) supervise or have direct management responsibility for the audit, (2) evaluate the performance or recommend the compensation of the audit engagement partner, or (3) provide quality control or other oversight of the audit.

(Continued)

Covered Person	The following are considered covered members: (1) An individual on the audit or attest engagement team; (2) An individual in a position to influence the audit or attest engagement; (3) A partner or manager who provides nonattest services to the audit or attest client beginning once he or she provides 10 hours of nonattest services to the audit or attest client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide 10 or more hours of nonattest services to the audit or attest client on a recurring basis; (4) A partner in the office in which the lead audit or attest engagement partner primarily practices in connection with the audit or attest engagement; (5) The firm, including the firm's employee benefit plans; or (6) An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles [GAAP] for consolidation purposes) by any of the individuals or entities described in (1) through (5) or by two or more such individuals or entities if they act together.	The following partners, principals, shareholders, and employees of an accounting firm are considered covered members: (1) An individual on the audit engagement team, (2) An individual in the chain of command, (3) Any other partner, principal, shareholder, or managerial employee of the firm who has provided 10 or more hours of nonaudit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide 10 or more hours of nonaudit services to the audit client on a recurring basis, and (4) Any other partner, principal, or shareholder from an office of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit. *Authors'Note:* In essence,the "covered members" are the firm's professionals closely connected to the audit engagement and the firm's owners who are located in the office where the lead engagement partner practices. However, the SEC added the category of manager-level professionals and owners who provide nonaudit (tax, consulting) services for the audit client. Therefore, almost everyone who provides services of any type for an audit client must observe the independence rules.
Close Family Member	Parent, sibling, or nondependent child.	Person's spouse, spousal equivalent, parent, dependent child, nondependent child, or sibling.
Immediate Family Member	Spouse, spousal equivalent, or dependents (whether or not related).	Person's spouse, spousal equivalent, or dependents.

When a questionable practice or relationship arises, the CPA must evaluate whether the practice or relationship poses an unacceptable risk to a CPAs' independence.[11] Because there is not a rule or interpretation for every ethical dilemma a CPA might face, there is a Conceptual Framework (Figure B.1) that CPAs can use when facing a situation not covered in the Code of Conduct.

[11] In April 2006, the PEEC adopted the *Conceptual Framework for AICPA Independence Standards,* which describes the PEEC's risk-based approach to analyzing independence issues that arise.



www.aicpa.org

B.1 AICPA Code of Conduct Conceptual Framework

The Conceptual Framework uses a three-step risk-based approach that involves (1) identifying and evaluating threats to independence, (2) determining whether safeguards eliminate or sufficiently mitigate the identified threats, and (3) determining whether independence is impaired.

Identified threats to independence include the following:

1. *Adverse interest threat.* CPAs acting in opposition to clients (e.g., through litigation).
2. *Advocacy threat.* CPAs promoting a client's interests or position.
3. *Familiarity threat.* CPAs becoming too sympathetic to client interests because of long-standing or close relationships.
4. *Management participation threat.* CPAs taking on the role of client management or otherwise performing management functions.
5. *Self-interest threat.* CPAs having a financial relationship with a client.
6. *Self-review threat.* CPAs reviewing their own work.
7. *Undue influence threat.* Attempts to coerce or otherwise influence the CPA member (e.g., significant gifts or threats to replace the auditor over an accounting principles disagreement).

Next we take a closer look at threats to independence and their related interpretations that address those threats.

Familiarity Threat

An immediate family member may not hold a position of influence (key position) in an audit client. The close family member's definition comes into play in connection with (1) ownership or control of an audit client or (2) employment with an audit client. An example of (1) is the impairment of the public accounting firm's independence when a close family member of a covered person in the firm owns a material investment in an audit client or is in a position to exert significant influence over an audit client. An example of (2) is the impairment of the public accounting firm's independence when a close family member works in an accounting or financial reporting role at an audit client or was in such a role during any period covered by an audit for which the person in the firm is a covered person. (Neither an immediate family member nor a close family member can work in a capacity such as a member of the board of

directors, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or vice president of marketing.)

Independence problems do not end when owners (partners, shareholders) and professional employees retire, resign, or otherwise leave a public accounting firm. A former owner or professional can cause independence to be impaired if a relationship continues with a client of the former firm. However, the problems are solved and independence is not impaired if (l) the person's retirement benefits are fixed, (2) the person is no longer active in the public accounting firm (sometimes retired owners remain "active"), and (3) the former owner is not held out to be associated with the public accounting firm.

In addition to the preceding considerations, the public accounting firm must ensure that appropriate consideration is given to any increase in risks that may exist due to the former partner's or professional's knowledge of the firm's audit plan and procedures. The firm must consider the following:

- The interaction with the former partner or professional.
- The ability of audit team members to manage the interaction with the former partner or professional employee.
- Modification of the engagement procedures.
- The appropriateness of the review to determine that an appropriate level of skepticism was maintained.

Adverse Interest and Undue Influence Threats

Conditions can arise when a public accounting firm and a client move into an adversary relationship instead of the cooperative relationship needed in an attest engagement. Public accounting firm independence is considered impaired when the firm is involved in threatened or actual litigation involving an audit. Such cases may be rare, but the AICPA has provided auditors a way out of the difficult audit situation by this rule requiring them to declare "nonindependence" and the ability to give only a disclaimer on financial statements or other information. Essentially, the CPA–client relationship ends and the litigation begins a new relationship.

Occasionally, the public accounting firm may find that it is a defendant in a lawsuit initiated by a third party or parties. Normally, this type of litigation is not considered to adversely impact the independence of the public accounting firm. However, sometimes these lawsuits result in claims from the client's management that existing problems are the result of audit deficiencies or claims from the auditor that deficiencies are the result of fraud or deceit on the part of management. When such cross-claims are threatened or filed, independence may be impaired.

Self-Review Threat

Independence is impaired if the public accounting firm performs the bookkeeping or makes accounting or management decisions for a company whose management does not know enough about the financial statements to take primary responsibility for them. The problem in this situation is the appearance of the public accounting firm having both prepared the financial statements or other information and provided the auditors' report or other attestation on its own work. In the final analysis, the management must be able to say, "These are our financial statements (or other information); we made the choices of accounting principles; we take primary responsibility for them." The auditors cannot authorize transactions, control assets, sign checks or reports, prepare source documents, supervise the client's personnel, or serve as the client's registrar, transfer agent, or general counsel.

Financial Self-Interest Threat

Any direct financial interest (e.g., ownership of common or preferred stock) is prohibited. This requirement is the strictest one in the code. There are no exceptions; indirect financial interests, on the other hand, are allowed up to the point of materiality (with reference to the member's wealth). This provision permits members to have some limited business transactions with clients so long as they do not reach material

proportions. Other provisions define certain specific types of prohibited and allowed indirect financial interests. Immediate family members are subject to the same provisions that prescribe the acceptable actions of the covered person. Like the covered person, an immediate family member may not have a direct financial or material indirect financial interest in a client.

We already understand that a covered member cannot have a financial relationship with a client. However, suppose the client is an investor in another company and the covered member has also invested in that company. Has independence been impaired? If the covered member's investment is a direct or materially indirect financial interest in a nonclient investee, independence is considered to be impaired. The reasoning for the basic rule is that the client investor, through its ability to influence a nonclient investee, can increase or decrease the CPA's financial stake in the investee by an amount material to the CPA, and therefore, the CPA may not appear to be independent. If the investment by the client is not material to the nonclient (i.e., there does not appear to be any influence over the investee), then independence is not impaired unless the covered member's investment allows the member to exercise significant influence over the nonclient.

Material cooperative arrangements with clients (i.e., joint participation in a business activity) also impair independence. Examples include joint ventures to develop or market products or to market a package of client and CPA services or one party working to market the products or services of the other.

Most loans to or from audit clients are prohibited: "Independence is considered impaired if a covered member has a loan from a client, officer, director, or any individual owning 10 percent or more of a client." Similarly, independence is impaired if there are unpaid fees or a note receivable arising from unpaid fees from the client outstanding for more than a year. The only loans permitted are "grandfathered loans" and "other permitted loans."

Grandfathered loans are those loans that were obtained either (1) before the independence rules changed (but met the requirements of the Independence Rule in effect at that time) or (2) from a financial institution before it became a client for services requiring independence. These grandfathered loans must at all times be current under all of their terms and the terms shall not be renegotiated. The specific types of loans that are grandfathered are home mortgages, loans not material to the CPA's net worth, and secured loans for which the collateral value must exceed the balance of the loan at all times.

Other permitted loans include

- Auto loans and leases collateralized by the automobile.
- Insurance policy loans based on policy surrender value.
- Loans collateralized by cash deposits at the same financial institution.
- Credit card balances and cash advances of $10,000 or less.

Ethics rules do not cover all circumstances in which the appearance of independence might be questioned. It is the member's responsibility to determine whether the personal and business relationships would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence.

Management Participation and Advocacy Threats

In addition to prohibitions against financial relationships with clients, a covered member is prohibited from acting in the capacity of a manager, employee, promoter, or trustee of a client. Generally, independence is impaired if the public accounting firm even *appears* to outside observers to be working in the capacity of management or employees of the client. The client management (including its board of directors and audit committee) must understand that they are responsible for establishing and maintaining internal control and directing the internal audit function, if any. The board of directors and/or audit committee (i.e., those charged with governance) must understand their roles and responsibilities with regard to extended audit services including the establishment of guidelines for both management and the public accounting firm to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

In addition to the guidance discussed in the previous paragraphs, the following additional activities would impair independence:[12]

- Performing ongoing monitoring or control activities.
- Determining which, if any, recommendations for improving internal control should be implemented.
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function.
- Authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of the client.
- Preparing source documents for transactions.
- Having custody of assets.
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope project priorities and frequency of performance of audit procedures.
- Performing forensic accounting services, litigation support work, or any other service in which it appears that the CPA is taking an advocacy position on the client's behalf. Although performing tax compliance work would not normally impair independence, certain tax work in which an advocacy position is required does (e.g., representing a client in court to resolve a tax dispute).
- Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client's internal audit function, or using the client's letterhead or internal correspondence forms in communications).

Although this list is not all-inclusive, a prohibited activity is any that would force the CPA to either act in the capacity of management or as an advocate for management.

As noted, independence is ordinarily impaired if a CPA serves on an organization's board of directors. However, members can be *honorary* directors of organizations such as charity hospitals, fund drives, symphony orchestra societies, and similar not-for-profit organizations so long as (1) the position is purely honorary, (2) the CPA is identified as an honorary director on letterheads and other literature, (3) the only form of participation is the use of the CPA's name, and (4) the CPA does not vote with the board or participate in management functions. When all of these criteria have been satisfied, the CPA/board member can perform audit and attest services because the appearances of independence will have been preserved.

Other Independence Rule interpretations include relationships with governmental entities and alternative practice structures. The full list of interpretations, with accompanying detail, can be found on the AICPA's website (pub.aicpa.org/codeofconduct). As you can see, the detail is substantial, yet you have no choice but to understand the full details of the AICPA independence requirements. Lack of knowledge of the appropriate jurisdiction's ethical requirements is not a defense when facing severe sanctions and penalties.

We have examined a number of threats that have been identified that impair independence. What about those not specifically covered? When those situations arise, the Conceptual Framework guides the CPA to make the best decision to address the threats. Note that the Conceptual Framework is to be used only when specific guidance is not in the Code. It cannot be used to override existing rules or interpretations.

In addition to identifying and considering the significance of each threat, the CPA should also identify *safeguards* that might eliminate or reduce the threat to an acceptable level. Safeguards can be client or firm-specific, including policies and procedures in place to prevent ethical problems. Examples include

[12] Although the following information does not prohibit auditors from providing internal audit and a variety of other services, it should be emphasized that the interpretation covers client companies that are public and private. Audits of public companies must comply with the rules of the SEC, the appropriate stock exchange, and the PCAOB. These agencies have rules that prohibit auditors from providing internal audit services to audit clients in most cases and have more stringent requirements regarding extended services.

training on the importance of independence, threats of disciplinary action, hotlines to discuss ethical dilemmas, tone at the top, the use of different offices (or different firms) to perform parts of the engagement.

Lastly, whenever the CPA runs into ethical issues, especially those in which safeguards are identified to eliminate or reduce significant threats, the CPA must document the decisions reached. Failure to do so would be a violation of the Compliance with Standards Rule (discussed later in this module).

SEC and PCAOB Independence Rules

Prior to the issuance of Sarbanes–Oxley in 2002, the SEC accepted most of the independence rules established by the PEEC. However, the SEC became concerned about the public accounting profession's emphasis on consulting fees and the resulting effect on public accounting firm independence. In fact, the SEC issued a comprehensive independence rule in November 2000. The rule is based upon two premises: (1) *independence in fact* is a mental state of objectivity and lack of bias and (2) *independence in appearance* depends on whether a reasonable investor, with knowledge of all relevant facts and circumstances, can conclude that the auditor is not capable of exercising objective and impartial judgment. Hence, an auditor's independence depends on auditors both having the proper mental state and passing the appearance test.

In a preface to the rule, the SEC stated four principles for determining whether a public accounting firm is independent of an audit client, factors the SEC will first consider when making independence determinations in controversial cases. Auditors are *not* independent if they have a relationship that

- Creates a mutual or conflicting interest between the public accounting firm and the audit client.
- Places the public accounting firm in the position of auditing its own work.
- Results in the public accounting firm personnel acting as management or employees of the audit client.
- Places the public accounting firm in a position of being an advocate for the audit client.

The SEC independence rules relating to financial relationships are very similar to the AICPA Code of Professional Conduct Rule 101 Interpretations explained earlier. The most significant categories addressed by the SEC rules are in the areas of financial and employment relationships, nonaudit services (e.g., taxation, consulting), and disclosure of fees.

Nonaudit Services

The SEC is very concerned about the fact and appearance of independence when public accounting firms perform consulting services for audit clients. A major issue in the Enron case was that more than half of the fee it paid to Arthur Andersen was for consulting services. This fact exacerbated the concern that auditors would allow a client's improper financial reporting for the sake of preserving lucrative fees from other services. The SEC's concern in this regard is controversial, but the PCAOB has reinforced it. The SEC and PCAOB independence rules prohibit or place restrictions on the following types of nonaudit services provided to *audit* clients:

- Bookkeeping or other services related to the audit client's accounting records or financial statements (including maintaining or preparing the accounting records, preparing the financial statements, or preparing or originating source data underlying the financial statements *except* in emergency situations).
- Financial information systems design and implementation (including operating or supervising the client's information system, designing or implementing a hardware or software system that generates information that is significant to the client's financial statements *unless* the audit client's management takes full and complete responsibility for all design, implementation, internal control, and management decisions about the hardware and software).

- Appraisal or valuation services or fairness opinions (including any such services material to the financial statements when the auditor might audit the results of the public accounting firm's own work, *but* the public accounting firm's valuation experts may audit actuarial calculations, perform tax-oriented valuations, and perform nonfinancial valuations for audit clients).
- Actuarial services (including determination of actuarial liabilities *unless* the audit client management first uses its own actuaries and accepts responsibility for significant actuarial methods and assumptions).
- Internal audit services (including those related to the client's internal accounting controls, financial systems, or financial statements).
- Management functions (including acting temporarily or permanently as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client).
- Human resources (including all aspects of executive search activities, reference checking, status and compensation determination, and hiring advice).
- Broker–dealer services (including acting as a broker–dealer, promoter, or underwriter on behalf of an audit client; making investment decisions or otherwise having discretionary authority over investments; executing a transaction to buy or sell investments; or having custody of assets).
- Legal services (including any service under circumstances in which the person providing the service must be admitted to practice before the courts of a U.S. jurisdiction).
- Expert services (including providing expert opinions or other services to an audit client or legal representative of an audit client for the purpose of advocating that the audit client's interests in litigation, regulatory, or administrative investigations or proceedings; the auditor may perform internal investigations at the direction of the audit committee or its legal counsel).
- Any service performed for an audit client where the auditor is paid a contingent fee or commission.
- Tax services that are based on judicial proceedings or aggressive interpretations of tax law.
- Planning or opining on the tax consequence of a transaction.
- Tax services for key company executives.

The PCAOB's Rule 3526 (*Communication with Audit Committees Concerning Independence)* requires public accounting firms to discuss any independence issues with the audit committee (or those charged with governance) *prior* to accepting an initial engagement. This discussion must be documented (usually in the engagement administrative file workpapers).

Disclosures about Fees

The SEC believes that investors who use financial statements and auditors' reports can be enlightened with information about auditors' fee arrangements with clients. Hence, SEC rules require that companies (not auditors) disclose the following in proxy statements delivered to their shareholders:

- Total audit fees paid to the public accounting firm for the annual audit and the reviews of quarterly financial information.
- Total fees paid to the public accounting firm for tax and other advisory work (over and above the audit fees).
- Whether the audit committee or the board of directors considered the public accounting firm's advisory work to be compatible with maintaining the auditor's independence.
- The percentage of the audit hours performed by persons other than the principal auditor's full-time, permanent employees, if greater than 50% of the total audit hours. (This disclosure refers to "leased employees" in an "alternative practice structure" arrangement.)

AUDITING INSIGHT

E&Y, PeopleSoft, and a Loss of Independence

An administrative law judge recommended that **Ernst & Young** (E&Y) pay the government $1.7 million and be barred from taking new auditing clients for six months for violating SEC conflict-of-interest regulations involving a joint marketing agreement with **PeopleSoft,** a former audit client. The judge found that E&Y had "engaged in improper professional conduct because it violated applicable professional standards for auditors by conduct that was both reckless and negligent." Furthermore, the Big Four firm had displayed "an utter disdain for the commission's rules and regulations of auditor independence." Although no wrongdoing was alleged in its auditing of the software company, the joint marketing agreement violated SEC rules against having anything more than a "consumer" relationship with audit clients. The firm sold its consulting arm that created the conflict of interest.

Source: "Ernst & Young Hit Hard in PeopleSoft Case," April 16, 2004, available at www.thestreet.com.

Other Effects of Sarbanes–Oxley on Auditor Independence

Sarbanes–Oxley required the SEC to modify its position on auditor independence in several ways. Perhaps the most important change in independence arises from the changing role of the audit committee. Since the inception of the principle of the independence for auditors, it has been the auditor who was responsible for evaluating and determining the independence of the individual and firm. Auditors still must be vigilant in establishing and monitoring independence policy to ensure that they are in fact independent, but Sarbanes–Oxley has placed the responsibility for the determination of independence in appearance at the door of the audit committee. This is particularly evident by the fact that the audit committee bears the responsibility for determining the scope of services provided by the auditor and reviewing independence issues prior to the appointment of the auditor. The audit committee may do this on a case-by-case basis or may establish a set of policies and procedures that establish acceptable and unacceptable services.

In addition, Sarbanes–Oxley limits the engagement partners and concurring audit partners on an engagement to five-year terms. Other partners associated with the engagement are limited to seven-year terms with that client. Partners also are deemed as not independent if they receive compensation that is based on selling services to an audit client other than audits, reviews, or attestations.

In the past, it was not unusual for a member of an audit team, usually a manager or higher, to leave the public accounting firm to take a financial management position with a client. Under the rules established by Sarbanes–Oxley, a public accounting firm cannot perform an audit of a company in which an individual with financial reporting oversight responsibilities was a member of the audit engagement team for the audit period, up to the audit date.

Government Accountability Office (GAO) Independence Requirements

Many state agencies and local municipalities use public accounting firms to perform audits required by government charters, laws, or contractual obligations (usually as part of a grant). During these audits, the public accounting firm is required to follow all GAO standards included in the Government Auditing Standards manual (also called the *Yellow Book;* see Module D). These standards require the auditor to be independent with respect to the government entity. These standards differ from the SEC, AICPA, and Sarbanes–Oxley requirements in the following ways. Nonaudit services are allowed providing that the audit organization does not perform management functions, make management decisions, or audit their own work. However, the audit organization must employ the following safeguards:

1. Personnel who provide nonaudit services are prohibited from planning, conducting, or reviewing audit work related to the nonaudit services.
2. The audit organization may not reduce the scope or extent of work performed on the audit because a member of the firm performed the nonaudit work. The extent of the audit work may be reduced by an amount consistent with a reduction had the nonaudit been performed by another public accounting firm.
3. The audit organization must document its reasons that the nonaudit services do not affect the firm's independence.
4. The audit organization must document an understanding with the client regarding the objectives, scope, and work product for the nonaudit service.
5. The audit organization must have established policies and procedures to ensure that effects of nonaudit services on the present and future audits are considered.
6. The audit organization must communicate to the government entity any situation in which the nonaudit service would prohibit it from performing the audit.
7. When subjected to a peer review, the audit organization must identify all nonaudit services provided to the audited entity.

REVIEW CHECKPOINTS

B.7 Yolanda is the executive in charge of the Santa Fe office of Best & Co, an international public accounting firm. She is responsible for the practice in all areas of audit, tax, and consulting, but she does not serve as a field audit partner or a reviewer. Javier is the partner in charge of the Besame Inc. audit (an SEC filing). Is Best & Co independent if (a) Yolanda owns common stock of Besame or (b) her brother owns 10 shares of the common stock of Besame?

B.8 Can audit managers on the audit engagement team, who are also attorneys admitted to the state bar, assist in the defense of a lawsuit against an audit client for product liability defects?

B.9 Why do you think the SEC requires companies to disclose fees paid to independent accounting firms for audit and consulting services? What must be disclosed?

B.10 What do the SEC disclosure rules and PCAOB Rule 3526 have in common with auditors' relations with an audit client's board of directors and its audit committee?

B.11 Given what you have learned about independence, do you believe that there would be a perceived independence problem concerning members of an audit engagement team entertaining employment offers from audit clients? Why or why not?

AICPA RULES OF CONDUCT: INTEGRITY AND OBJECTIVITY, RESPONSIBILITIES TO CLIENTS, AND OTHER RESPONSIBILITIES

LO B-5

With reference to AICPA rules on topics other than independence, analyze factual situations and decide whether an accountant's conduct does or does not conform to the AICPA Code of Professional Conduct.

Now that we have discussed the Independence Rule, we can turn to the other AICPA rules of conduct.

Integrity and Objectivity Rule

> In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.(1.100.001 and 2.100.001)

The Integrity and Objectivity Rule applies not only to CPAs in public practice but also to CPAs working in business. (Santos, the staff accountant in the decision process illustration in Ethical Example 2, is a business CPA.) The rule requires integrity and objectivity in all types of professional work—tax practice and consulting practice as well as audit practice for public accountants—and all types of accounting work performed by CPAs employed in corporations, not-for-profit organizations, governments, and individual practices. In addition to integrity and objectivity, this rule emphasizes (1) being free from conflicts of interest between CPAs and others, (2) representing facts truthfully in reports and discussions, and (3) not letting other people dictate or influence the CPA's judgment and professional decisions.

Conflicts of interest refer to the need to avoid having business interests in which the accountant's personal financial relationships or the accountant's relationships with other clients might tempt the accountant to fail to serve the best interests of a client or the public. Some examples of conflicts of interest are those in which the CPA

- Is engaged to perform litigation support services for a plaintiff in a lawsuit filed against a client.
- Recommends that a client makes an investment in a business in which the CPA has a financial interest.
- Performs management consulting for a client and has a financial or managerial interest in a major competitor.

The phrases "shall not knowingly misrepresent facts" and "shall not subordinate his or her judgment to others" emphasize conditions people ordinarily identify with the concepts of integrity and objectivity. Accountants who know about a client's fraudulent tax return, about false journal entries, about material misrepresentations in financial statements, and yet do nothing, have violated both the spirit and the letter of the Integrity and Objectivity Rule.

The prohibition of misrepresentations in financial statements applies to the management accountants who prepare companies' statements. Business CPAs should not subordinate their professional judgment to superiors who try to produce materially misleading financial statements and fool their external auditors. They must be candid and not knowingly misrepresent facts or fail to disclose material facts when dealing with their employer's external auditor. They also cannot have conflicts of interest in their jobs and their outside business interests that are not disclosed to their employers and approved. The importance of integrity and objectivity for business CPAs cannot be overemphasized. Too often, CPAs relate the Code of Professional Conduct only to CPAs in public practice. In fact, one of the objectives of the recodification of the AICPA Code of Conduct is to emphasize the importance of business CPAs adhering to ethics rules that relate to them.

The Integrity and Objectivity Rule has two other applications. One concerns serving as a client advocate, which occurs frequently in taxation and rate regulation practice as well as in supporting clients' positions in FASB and SEC proceedings. Client advocacy in support or advancement of client positions is acceptable only so long as the member acts with integrity, maintains objectivity, and does not subordinate judgment to others. (Accountants-as-advocates do not adopt the same attitude as defense attorneys in a courtroom.) The other application is directed specifically to your college professors: They are supposed to maintain integrity and objectivity, be free of conflicts of interest, and not knowingly misrepresent facts to students.

AUDITING INSIGHT

You Can't Sacrifice Your Integrity When You Work in Industry

On May 19, 2008, the Securities and Exchange Commission filed civil fraud charges against eight former executives of **AOL Time Warner Inc.** for their roles in a fraudulent scheme that caused the company to overstate its advertising revenue by more than $1 billion. Two of those accused, both CPAs, also were charged with misleading the company's external auditor about the fraudulent transactions, a clear violation of the Code of Professional Conduct's Objectivity and Integrity rules.

Source: "SEC Statement on AOL Lawsuit," *The Wall Street Journal,* May 19, 2008.

General Standards Rule

A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council:

A. *Professional competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.

B. *Due professional care.* Exercise due care in the performance of professional services.

C. *Planning and supervision.* Adequately plan and supervise the performance of professional services.

D. *Sufficient relevant data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed. (1.300.001 and 2.300.001)

The General Standards Rule is a comprehensive statement of general standards that accountants are expected to observe in all areas of practice. This is the rule that enforces the various series of professional standards. The AICPA Council has authorized the following agencies, boards, and committees to issue enforceable standards under this rule:

- Public Company Accounting Oversight Board (PCAOB).
- Auditing Standards Board.
- Accounting and Review Services Committee.
- Tax Executive Committee.
- Management Consulting Services Executive Committee.

The General Standards Rule effectively prohibits the acceptance of any engagement that the CPA cannot competently complete. Such engagements may involve audits that require specialized industry knowledge or technical expertise the practitioner does not possess. Practitioners are allowed to accept an engagement if, through education, hiring of additional staff, or contracting with auditors' specialists, the practitioners can obtain the required knowledge *prior to the conclusion* of the engagement. As a result, a practitioner can accept an engagement for which he or she does not possess knowledge as long as this knowledge can be obtained prior to the conclusion of the engagement. This rule covers all areas of public accounting practice except personal financial planning and business valuation. Of course, a CPA may have to do some research to learn more about a unique problem or technique and may need to engage a colleague as a consultant.

Compliance with Standards Rule

A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council. (1.310.001 and 2.31.001)

The Compliance with Standards Rule requires adherence to duly promulgated technical standards in all areas of professional service. These areas include the ones cited in the rule: auditing, review and compilation (unaudited financial statements), consulting, tax, or "other" professional services. The "bodies designated by Council" are the Auditing Standards Board, the Accounting and Review Services Committee, the Tax Executive Committee, and the Consulting Services Executive Committee. The practical effect of this rule is to make noncompliance with technical standards (in addition to the general standards) subject to disciplinary proceedings. Therefore, failure to follow auditing standards, accounting and review standards, tax standards, and consulting standards is a violation of the Compliance with Standards Rule.

Accounting Principles Rule

> A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement. (1.320.001 and 2.320.001)

The AICPA Council has designated three rule-making bodies to pronounce accounting principles under the Accounting Principles Rule. The Financial Accounting Standards Board (FASB) is designated to pronounce standards in general, the Governmental Accounting Standards Board (GASB) has the responsibility to pronounce accounting standards for state and local government entities, and the Federal Accounting Standards Advisory Board (FASAB) is charged with respect to statements of federal accounting standards.

The Accounting Principles Rule requires adherence to official pronouncements unless such adherence would be misleading. The consequences of misleading statements to outside decision makers would be financial harm, so presumably the greater good would be realized by explaining a departure and thereby "breaking the rule of officially promulgated accounting principles." Such an instance occurs in very rare situations and the burden of proving that following pronouncements would be misleading is the responsibility of the auditor.

CPAs in business also can be subject to the Accounting Principles Rule. These accountants produce and certify financial statements and sign written management representation letters for their external auditors. They also present financial statements to regulatory authorities and creditors. Business accountants generally "report" that the company's financial statements conform to GAAP, and this report is taken as an expression of opinion (or negative assurance) of the type governed by the Accounting Principles Rule. The result is that accountants who present financial statements containing any undisclosed departures from official pronouncements face disciplinary action for violating the rule.

Confidential Client Information Rule

> A member in public practice shall not disclose any confidential information without the specific consent of the client. (1.700.001)

Confidential information is any information that is not available to the public (or in the public domain). As Scott London in this module's opening vignette was well aware, such information should not be disclosed to outside parties unless demanded by a court or an administrative body having subpoena or summons power. *Privileged information* is information that cannot even be demanded by a court. Common-law privilege exists for husband–wife and attorney–client relationships. While physician–patient and priest–penitent relationships have obtained the privilege through state statutes, no accountant–client privilege

exists under federal law and no state-created privilege has been recognized in federal courts. In all recognized privilege relationships, the professional person is obligated to observe the privilege, which can be waived only by the client, patient, or penitent. (These persons are said to be the *holders of the privilege.*)

The rules of privileged and confidential communication are based on the belief that they facilitate a free flow of information between parties to the relationship. The nature of accounting services makes it necessary for the accountant to have access to information about salaries, products, contracts, merger or divestment plans, tax matters, and other information required for the best possible professional work. Managers would be less likely to reveal such information if they could not trust the accountant to keep it confidential. If accountants were to reveal such information, the resulting reduction of the information flow might be undesirable, so no accountant should break the confidentiality rule without a good reason.

AUDITING INSIGHT

Spies, Lies, and Client Confidentiality

What would you do if a government intelligence agent approached you to assist him in a "top secret" assignment involving national security? Guy Enright, an accountant with KPMG's Financial Advisory Services Ltd. in Bermuda, said "yes" to Nick Hamilton, a British intelligence officer, and agreed to deposit confidential audit documents in plastic containers at "dead drop" sites located throughout Bermuda. Unfortunately for Enright, KPMG, and their client, **IPOC International Growth Fund Ltd.** (IPOC), "Nick Hamilton" was in fact Nick Day, a cofounder of **Diligence Inc.,** a Washington-based private intelligence firm that was gathering information for one of IPOC's business competitors.

The setup was quite elaborate. "Hamilton" required Enright to undergo a detailed background check, even producing an official-looking questionnaire with a British government seal at the top, before he could participate on "Project Yucca." The undercover mission came to an abrupt end when someone (still unknown) dropped off a package of Diligence business records and e-mails involving "Project Yucca" at KPMG's Montvale office. After KPMG sued, Diligence ended up paying $1.7 million.

Source: "Spies, Lies, and KPMG," www.businessweek.com, February 26, 2007.

Difficult problems arise over auditors' obligations to "blow the whistle" about clients' shady or illegal practices. For all practical purposes, information is not considered confidential if its disclosure is necessary to prevent financial statements from being misleading. If a client refuses to accept an auditors' report that has been modified because of the inability to obtain sufficient appropriate evidence about a suspected illegal act, failure to account for or disclose properly a material amount connected with an illegal act, or inability to estimate amounts involved in an illegal act, the public accounting firm should withdraw from the engagement and give the reasons in writing to the board of directors. In such an extreme case, the withdrawal amounts to whistle-blowing, but the action results from the client's decision not to disclose the information.

Auditors are not, in general, legally *obligated* to blow the whistle on clients. However, circumstances in which auditors are legally *justified* in making disclosures to a regulatory agency or a third party may exist. Such circumstances include when (1) a client has intentionally and without authorization associated or involved a CPA in its misleading conduct (e.g., used the CPA's name on financial statements), (2) a client has distributed misleading draft financial statements prepared by a CPA for internal use only, or (3) a client prepares and distributes in an annual report or prospectus misleading information for which the CPA has not assumed any responsibility. In addition, the Private Securities Litigation Reform Act of 1995 imposed another reporting requirement in connection with clients' illegal acts (see Module C).

The Confidential Client Information Rule possibly provides accountants the most difficulties and may be the most violated procedure. First, in its strictest interpretation, the principle of confidentiality applies to the communication of information to anyone who is not involved in the audit except as noted by the rule. Over lunch or after hours, however, you might find auditors discussing the day's work with other members of the firm or company. Second, CPAs should not view the Confidential Client Information Rule as an excuse for inaction when action may be appropriate to right a wrongful act committed or about to be committed by a client. In some cases, auditors' inaction may be viewed as part of a conspiracy or willingness to be an accessory to a wrong. A useful initial course of action is to consult an attorney about possible legal pitfalls of both whistle-blowing and silence.

Accountants can permit other accountants to review confidential audit documentation and other information about clients in connection with arrangements to sell or merge an accounting practice. The AICPA advises accountants to have an agreement among themselves that extends the confidentiality safeguard to the prospective purchasing accountant as it existed with the original accountant.

CPAs also may disclose confidential information without the client's permission to remain in compliance with applicable laws (e.g., responding to a subpoena), as part of an ethics investigation (*of a CPA*), or as part of a peer review or PCAOB investigation of *public accounting firm* practices. The exception related to ethics violations applies only to investigative or disciplinary bodies under the AICPA's jurisdiction, namely the AICPA Professional Ethics Division, the ethics enforcement committees in the various state societies of CPAs, and state boards of accountancy.

While the Client Confidential Information Rule specifically addresses CPAs responsibilities to clients, CPAs (both in public practice and in business) must also keep their employers' proprietary information confidential as well. Failure to do so would be a violation of the Acts Discreditable Rule discussed later in this module.

AUDITING INSIGHT

Crimes of the Heart?

An Ernst & Young partner was convicted of six counts of securities fraud related to insider trading arising from a relationship that began on an extramarital dating website. The principal witness against the partner was a woman who had befriended him online, and through a guessing game they played from their respective offices, guessed the impending mergers he was working on. She then traded 18 times on the insider information, netting approximately $400,000 on the transactions. Her trading was funded by another man she met on the same website. Her suspicious trading just before the mergers were announced caused her name to repeatedly appear on SEC watch lists. When confronted, she cut a deal, pleading guilty to 15 counts of securities fraud and agreeing to testify against the E&Y partner who apparently was unaware of the insider trading scheme and did not make a cent off the trades.

Source: "Insider Affair: An SEC Trial of the Heart," *The Wall Street Journal,* July 28, 2009, p. C1.

Fees and Other Types of Remuneration

Contingent Fees

A member in public practice shall not:

(1) Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the member or the member's firm performs:

(a) an audit or review of a financial statement; or

(b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

(c) an examination of prospective financial information; or

(2) Prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.(1.510.001)

Suppose you are a shareholder in New Medical Corporation. You have some concerns about the company's revenue practices, but the fact that New Medical received an unmodified audit opinion reassures you. Now let's assume that you discover that the New Medical contract with its auditor paid the auditor more for an unmodified opinion than a qualified opinion. How might that affect the value you placed on the auditor's report?

A **contingent fee** is a fee established for the performance of any service in an arrangement in which no fee will be charged unless a specific finding or result is attained or the fee otherwise depends on the result of the service. (Fees are not contingent if they are fixed by a court or other public authority or, in tax matters, determined as a result of the findings of judicial proceedings or the findings of government agencies; nor are fees contingent when they are based on the complexity or time required for the work.) CPAs can charge contingent fees for work such as representing a client in an IRS tax audit and certain other tax matters, achieving goals in a consulting service engagement, or helping a person obtain a bank loan in a financial planning engagement. However, the PCAOB has issued an independence rule that prohibits all contingent fees for audit clients of registered public accounting firms. CPAs are allowed to receive contingent fees *except* from clients for whom the CPAs perform attest services when users of financial information may be relying on the CPAs' work. The prohibitions in item 1(a), 1(b), and 1(c) all refer to attest engagements in which independence is required. Acceptance of contingent fee arrangements during the period in which the member or the member's firm is engaged to perform any of these attestations or during the period covered by any historical financial statements involved in any of these engagements is considered an impairment of independence.

Contingent fees are also prohibited in connection with the everyday tax practice of preparing original or amended tax returns. This prohibition arose from an interesting conflict of government agencies. The Federal Trade Commission (FTC) wanted to see contingent fees permitted, but the IRS objected on the grounds that such fees might induce accountants and clients to "play the audit lottery"—understate tax improperly in the hope of escaping audit. The IRS asserted that if the AICPA permitted such contingent fees, the IRS would make its own rules prohibiting them. The FTC agreed that the AICPA rule could contain this prohibition.

Commissions and Referral Fees

A. Prohibited Commissions

A member in public practice shall not recommend or refer to a client any product or service for a commission, or recommend or refer any product or service to be supplied by a client for a commission, or receive a commission, when the member or the member's firm also performs for that client:

(a) an audit or review of a financial statement; or

(b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or

(c) an examination of prospective financial information.

This prohibition applies during the period in which the member is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in such listed services.

B. Disclosure of Permitted Commission

A member in public practice who is not prohibited by this rule from performing services for, or receiving a commission from, and who is paid or expects to be paid a commission, shall disclose that fact to any person or entity to whom the member recommends or refers a product or service to which the commission relates.

C. Referral Fees

Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client. (1.520.001)

A **commission** is generally defined as a percentage-based fee charged for professional services in connection with executing a transaction or performing some other business activity. Examples are insurance sales commissions, real estate sales commissions, and securities sales commissions. A CPA can earn commissions except in connection with any client for whom the CPA performs attestation services.

Commissions are an impairment of independence similar to contingent fees. Recall that *contingent fees* are based on attaining a specific finding or result and are prohibited for attestation clients. When involved in an attest engagement with a client, the CPA cannot receive a commission from anyone for (1) referring a product or service to the client or (2) referring to someone else a product or service supplied by the client. It does not matter which party actually pays the commission.

Commissions are permitted provided that the engagement *does not involve attestation* of the types cited in Part A of the rule. This permission is tempered by the requirement that the CPA must disclose to clients an arrangement to receive a commission.

Most of the commission fee activity takes place in connection with personal financial planning services. CPAs often recommend insurance and investments to individuals and families. Some critics point out that clients cannot always trust commission agents (e.g., insurance salespersons, securities brokers) to have clients' best interests in mind when the agents' own compensation depends on clients' buying the product that produces commissions.

Referral fees, are fees (1) a CPA receives for recommending another CPA's services or (2) a CPA pays to obtain a client. Referral involves the practice of sending business to another CPA and paying other CPAs or outside agencies for drumming up business. Some CPAs have hired services that solicit clients on their behalf, paying a fixed or percentage fee. Many CPAs frown on these arrangements, but they are permitted. However, CPAs must disclose such fees to clients.

Acts Discreditable Rule

A member shall not commit an act discreditable to the profession. (1.400.001, 2.400.001, and 3.400.001)

The Acts Discreditable Rule may be called the *moral clause* of the code, but it is only occasionally the basis for disciplinary action. Penalties normally are invoked automatically under the AICPA bylaws, which provide for expulsion of members found by a court to have committed any fraud, filed false tax returns, been convicted of any criminal offense, or found by the AICPA Trial Board to have been guilty of an act discreditable to the profession.

AICPA interpretations have determined the following to be discreditable acts:

- Withholding a client's books and records and important documentation when the client has requested their return.
- Being found guilty by a court or administrative agency as having violated employment antidiscrimination laws, including ones related to sexual and other forms of harassment.
- Failing to follow government audit standards and guides in governmental audits when the client or the government agency expects such standards to be followed.

- Failure to follow the requirements of governmental bodies, commissions, or other regulatory bodies including the PCAOB.
- Soliciting or disclosing CPA Examination questions and answers from the CPA Examination.
- Failing to file tax returns or remit payroll and other taxes collected for others (e.g., employee taxes withheld).
- Making, or permitting others to make, false and misleading entries in records and financial statements.

This last item is specifically applicable to all CPAs, whether in public practice, in business, between jobs, or in retirement. Any management accountant who participates in the production of false and misleading financial statements commits a discreditable act.

AUDITING INSIGHT

Discreditable Act?

The Enforcement Committee found that Respondent drew a gun from his desk drawer during a dispute with a client in his office in contravention of Section 501.41 [discreditable acts prohibition] of the [Texas] Rules of Professional Conduct. Respondent agreed to accept a private reprimand to be printed . . . in the Texas State Board Report.

Source: Texas State Board of Accountancy Report.

Advertising and Other Forms of Solicitation Rule

> A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited. (1.600.001)

Advertising consists of messages designed to attract business that are broadcast widely to an undifferentiated audience (e.g., print, radio, television, billboards). Advertising is permitted with only a few limitations. The current rule applies only to CPAs practicing public accounting and relates to their efforts to obtain clients. The guidelines basically prohibit false, misleading, and deceptive messages:

- Advertising may not create false or unjustified expectations of favorable results.
- Advertising may not imply the ability to influence any court, tribunal, regulatory agency, or similar body or official.
- Advertising may not contain a fee estimate when the CPA knows it is likely to be substantially increased unless the client is notified.
- Advertising may not contain any other representation likely to cause a reasonable person to misunderstand or be deceived.

Most CPAs carry out only modest advertising efforts, and many do no advertising at all. Public practice is generally marked by decorum and a sense of good taste. However, there are exceptions, and they tend to get much negative attention from other CPAs and the public in general. The danger in bad advertising lies in creating the image of a professional huckster, which may backfire on efforts to build a practice.

Solicitation generally refers to direct contact (e.g., in person, mail, telephone) with a specific potential client. In regard to solicitation, Rule 502 basically prohibits extreme bad behavior (coercion, overreaching, or harassing conduct). Many CPAs abhor solicitation and many state boards of accountancy try to prohibit direct, uninvited approaches to prospective clients, especially when the client already has a CPA. Nevertheless, the U.S. Supreme Court has struck down state solicitation prohibitions, declaring them to be an infringement of personal and business rights to free speech and due process.

AUDITING INSIGHT

Felicity and Solicitations

CPA Fane moved to Florida and conducted face-to-face meetings to obtain clients. The Florida Board of Accountancy brought suit to enforce its antisolicitation rule but lost in a Supreme Court decision. As a result, some state boards try to discourage solicitation with restrictive rules they hope will not run afoul of the Supreme Court decision. Other state boards are trying to put antisolicitation rules into their state laws when they think they will be shielded from the U.S. Supreme Court. Currently, solicitation is legal, but be aware that your local state board may have rules or laws prohibiting it.

Source: *Edenfield v. Fane,* 507 U.S. 761 (1993).

CPAs sometimes hire marketing firms to obtain clients. The AICPA permits such arrangements but warns that all such "practice development" activity is subject to the Advertising and Other Forms of Solicitation Rule because members cannot do through others things they are prohibited from doing themselves.

Form of Organization and Name Rule

> A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council. A member shall not practice public accounting under a firm name that is misleading. Names of one or more past owners may be included in the firm name of a successor organization. A firm may not designate itself as "Member of the American Institute of Certified Public Accountants" unless all of its CPA owners are members of the Institute. (1.800.001)

The Form of Organization and Name Rule allows CPAs to practice public accounting in any form of organization permitted by a state board of accountancy and authorized by law. Organization forms include sole proprietorship, partnership, limited partnership, limited liability partnership (LLP), professional corporation (PC), limited liability corporation (LLC), and ordinary corporation (Inc.). You may have noticed that the large international accounting firms now place LLP after their firm names. Many small accounting firms include PC in their names.

CPAs in public practice cannot use misleading firm names. For example, suppose CPAs Stone and Thompson, who are not in partnership, agree to share expenses for office support, advertising, and continuing education. They cannot put up a sign that states "Stone & Thompson CPAs" because this name suggests a partnership where there is none.

A member who practices public accounting also can participate in the operation of another business organization (e.g., a consulting or tax preparation firm) that offers professional services of the types offered by public accounting firms. If this business is permitted to practice public accounting under state law, the member also is considered to be in the practice of public accounting in it and must observe all rules of conduct. CPAs who work in alternative practice structures occupy an odd position. They can prepare compiled (unaudited) financial statements, which is considered a form of public accounting practice. In such a case, CPA employees of the alternative practice structure (e.g., "PublicCo") must take final responsibility for the accountants' compilation report and must sign it with their own personal names (not the name of PublicCo).

The last paragraph of the Form of Organization and Name Rule permits a mixed accounting organization consisting of CPA and non-CPA owners to designate itself "Members of the AICPA" if all of the CPA owners are actually AICPA members. However, the AICPA Council limits this privilege of organizational form by expressing certain requirements for ownership and control, especially regarding non-CPAs who have ownership interests in an organization that practices public accounting. (See the Council Resolution

provisions in the feature "Council Resolution: Form of Organization and Name." The purpose of the Council Resolution is to conform the operations of an accounting organization as closely as possible to the traditional accounting firm and to ensure control of professional services in the hands of CPAs.)

COUNCIL RESOLUTION: FORM OF ORGANIZATION AND NAME

(EXCERPTS)

The characteristics of an accounting organization under the Form of Organization and Name Rule are as follows:

- A majority (50 percent or more) ownership and voting rights must belong to CPAs.
- Non-CPA owners must be active in the firm, not passive investors.
- A CPA must have ultimate responsibility for the firm's services.
- Non-CPA owners can use titles such as "principal, owner, officer, member, and shareholder" but cannot hold out to be a CPA.
- Non-CPA owners must abide by the AICPA Code of Professional Conduct.
- Non-CPA owners must hold a bachelor's degree, and after the year 2010, must have 150 semester hours of college education.
- Non-CPA owners must complete the same continuing education requirements as CPAs who are members of the AICPA.
- Non-CPA owners are not eligible to be members of the AICPA.

The International Ethics Standards Board for Accountants (IESBA) Code

The IESBA Code must be followed by auditors whenever an audit engagement is completed for a multinational client. As a result, the importance of the IESBA Code has increased dramatically in recent years. Although there are some differences between the IESBA Code and the AICPA Code of Ethics, the codes are quite similar. For example, each code is highly focused on the possible threats to auditor independence, and each code provides many safeguards to mitigate these threats. However, there are differences in the way that these threats and safeguards are described.[13] Given the increased importance of the international standards, the AICPA revised its Code of Conduct to better align ("converge") the two codes.

REVIEW CHECKPOINTS

B.12 What ethical responsibilities do members of the AICPA have for acts of nonmembers who are under their supervision (e.g., recent college graduates who are not yet CPAs)?

B.13 What rules of conduct apply specifically to members in government and industry?

B.14 What provisions of the AICPA Council Resolution on form of organization place control of accounting services in the hands of CPAs?

B.15 What is the primary difference between commissions and referrals?

[13] For a summary of the specific differences between the IESBA and the AICPA codes, please consult C. Allen, "Comparing the Ethics Codes: AICPA and IFAC," *Journal of Accountancy,* October 2010, pp. 24–32.

CONSEQUENCES OF VIOLATING THE CODE OF PROFESSIONAL CONDUCT

LO B-6

Explain the types of penalties that can be imposed on accountants.

Public accounting firms and responsible professional accountants understand the importance of ethics to the profession and seek to ensure that the organization and all employees are acting in an ethical manner. Unethical behavior by an auditor can have financial implications (e.g., fines, lawsuits) and reputation implications that may be difficult to remedy. Quality control practices and disciplinary proceedings provide the mechanisms of *self-regulation*. **Self-regulation** refers to the quality control reviews and disciplinary actions conducted by fellow CPAs—professional peers.

Self-Regulatory Discipline

Individual persons (not accounting firms) are subject to the rules of conduct of state CPA societies and the AICPA only if they choose to join these organizations. The AICPA and most of the state societies have entered into a Joint Ethics Enforcement Program through which the AICPA can refer complaints against CPAs to state societies or state societies can refer them to the AICPA. Both organizations have ethics committees to hear complaints. They can (1) acquit an accused CPA, (2) find the CPA in violation of rules and issue a letter of required corrective action, or (3) refer serious cases to an AICPA trial board. The letter of required corrective action ordinarily admonishes the CPA and requires specific continuing education courses to bring the CPA up to date in technical areas.

The trial board panel has the power to (1) acquit the CPA, (2) admonish the CPA, (3) suspend the CPA's membership in the state society and the AICPA for up to two years, or (4) expel the CPA from the state society and the AICPA. The AICPA bylaws (not the Code of Professional Conduct) provide for automatic expulsion of CPAs judged to have committed a felony, failed to file their tax returns, or aided in the preparation of a false and fraudulent income tax return. The trial board panels are required to publish the names of the CPAs disciplined in their proceedings.

AUDITING INSIGHT

The AICPA Joint Trial Board in Action

The following is the AICPA's report on cases investigated and their resolutions for 2014 and 2013 cases:

	2014	2013
Total cases at beginning of period (including 141 and 140, respectively, deferred due to pending litigation)	734	827
Cases opened during period	708	437
Cases completed during period	(530)	(530)
Total cases at end of period (including 133 and 141, respectively, deferred due to pending litigation)	912	734
Summary of Disposition of Completed Cases		
Expelled or suspended	113	90

(Continued)

Admonished	66	76
Corrective action required	113	167
No violation/dismissed	81	69
No further action	100	85
Subsequent monitoring completed satisfactorily	32	30
Other	25	13
	530	530

Source: AICPA website (www.aicpa.org).

The expulsion penalty, while severe, does not prevent a CPA from continuing to practice accounting. Membership in the AICPA and state societies, while beneficial, is not required. However, a CPA must have a valid state license in order to practice. State boards of accountancy are the agencies that can suspend or revoke the license to practice.

Public Regulation Discipline

State boards of accountancy are government agencies consisting of CPA and non-CPA officeholders. They issue licenses to practice accounting in their jurisdictions. Most state laws require a license to use the designation CPA or certified public accountant and limit the attest (audit) function to license holders only.

State boards have rules of conduct and trial board panels. They can admonish a license holder; perhaps more importantly, they can suspend or revoke the license to practice. Suspension and revocation are severe penalties because a person no longer can use the CPA title and cannot sign auditors' reports. When candidates have successfully passed the CPA examination and are ready to become CPAs, some state boards administer an ethics examination or require taking an ethics course intended to familiarize new CPAs with the state rules.

The SEC and the PCAOB also conduct public disciplinary actions. Their authority comes from their rules of practice, of which Rule 102(e) provides that the SEC can deny, temporarily or permanently, the privilege of practice before the SEC to any person found to have engaged in unethical or improper professional conduct. When conducting a "Rule 102(e) proceeding," the SEC acts in a quasi-judicial role as an administrative agency.

AUDITING INSIGHT

Be Audit You Can Be

The PCAOB instituted disciplinary proceedings against **Deloitte & Touche LLP** and a former Deloitte audit partner, James L. Fazio, CPA, for violations of the board's interim auditing standards in connection with the firm's 2003 audit for **Ligand Pharmaceuticals Incorporated.** Without admitting or denying the board's findings, Deloitte consented to an order imposing a $1 million civil penalty. In addition to the monetary fine, as described in the order, Deloitte has implemented changes to its system of quality control for identifying and addressing potential audit quality concerns regarding the performance and deployment of its audit partners. The order requires Deloitte to undertake certain documentation practices relating to these additional quality control policies and procedures. The firm also was censured. The PCAOB also sanctioned accountants with **BDO Seidman** and **Geisler & Oppenheimer** for failing to review the audit work of a junior member of the firm and then trying to

(Continued)

cover up by backdating documents (including backdating initials and signatures) and independence violations, respectively.

Sources: "PCAOB Sanctions Three Auditors," *CFO.com,* December 18, 2007; "Ex-BDO Seidman Auditors Disciplined by PCAOB" *WebCPA,* December 18, 2007.

The SEC penalty bars an accountant from signing any documents filed by an SEC registered company. The penalty effectively stops the accountant's SEC practice. In a few severe cases, Rule 102(e) proceedings have resulted in settlements barring not only the individual accountant but also her or his accounting firm or certain of its practice offices from accepting new SEC clients for a period of time.

The PCAOB's Division of Enforcement and Investigations (DEI) handles disciplinary actions involving accountants (and their firms) who are engaged to audit public companies (also known as "issuers"). The DEI's role is to identify matters (often from tips) for further investigation, conduct an investigation, and recommend disciplinary proceedings (if considered necessary). Common investigations include violations of the PCAOB's *Auditing Standards,* independence violations, and failures to cooperate with inspections/investigations. If violations are found, the DEI makes recommendations for sanctions to the Board. The Board may decide to suspend or permanently bar an accountant from auditing any public companies, suspend or revoke an accounting firm's registration, appoint a monitor to oversee a firm's practice, impose monetary penalties, require additional continuing professional education, and/or impose other sanctions permitted under PCAOB rules.

AUDITING INSIGHT

What Do Other Countries Do?

Different countries have different penalties for accountants caught not honoring the public trust. In China, the *death sentences* for Zhou Limin, the former head of the China Construction Bank, and Liu Yibing, an accountant, were upheld by China's State Supreme Court. The pair was found guilty of stealing more than $60 million by offering fake accounts with high interest rates.

Source: "Accountant Gets Death Penalty," *CFO.com,* December 14, 2006.

REVIEW CHECKPOINTS

B.16 What penalties can be imposed by the AICPA and the state societies on CPAs in their "self-regulation" of ethics code violators?

B.17 What penalties can the SEC and PCAOB impose on CPAs who violate rules of conduct?

Summary

This module begins with philosophers' considerations of moral philosophy, explains the AICPA Code of Professional Conduct as well as the SEC and PCAOB rules related to auditors' independence, provides an overview of the IESBA Code of Ethics, and ends with a review of enforcement actions against those CPAs who choose not to follow the rules. It is important to remember that accounting is the only business discipline that is considered a profession as are medicine and the law. As a result, professional ethics for accountants is not simply a matter covered by a few rules in a formal code of professional conduct. Concepts of proper professional conduct permeate all areas of practice. Ethics and accompanying sanctions for ethical failures provide the foundation for public accountants' value in the marketplace.

The spirit of the AICPA Code of Professional Conduct is that, although independence is required for audit and attest services, integrity and objectivity are required in connection with all professional services. In this context, integrity and objectivity are the larger concepts and "independence" is a special condition largely defined by the matters of appearance specified in the interpretations of the Independence Rule. The ethics rules may appear to be restrictive, but they are intended to benefit the public, protect the profession, and allow for sanctions to those CPAs choosing not to comply with the rules. The AICPA Code of Professional Conduct was recently reorganized to address situations faced by accountants in varying business environments; the following graphic illustrates how the different rules affect the varying roles that accountants play, whether if public practice, in business or in other situations (e.g., between jobs).

Applicability of the New AICPA Code of Ethics to CPAs

All CPAs	CPAs in Business	CPAs in Public Practice
(including those unemployed and retired) Acts Discreditable	Integrity and Objectivity General Standards Compliance with Standards Accounting Principles	Independence Fees and Other Types of Remuneration Advertising and Other Forms of Solicitation Confidential Information Form of Organization and Name

Specific rules in the AICPA Code of Professional Conduct may not necessarily be classified under one of the ethics principles. Decisions based on a rule may involve imperative, utilitarian, or personal virtue considerations, or elements of all three. The rules have the form of imperatives because that is the nature of a code. However, elements of utilitarianism and generalization seem to be apparent in the underlying rationale for most of the rules. If this perception is accurate, auditors may use these two principles in difficult decision problems for which adherence to a rule could produce an undesirable result. Your knowledge of philosophical principles in ethics—the imperative, utilitarian, and virtue theories—will help you make decisions about the AICPA, SEC, and PCAOB rules. This structured approach to thoughtful decisions is important not only when you are employed in public accounting but also when you work in government, industry, and education.

Public accountants must be careful in all areas of practice. As an accountant, you must not lose sight of the nonaccountants' perspective. No matter how complex or technical a decision may be, a simplified view of it always tends to cut away the details of special technical issues to get directly to the heart of the matter. A sense of professionalism coupled with sensitivity to the effect of decisions on other people is invaluable in the practice of accounting and auditing. Remember that when you face an ethical dilemma, you are not alone. The AICPA, other professional organizations, and most accounting firms have anonymous hotlines for you to ask questions, and you always have your colleagues, friends, and family members to talk to.

Key Terms

act-utilitarianism The emphasis on an individual act as it is affected by the specific circumstances of a situation

categorical imperative Kant's specification of an unconditional obligation to act as one thinks others should act regardless of circumstances

commission A percentage fee charged for professional services in connection with executing a transaction or performing some other business activity

contingent fee A type of compensation established for the performance of any service in an arrangement in which no amount will be charged unless a specific finding or result is attained or the fee otherwise depends on the result

covered member Broadly defined, any individual who might be in a position to compromise the integrity of an audit. In the AICPA Code of Professional Conduct, the term is defined as any individual, among others, who is (1) on the audit engagement team, (2) in a position to influence the audit engagement, (3) a partner or manager of a nonaudit client service team, or (4) a partner from the local office of the public accounting firm

generalization argument A judicious combination of the imperative and utilitarian principles; to act as one thinks others should act in a similar circumstance

independence A mental attitude and the appearance that the auditor is not influenced by others in judgments and decisions

referral fee The (1) compensation that a CPA receives for recommending another CPA's services and (2) that a CPA pays to obtain a client; may or may not be based on a percentage of the amount of any transaction

rule-utilitarianism The emphasis on the centrality of rules for ethical behavior while still maintaining the criterion of the greatest universal good

self-regulation The quality control reviews and disciplinary actions conducted by fellow CPAs—professional peers

virtue ethics The focus on the role of one's character in the decision-making process

Multiple-Choice Questions for Practice and Review

All applicable questions are available with McGraw-Hill's *Connect® Accounting*

LO B-4

B.18 Auditors are interested in having independence in appearance because

a. They want to impress the public with their independence in fact.
b. They want the public at large to have confidence in the profession.
c. They need to comply with the fundamental principles of GAAS.
d. Audits should be planned and properly supervised.

LO B-4

B.19 Under Sarbanes–Oxley and PCAOB rules, ensuring that the auditor is independent in appearance is the responsibility of

a. The public accounting firm.
b. Senior management.
c. The audit committee.
d. The PCAOB.

LO B-2

B.20 If a public accounting firm says it always follows the rule that requires adherence to FASB pronouncements in order to give a standard unmodified auditors' report, it is following a philosophy characterized by

a. The imperative principle.
b. The utilitarian principle.
c. Virtue ethics.
d. Reliance on members' collective conscience.

LO B-3

B.21 Which of the following agencies issues independence rules for the auditors of public companies?

a. Financial Accounting Standards Board (FASB).
b. Government Accountability Office (GAO).
c. Public Company Accounting Oversight Board (PCAOB)
d. AICPA Accounting and Review Services Committee (ARSC).

LO B-4

B.22 Audit independence in fact is most clearly lost when

a. A public accounting firm audits competitor companies in the same industry (e.g., Coca-Cola and Pepsi).
b. An auditor agrees to the argument made by the client's financial vice president that deferring losses on debt refinancing is in accordance with generally accepted accounting principles.
c. An audit team fails to discover the client's misleading omission of disclosure about permanent impairment of asset values.
d. A public accounting firm issues a standard unmodified report, but the reviewing partner fails to notice that the assistant's observation of inventory was woefully incomplete.

LO B-4

B.23 The audit committee's responsibility for auditor independence concerns

a. Ensuring that partners of the public accounting firm are not stockholders in the company.
b. Ensuring that nonaudit services provided by the auditor do not impair independence.
c. Reporting on auditor independence to the PCAOB.
d. Ensuring that all nonaudit services are provided by auditors who do not perform the financial statement audit.

LO B-5

B.24 AICPA members who work in industry and government must always uphold which *two* of the following AICPA rules of conduct?

a. The Independence Rule.
b. The Integrity and Objectivity Rule.
c. The Confidential Client Information Rule.
d. The Acts Discreditable Rule.

LO B-4

B.25 A public accounting firm's independence is not impaired when members of the audit engagement team does which of the following for a public company audit client?

a. Prepares special purchase orders for active plutonium in secure national defense installations.
b. Completes operational internal audit assignments under the directions of the client's director of internal auditing.
c. Prepares outsourced internal audit work on the client's financial accounting control monitoring.
d. Prepares actuarial assumptions used by the client's actuaries for life insurance actuarial liability determination.
e. All of the above would impair the public accounting firm's independence.

LO B-4

B.26 When a public accounting firm audits FUND-A in a mutual fund complex that has sister funds FUND-B and FUND-C, independence for the audit of FUND-A is *not* impaired when

a. Managerial-level professionals located in the office where the engagement audit partner is located but who are not on the engagement team own shares in FUND-B, which is not an audit client.
b. The wife of the FUND-A audit engagement partner owns shares in FUND-C (an audit client of another of the firm's offices) and these shares are held through the wife's employee benefit plan funded by her employer, the AllSteelFence Company.
c. Both (a) and (b).
d. Neither (a) nor (b).

LO B-4

B.27 Which of the following is considered a close relative (but not an immediate family member) as defined by the AICPA?

a. Spouse.
b. Spousal equivalent.
c. Parent.
d. Uncle.

LO B-5

B.28 Which of the following is true if an auditor performs nonaudit services for a government entity?

a. The scope of the audit must be reduced so that the auditor does not audit the area for which the nonaudit work was performed.
b. The auditor is prohibited from providing nonaudit work in areas directly related to the production of accounting information.
c. The senior members of the government entity must document their review of the nonaudit service and indicate why it is appropriate for the auditors to perform this service.
d. The scope of the audit cannot be reduced because the nonaudit work was performed by the public accounting firm.

LO B-4

B.29 Which of the following is true?

a. Members of an audit engagement team cannot speak with audit client officers about matters outside the scope of the audit while the audit engagement is in progress.
b. Audit team members who leave the public accounting firm for employment with audit clients can provide audit efficiencies (next year) because they are very familiar with the firm's audit plans.
c. Audit team partners who leave the public accounting firm for employment with audit clients can retain variable annuity retirement accounts established in the person's former firm retirement plan.
d. The public accounting firm must discuss with the audit client's board or its audit committee the independence implications of the client's having hired the audit engagement team manager as its financial vice president.

LO B-3

B.30 Which of the following "bodies designated by Council" have been authorized to promulgate general standards enforceable under the General Standards Rule of the AICPA Code of Professional Conduct?

a. AICPA Division of Professional Ethics.
b. Financial Accounting Standards Board.
c. Government Accounting Standards Board.
d. Accounting and Review Services Committee.

LO B-5

B.31 Which of the following "bodies designated by Council" have been authorized to promulgate accounting principles enforceable under the Accounting Principles Rule of the AICPA Code of Professional Conduct?

a. Auditing Standards Board.
b. Federal Accounting Standards Advisory Board.
c. Consulting Services Executive Committee.
d. Accounting and Review Services Committee.

LO B-5

B.32 Phil Greb has a thriving practice in which he assists attorneys in preparing litigation dealing with accounting and auditing matters. He is "practicing public accounting" if he

a. Uses his CPA designation on his letterhead and business card.
b. Is in partnership with another CPA.
c. Practices in a professional corporation with other CPAs.
d. Never lets his clients know that he is a CPA.

LO B-5

B.33 The AICPA removed its general prohibition of CPAs taking commissions and contingent fees because

a. CPAs prefer more price competition to less.
b. Commissions and contingent fees enhance audit independence.
c. Nothing is inherently wrong about the form of fees charged to nonaudit clients.
d. Objectivity is not always necessary in accounting and auditing services.

LO B-4

B.34 CPA Kara Rambo is the auditor of Ajax Corporation. Her audit independence will *not* be considered impaired if she

a. Owns $1,000 worth of Ajax stock.

b. Has a husband who owns $1,000 worth of Ajax stock.

c. Has a sister who is the financial vice president of Ajax.

d. Owns $1,000 worth of the stock of Pericles Corporation, which is controlled by Ajax as a result of Ajax's ownership of 40 percent of Pericles' stock, and Pericles contributes 3 percent of its total assets and income in Ajax's financial statements.

LO B-5

B.35 When a client's financial statements contain a material departure from an FASB *Statement on Accounting Standards* and the public accounting firm believes the departure is necessary to ensure that the statements are not misleading,

a. The public accounting firm must qualify the auditors' report for a departure from GAAP.

b. The public accounting firm can explain why the departure is necessary and then give an unmodified opinion paragraph in the auditors' report.

c. The public accounting firm must give an adverse auditors' report.

d. The public accounting firm can give the standard unmodified auditors' report with an unmodified opinion paragraph.

LO B-5

B.36 Which of the following would *not* be considered confidential information obtained in the course of an engagement for which the client's consent would be needed for disclosure?

a. Information about whether a consulting client has paid the CPA's fees on time.

b. The actuarial assumptions used by a tax client in calculating pension expense.

c. Management's strategic plan for next year's labor negotiations.

d. Information about material contingent liabilities relevant for audited financial statements.

LO B-5

B.37 Which of the following would probably *not* be considered an "act discreditable to the profession"?

a. Numerous moving traffic violations.

b. Failing to file the CPA's own tax return.

c. Filing a fraudulent tax return for a client in a severe financial difficulty.

d. Refusing to hire Asian Americans in an accounting practice.

LO B-5

B.38 According to the AICPA Code of Conduct, which of the following acts is generally forbidden to CPAs in public practice?

a. Purchasing bookkeeping software from a high-tech development company and reselling it to tax clients.

b. Being the author of a "TaxAid" newsletter promoted and sold by a publishing company.

c. Having a commission arrangement with an accounting software developer to receive 4 percent of the price of programs recommended and sold to audit clients.

d. Engaging a marketing firm to obtain new financial planning clients for a fixed fee of $1,000 for each successful contact.

LO B-6

B.39 A CPA's legal license to practice public accounting can be revoked by the

a. American Institute of Certified Public Accountants.
b. State society of CPAs.
c. Auditing Standard Board.
d. State board of accountancy.

LO B-5

B.40 According to the Acts Discreditable Rule for accountants in public practice, which of the following is *not* a "discreditable act"?

a. Withholding a client's sales records.
b. Failing to file or remit tax payments.
c. Failing to follow requirements of the PCAOB during the audit of an SEC client.
d. Advertising that indicated the firm can reduce IRS penalties.

LO B-4

B.41 An auditor's independence would *not* be considered impaired if she or he had

a. Owned common stock of the audit client but sold it before the company became a client.
b. Sold short the common stock of an audit client while working on the audit engagement.
c. Served as the company's treasurer for six months during the year covered by the audit but resigned before the company became a client.
d. Performed the bookkeeping and financial statement preparation for the company, which had no accounting personnel and for which the president had no understanding of accounting principles.

LO B-5

B.42 When a CPA knows that a tax client has skimmed cash receipts and not reported the income in the federal income tax return but signs the return as a CPA who prepared the return, the CPA has violated which of the following AICPA rules of conduct?

a. The Confidential Client Information Rule.
b. The Integrity and Objectivity Rule.
c. The Independence Rule.
d. The Accounting Principles Rule.

LO B-5

B.43 An accountant recommends a local computer company to a client that is trying to upgrade its computerized sales records. The client purchases $25,000 worth of equipment and sends a check to the accountant for 5 percent of the total sales. This is an example of a

a. Commission.
b. Contingent fee.
c. Referral fee.
d. Nonaudit fee.

LO B-5

B.44 Which of the following ownership situations is permissible for a public accounting firm?

a. A partner of the firm is responsible for fraud issues related to audits and audit clients. He owns 20 percent of the firm and is not a CPA.

b. Because the firm now specializes in fraud auditing and fraud investigation, the managing partner of the firm has a background in law enforcement and fraud investigation but is not a CPA.

c. A partner of the firm who owns 50 shares of stock in an audit client of the firm is responsible for fraud issues related to audits and audit clients.

d. A partner of the firm who has 20 years of experience in law enforcement and fraud investigation is responsible for fraud issues related to audits and audit clients. The partner's career began as a police officer after receiving a law enforcement degree from a local community college.

Exercises and Problems

All applicable questions are available with McGraw-Hill's *Connect® Accounting*

B.45

LO B-4

SEC Independence Rules. Is independence impaired for the individual or the public accounting firm on these SEC filing audits according to SEC independence rules?

a. CPA Yolanda is the Best & Co engagement partner on the Casa Construction Company (CCC) audit supervised from the Santa Fe office of the firm. Yolanda owns 100 shares of CCC.

b. CPA Yolanda sold the 100 CCC shares to CPA Javier, who is another partner in the Santa Fe office but who is not involved in the CCC audit.

c. CPA Javier transferred ownership of the 100 CCC shares to his wife.

d. CPA Javier's wife gave the shares to their 12-year-old son.

e. CPA Javier's son sold the shares to Javier's father.

f. CPA Javier's father was happy to combine the 100 CCC shares with shares he already owned because now he owns 25 percent of CCC and can control many decisions of the board of directors.

g. CPA Javier's father declared personal bankruptcy and sold his CCC stock. CCC then hired him to fill the newly created position of director of financial reporting.

B.46

LO B-4

SEC Independence and Nonaudit Services. Is independence impaired on these SEC filing audits according to SEC independence rules regarding nonaudit services?

a. CPA Dakota Tidrick is a staff assistant II auditor on the Section Co. audit. Upon the audit completion date in January, Tidrick drafted the balance sheet, income statement, comprehensive income statement, statement of cash flows, and notes for review by the engagement partner before the auditors' report was finalized.

b. CPA Mel Carnes is a manager in the firm's consulting division. He spent 100 hours with the Section Co. audit client on an accounts payable information system study, which involved selecting the preferred software and supervising Section Co.'s employees in startup operations.

c. CPA Nicky Webber, working in the public accounting firm's asset valuation consulting division located in Chicago, prepared for Section Co. an appraisal of the fair value of assets purchased in

Section's merger with the Group Co. These valuations were then audited by the engagement team located in Dallas in connection with the purchase accounting for the merger.

d. CPA Fran Young is the engagement partner on the Section Co. audit and is also an actuarial consultant in the firm's consulting division. Young personally audited the client's postemployment benefits calculations, which had been prepared by Section's actuaries.

e. Section Co. appointed its own employee, certified internal auditor (CIA) Pat Mumta, to be director of internal auditing with complete responsibility for planning, management, and review of all internal audit work. Mumta engaged Section Co.'s independent public accounting firm to supply staff to perform all operational audit studies of efficiency and effectiveness in Section's domestic subsidiary companies. The public accounting firm used half of these same staff professionals to work on the audit of Section's financial statement audit.

f. CPA Dale Churyk is the partner in charge of the Dallas office where the Section Co. audit is managed (by engagement partner Jack). Churyk has no direct role on the audit engagement team. However, Section relies on Churyk to prepare the confidential papers for the board of directors' stock options and sign the release forms for option grants.

g. CPA Robin Mantzke works in the executive search department of the public accounting firm's consulting division, located in New York City. In connection with Section Co.'s hiring of its new vice president for marketing, Mantzke checked the references on the lead candidate Smith and performed a thorough background investigation that led to the firm's advice that Smith was the best person for the appointment. Section Co. board members investigated other candidates and hired Smith in Dallas without further interaction with Mantzke.

h. Section Co. completed a private placement of long-term bonds during the year under audit. The bonds were distributed to 40 qualified-exempt investors through the brokerage firm of Amalgamated Exchange Inc., which is 50 percent owned by the public accounting firm and 50 percent owned by Lynch Merrill Investment Corporation.

i. The public accounting firm's tax consulting division prepared Section Co.'s export-import tax reports, which involved numerous interpretations of complicated export-import tax law provisions.

B.47
LO B-4

Independence, Integrity, and Objectivity Cases. Read the following cases.

Required:

For each case, state whether the action or situation shows a violation of the AICPA Code of Professional Conduct, explain why if it does, and cite the relevant rule.

a. CPA Ellen Stout performs the audit of the local symphony society. Because of her good work, she was elected an honorary member of the board of directors.

b. CPA Darcy Wolfe practices management consulting in the area of computerized information systems under the firm name of Wolfe & Associates. The "associates" are not CPAs and the firm is not an accounting firm. However, Wolfe shows "CPA" on business cards and uses these credentials when dealing with clients.

c. CPA Alex Goodwin performs significant day-to-day bookkeeping services for Harper Corporation and supervises the work of the one part-time bookkeeper employed by Hadley Harper. This year, Harper wants to engage CPA Goodwin to perform an audit.

d. CPA H. Poirot bought a home in 1989 and financed it with a mortgage loan from Farraway Savings and Loan. Farraway was merged into Nearby S&L, and Poirot became the manager in charge of the Nearby audit.

e. Poirot inherited a large sum of money from old Mr. Giraud in 2000. Poirot sold his house, paid off the loan to Nearby S&L, and purchased a much larger estate. Nearby S&L provided the financing.

f. Poirot and Mala Lemon (a local real estate broker) formed a partnership to develop apartment buildings. Lemon is a 20 percent owner and managing partner. Poirot and three partners in the accounting firm are limited partners. They own the remaining 80 percent of the partnership but have no voice in everyday management. Lemon obtained permanent real estate financing from Nearby S&L.

g. Lemon won the lottery and purchased part of the limited partners' interests. She now owns 90 percent of the partnership and remains general partner while the CPAs remain limited partners with 10 percent interest.

h. CPA Justin Shultz purchased a variable annuity insurance contract that offered the option to choose the companies in which this contract will invest. As directed, the insurance company purchased common stock in one of Shultz's audit clients.

B.48

LO B-4

Independence, Integrity, and Objectivity Cases. Read the following cases.

Required:

For each separate case, state whether the action or situation shows a violation of the AICPA Code of Professional Conduct; if so, explain why and cite the relevant rule or interpretation.

a. Your client, Contrary Corporation, is very upset over the fact that your audit last year failed to detect an $800,000 inventory overstatement caused by employee theft and falsification of the records. The board discussed the matter and authorized its attorneys to explore the possibility of a lawsuit for damages.

b. Contrary Corporation filed a lawsuit alleging negligent audit work, seeking $1 million in damages.

c. In response to the lawsuit by Contrary, you decided to bring litigation against certain officers of the company alleging management fraud and deceit. You are asking for a damage judgment of $500,000.

d. The Allright Insurance Company paid Contrary Corporation $700,000 under a fidelity bond covering an inventory theft by employees. Allright is suing your public accounting firm for damages on the grounds of negligent performance of the audit, claiming that a proper audit would have uncovered the theft sooner and the amount of loss would have been considerably less.

e. Your audit client, Science Tech Inc. installed a cost accounting system devised by the consulting services department of your firm. The system failed to account properly for certain product costs (according to management), and the system had to be discontinued. Science Tech management was very dissatisfied and filed a lawsuit demanding return of the $10,000 consulting fee. The audit fee is normally about $50,000, and $10,000 is not an especially large amount for your firm. However, you believe that Science Tech management operated the system improperly. You are willing to do further consulting work at a reduced rate to make the system operate, but you are unwilling to return the entire $10,000 fee.

f. A group of dissident shareholders filed a class action lawsuit against both you and your client, Amalgamated Inc. for $30 million. They allege there was a conspiracy to present misleading financial statements in connection with a recent merger.

g. CPA Ellis Lisa, a shareholder in the firm of Eden, Benjamin, and Block, P.C. (a professional accounting corporation), owns 25 percent of the common stock of Dove Corporation (not a client of Eden, Benjamin, and Block). This year, Dove purchased a 32 percent interest in Tale Company and is accounting for the investment using the equity method of accounting. The investment amounts to 11 percent of Dove's consolidated net assets. Tale Company has been an audit client of Eden, Benjamin, and Block for 12 years.

h. CPAs Mark and Ben Saliba are the father-and-son partners of Queens, LLP. They have a 12 percent joint private investment in ownership of the voting common stock of Hydra Corporation, which is not an audit client of Queens, LLP. However, the firm's audit client, Howard Company, owns 46 percent

of Hydra, and this investment accounts for 20 percent of Howard's assets (using the equity method of accounting).

i. Drew Francie and Madison Brian, CPAs, regularly perform the audit of the First National Bank, and the firm is preparing for the audit of the financial statements for the year ended December 31, 2014.

   (1) Two directors of the First National Bank became partners in Francie and Brian, CPAs, on July 1, 2014, resigning their directorship on that date. They will not participate in the audit.

   (2) During 2014, the former controller of the First National Bank, now a partner in Francie and Brian, was frequently called on for assistance regarding loan approvals and the bank's minimum checking account policy. In addition, the former controller conducted a computer feasibility study for First National.

j. The Cather Corporation is indebted to a CPA for unpaid fees and has offered to give the CPA unsecured interest-bearing notes. Alternatively, Cather Corporation offered to give the CPA two shares of its common stock, after which 10,002 shares would be outstanding.

k. May Debra is not yet a CPA but is doing quite well in her first employment with a large public accounting firm. She has been on the job two years and has become an "experienced assistant." If she passes the CPA exam this year, she will be promoted to senior accountant. This month, during the audit of Row Lumber Company, Debra told the controller that she is remodeling an old house. The controller likes Debra and had a load of needed materials delivered to the house, billing Debra at a 70 percent discount—a savings over the normal cash discount of about $300. Debra paid the bill and was happy to have the materials that she otherwise could not afford on her meager salary.

l. Groaner Corporation is in financial difficulty. You are about to sign the report on the current audit when your firm's office manager informs you the audit fee for last year has not yet been paid.

m. CPA Aubrey Rowan prepared Goodwin's tax return this year. Last year, Goodwin prepared the return and paid too much income tax because the tax return erroneously contained "income" in the amount of $300,000 from an inheritance received when dear Aunt Martha died. This year, Goodwin sold the inherited property for $500,000. Goodwin argued with Rowan, who agreed to omit the sale of the property and the $200,000 gain this year on the grounds that Goodwin had already overpaid tax last year and this omission would make things even.

n. CPA Sage Watson is employed by Baker Street Company as its chief accountant. Lee Lestrade, also a CPA and the financial vice president of Baker, owns a trucking company that provides shipping services to Baker in a four-state area. The trucking company needs to buy 14 new trailers, and Lestrade authorized a payment to finance the purchase in the amount of $750,000. The related document cited repayment in terms of reduced trucking charges for the next seven years. Lestrade created the journal entry for this arrangement, charging the $750,000 to prepaid expenses. Watson and Lestrade signed the representation letter to Baker's external auditors and stated that Baker had no related-party transactions that were not disclosed to the auditors.

B.49

LO B-5

Integrity and Objectivity. In 1997, a disagreement arose between **Livent Inc.** and its auditor, Deloitte and Touche. Livent, which operated several theaters for live stage production, had sold the naming rights to one of its theaters to **AT&T** for $12.5 million. The agreement was oral and one of the theaters was under construction. The auditors for Deloitte believed that only a portion of the deal should be included in revenue, but Livent wanted to book the entire $12.5 million. Livent retained Ernst & Young (E&Y) to provide an opinion on the transaction. E&Y's report indicated that all $12.5 million could be recorded as revenue. Deloitte hired **Price Waterhouse** (currently **PricewaterhouseCoopers**) to review the transaction. Price Waterhouse agreed with E&Y and Livent, and Deloitte allowed Livent to book the $12.5 million. In 1998, Livent issued a series of press releases indicating the discovery of significant account irregularities and, later in 1998, declared bankruptcy.

Required:

Comment on the decision to engage E&Y and Price Waterhouse concerning the $12.5 million transaction. What would your position be on the need for other opinions? What would your position be for the disposition of the transaction?

B.50

LO B-5

General and Technical Rule Cases. Read the following cases. For each, state whether the action or situation shows a violation of the AICPA Code of Professional Conduct; if so, explain why and cite the relevant rule.

a. CPA Jerry Cheese became the new auditor for Python Insurance Company. Cheese knew a great deal about insurance accounting but had never conducted an audit of an insurance company. Consequently, Cheese hired CPA Tate Gilliam, who had six years of experience with the State Department of Insurance Audit. Gilliam managed the audit and Cheese was the partner in charge.

b. CPA Mackenzie Palin practices public accounting and is a director of Comedy Company. Palin's firm performs consulting and tax services for Comedy. Palin prepared unaudited financial statements on Comedy's letterhead and submitted them to First National Bank in support of a loan application. Palin's accounting firm received a fee for this service.

c. CPA Ellery Idle audited the financial statements of Monty Corporation and gave an unmodified report. Monty is not a public company, so the financial statements did not contain the SEC-required reconciliation of deferred income taxes.

d. CPA Gwyn Chapman audited the financial statement of BTV Ltd. These financial statements contain capitalized leases that do not meet FASB criteria for capitalization. They resemble more closely the criteria for operating leases. The effect is material, adding $4 million to assets and $3.5 million to liabilities. However, BTV has a long experience with acquiring such property as its own assets after the "lease" terms end. Chapman and BTV management believe the financial statements should reflect the operating policy of the management instead of the technical requirements of the FASB. Consequently, the auditors' report explains the accounting and gives an unmodified opinion.

B.51

LO B-5

Responsibilities to Clients' Cases. Read the following cases. For each case, state whether the action or situation shows a violation or potential for violation of the AICPA Code of Professional Conduct, explain why, and cite the relevant rule.

a. CPA Sal Colt has discovered a way to eliminate most of the boring work of processing routine accounts receivable confirmations by contracting with the Cohen Mail Service. After the auditor has prepared the confirmations, Cohen stuffs them in envelopes, mails them, receives the return replies, opens the replies, and returns them to Colt.

b. Cadentoe Corporation, without consulting Jora Cramer, its CPA, has changed its accounting so that it is not in conformity with GAAP. During the regular audit engagement, Cramer discovers that the statements based on the accounts are so grossly misleading that they might be considered fraudulent. Cramer resigns the engagement after a heated argument. Cramer knows that the statements will be given to Sandy Panzer, a friend at the Last National Bank, and that Panzer is not a very astute reader of complicated financial statements. Two days later, Panzer calls Cramer and asks some general questions about Cadentoe's statements and remarks favorably on the very thing that is misrepresented. Cramer corrects the erroneous analysis and Panzer is very much surprised.

c. A CPA who had reached retirement age arranged to sell the practice to another certified public accountant. Their agreement called for the review of all audit documentation and business correspondence by the accountant purchasing the practice.

d. Martha Jacoby, CPA, withdrew from the audit of Harvard Company after discovering irregularities in Harvard's income tax returns. One week later, Jacoby received a phone call from Jake Henry, CPA, who explained that he had just been retained by Harvard Company to replace her. Henry asked Jacoby why she withdrew from the Harvard engagement, and she told him.

e. CPA Chen Wallace has two audit clients: Willingham Corporation owned by Jayden Willingham and Ward Corporation owned by Bailey Ward. Willingham Corp. sells a large proportion of its products to Ward Corp., which amounts to 60 percent of Ward Corp.'s purchases in most years. Willingham and Ward are also Wallace's tax clients as individuals. This year, while preparing Ward's tax return, Wallace discovered information that suggested Ward Corporation is in a failing financial position. In consideration of the fact that the companies and individuals are mutual clients, Wallace discussed Ward Corporation's financial difficulties with Willingham.

f. Ashley Fiddle, CPA, prepared an uncontested claim for a tax refund on Faddle Corporation's amended tax return. The fee for the service was 30 percent of the amount the IRS rules to be a proper refund. The claim was for $300,000.

g. After Faddle had won a $200,000 refund and Fiddle collected the $60,000 fee, Jordan Faddle, the president, invited Fiddle to be the auditor for Faddle Corporation.

h. Burgess Company engaged CPA Kim Philby to audit Maclean Corporation in connection with a possible initial public offering (IPO) of stock registered with the SEC. Burgess Company established a holding company named Cairncross Inc. and asked Philby to issue an engagement letter addressed to Cairncross stating that Cairncross would receive the auditors' report. Cairncross has no assets and Philby agreed to charge a fee for the audit of Maclean only if the IPO is successful.

B.52

LO B-5

Other Responsibilities and Practices Cases. Read the following cases. For each, state whether the action or situation shows a violation or potential for violation of the AICPA Code of Professional Conduct; if so, explain why, and cite the relevant rule.

a. CPA Ron Stout completed a review of the unaudited financial statements of Wolfe Gifts. Arvida Wolfe was very displeased with the report. An argument ensued and she told Stout never to darken her door again. Two days later, she telephoned Stout and demanded that he return (1) Wolfe's cash disbursement journal, (2) Stout's documentation schedule of adjusting journal entries, (3) Stout's inventory analysis documentation, and (4) all other documentation prepared by Stout. Wolfe had not yet paid her bill, so Stout replied that state law gave him a lien on all of the records and he would return them as soon as she paid his fee.

b. CPA O'Dell May teaches a CPA review course at the university. He needs problem and question material for students' practice, but the CPA examination questions and answers are no longer published. He pays $5 to students who take the exam for each question they can "remember" after taking the examination.

c. CPA Kelsey Blitz has been invited to conduct a course in effective tax planning for the City Chamber of Commerce. The chamber's president said a brochure would be mailed to members giving the name of Blitz's firm, Blitz's educational background and degrees held, professional society affiliations, and testimonials from participants in the course held last year comparing Blitz's excellent performance with other CPAs who have offered competing courses in the city.

d. CPA Reece Philby is a member of the state bar whose practice is a combination of law and accounting and is heavily involved in estate planning engagements. Philby's letterhead has the following: Member, State Bar of Illinois, and Member, AICPA.

e. The public accounting firm of Burgess & Maclean (B&M) has made a deal with Brit & Company, a firm of management consulting specialists, for mutual business advantage. B&M agreed to recommend Brit to clients who need management consulting services. Brit agreed to recommend B&M to clients who need improvements in their accounting systems. During the year, both firms

would keep records of fees obtained by these mutual referrals. At the end of the year, Brit and B&M would settle the net differences based on a referral rate of 5 percent of fees.

f. Jack Robinson and Archie Robertson (both CPAs) are not partners, but they have the same office, the same employees, and a joint bank account and work together on audits. A letterhead they use shows both their names and the description "Members, AICPA."

g. CPA Lou Dewey retired from the two-person firm of Dewey & Cheatham (D&C). One year later, D&C merged practices with Howe & Company to form a regional firm under the name of Dewey, Cheatham, & Howe Company.

B.53

LO B-4

AICPA Independence and Other Services. The Independence Rule of the AICPA Code of Conduct cites several "other services" that do and do not impair audit independence.

Required:

Go to the AICPA website (www.aicpa.org) and find whether the following items impair independence (Yes) or do not impair independence (No) when performed for audit clients.

a. Post the client-approved entries to a client's trial balance.
b. Authorize the client's customer credit applications.
c. Use CPA's information-processing facilities to prepare the client's payroll and generate checks for the client treasurer's signature.
d. Sign the client's quarterly federal payroll tax return.
e. Advise client management about the application or financial effect of provisions in an employee benefit plan contract.
f. Have emergency signature authority to cosign cash disbursement checks in connection with a client's hospital benefit plan.
g. As an investment advisory service, provide analyses of a client's investments in comparison to benchmarks produced by unrelated third parties.
h. Take temporary custody of a client's investment assets each time a purchase is made as a device to reduce cash float expense.

B.54

LO B-1

General Ethics. Is there any moral difference between a disapproved action in which you are caught and the same action that never becomes known to anyone else? Do many persons in business and professional society make a distinction between these two circumstances? If you respond that you do (or do not) perceive a difference while persons in business and professional society do not (or do), how do you explain the differences in attitudes?

B.55

LO B-2

Competition and Audit Proposals. Accounting firms are often asked to present "proposals" to companies' boards of directors. These proposals are comprehensive booklets, accompanied by oral presentations, telling about the firm's personnel, technology, special qualifications, and expertise in the hope of convincing the board to award the work to the firm.

Kourtney Dena has a new job as staff assistant to Selby Michael, chairman of the board of Granof Grain Company. The company has a policy of engaging new auditors every seven years. The board will hear oral proposals from 12 accounting firms. This is the second day of the three-day meeting. Dena's job is to help evaluate the proposals. During the first day of meetings, the proposal presented by Eden, Benjamin, and Block was clearly the best.

At the end of the day, Dena sees Michael's staff chief slip a copy of Eden, Benjamin, and Block's written proposal into an envelope. He then tells Dena to take it to a friend who works for Hunt and Hunt, a public accounting firm scheduled to make its presentation tomorrow, saying, "I told him we'd let him glance at the best proposal." Michael is absent from the meeting and will not return for two hours.

Required:

What should Dena do? What should CPA Hunt do if he receives the Eden, Benjamin, and Block proposal, assuming he has time to modify the Hunt and Hunt proposal before tomorrow's presentation?

B.56
LO B-2

Engagement Timekeeping Records. A time budget is always prepared for audit engagements. Numbers of hours are estimated for various segments of the work, for example, internal control evaluation, cash, inventory, and report review. Audit supervisors expect the work segments to be completed "within budget" and evaluate staff accountants' performance in part on the ability to perform audit work efficiently within budget.

Jessica Sara is an audit manager who has worked hard to get promoted. She hopes to become a partner in two or three years. Finishing audits on time is heavily weighted on her performance evaluation. She assigned the cash audit work to Paul Ed, who has worked for the firm for 10 months. Ed hopes to get a promotion and salary raise this year. Twenty hours were budgeted for the cash work. Ed is efficient, but it took 30 hours to finish because the company had added seven new bank accounts. Ed was worried about his performance evaluation, so he recorded 20 hours for the cash work and put the other 10 hours under the internal control evaluation budget.

Required:

What do you think about Ed's resolution of his problem? Was his action a form of lying? What would you think of his action if the internal control evaluation work was presently under budget because it was not yet complete and another assistant was assigned to finish that work segment later?

B.57
LO B-2

Audit Overtime. The performance evaluation of all accountants is based in part on their ability to do audit work efficiently and within the time budget planned for the engagement. New staff accountants, in particular, usually have some early difficulty learning speedy work habits, which demand that no time be wasted.

Cynthia Elizabeth started work for Julie and Jacob CPAs in September. After attending the staff training school, she was assigned to the Rising Sun Company audit. Her first work assignment was to complete the extensive recalculation of the inventory compilation using the audit test counts and audited unit prices for several hundred inventory items. Her time budget for the work was six hours. She started at 4 P.M. and was not finished when everyone left the office at 6 P.M. Not wanting to stay downtown alone, she took all necessary audit documentation home. She resumed work at 8 P.M. and finished at 3 A.M. The next day, she returned to the CPA offices, put the completed documentation in the file, and recorded six hours in the time budget/actual schedule. Her supervisor was pleased, especially about her diligence in taking the work home.

Required:

a. What do you think about Elizabeth's diligence and her understatement of the time she took to finish the work?
b. What would you think of the case if she had received help at home from her husband Paul?

c. What would you think of the case if she had been unable to finish and had left the work at home for her husband to finish?

B.58

LO B-5

Conflict of Client's Interests. Jon Williams, CPA, is in the middle of the real-life soap opera, "Taxing Days of Our Lives."

The Cast of Characters

Oneway Corporation is Williams's audit and tax client. The three directors are the officers and the only three stockholders, each owning exactly one-third of the shares.

President Raul Jack founded the company and is now nearing retirement. As an individual, he is also Williams's tax client.

Vice President Jana Jill manages the day-to-day operations. She has been instrumental in increasing the business and its profits. Jill's individual tax work is done by CPA Corin Phil.

Treasurer Chris Bill has been a long-term, loyal employee and has been responsible for many innovative financial transactions and reports of great benefit to the business. He is Williams's close personal friend and an individual tax client.

The Conflict

President Jack discussed with CPA Williams the tax consequences to him as an individual of selling his one-third interest in Oneway Corporation to Vice President Jill. Later, meeting with Bill to discuss his individual tax problems, Williams learns that Bill fears that Jack and Jill will make a deal, put him in a minority position, and force him out of the company. Bill says, "Jon, we've been friends a long time. Please keep me informed about Jack's plans, even rumors. My interest in Oneway Corporation represents my life savings and my resources for the kid's college. Remember, you're little Otto's godfather."

Thinking back, Williams realized that Vice President Jill has always been rather hostile. Chances are that Phil would get the Oneway engagement if Jill acquires Jack's shares and controls the corporation. Nevertheless, Bill will probably suffer a great deal if he cannot learn about Jack's plans, and Williams's unwillingness to keep him informed will probably ruin their close friendship.

Later, on a Dark and Stormy Night:

Williams ponders the problem. "Oneway Corporation is my client, but a corporation is a fiction—only a form. The stockholders personify the real entity, so they are collectively my clients, and I can transmit information among them as though they were one person. Right? On the other hand, Jack and Bill engage me for individual tax work, and information about one's personal affairs is really no business of the other. What to do? What to do?"

Required:

Give Williams advice about alternative actions, considering the constraints of the AICPA Code of Professional Conduct.

B.59

LO B-4

AICPA Code of Professional Conduct. Reread the Module B introduction about Scott London, CPA.

Required:

a. What code violations have occurred in this case?
b. What is the range of penalties that the PCAOB could levy against London? By the California State Board of Accountancy?
c. What do you think is the appropriate penalty?

B.60
LO B-6

Disciplinary Action. Go to the PCAOB website (www.pcaobus.org) and find settled disciplinary orders. Review the cases and the penalties indicated for each case.

Required:

What did Susan Birkert do to get in trouble and what was her sanction?

B.61
LO B-6

Ethics Case.[14] Sandy Sally is a sole proprietor CPA who runs a successful practice with five employees. Several years ago, Sally purchased an office building and relocated the practice in about 20 percent of the space and rented out the remaining portion. Things went well for the first few months, but then two of Sally's tenants ran into financial difficulties and had to vacate the building. Sally was unable to quickly find new tenants for the space.

Sally struggled to keep current with the mortgage payments for a few months, but the loss of tenant income combined with the expense of operating a building became a large burden. Cash flow became very tight, and Sally stopped remitting the employee payroll taxes withheld.

The IRS filed a lien for nonpayment of employee payroll taxes, which was published in a local newspaper. A concerned citizen filed an ethics complaint.

Investigation found that although the company had been delinquent in remitting employee payroll taxes and a federal tax lien had been filed, Sally had brought the tax liabilities into current status and produced evidence that the IRS lien had been released.

Required:

a. What code violation(s) have occurred in this case?
b. What is the range of penalties that could be levied against Sally?
c. What do you think is the appropriate penalty?

B.62
LO B-4

Kaplan CPA Exam Simulation: Independence Requirements.

Required:

Go to the Kaplan website link at www.mhhe.com/louwers6e, click on Able, Baker & Charles, CPAs (Independence) AUD TBS and provide your answer.

[14] The following information was obtained from the *Pennsylvania CPA Journal* and is adopted from a case brought before the Pennsylvania Ethics Committee; see R. J. DePasquale and C. Williams, "The CPA's Taxes and the Code of Ethics," *Pennsylvania CPA Journal,* Winter 2004.

B.63
LO B-5

Mini-Case: Ethics. Refer to the mini-case “Andersen: An Obstruction of Justice?” shown on page C1 and respond to question 6.

B.64
LO B-4

Mini-Case: Nonaudit Services and Independence. Refer to the mini-case “How Many Firms?” shown on page C17 and respond to questions 1, 2, and 3.

B.65
LO B-4

Mini-Case: Nonaudit Services and Independence. Refer to the mini-case “How Much Are Auditors Paid?” shown on page C23 and respond to questions 1 and 2.

B.66
LO B-4

Mini-Case: Effect of Sarbanes–Oxley on Fees. Refer to the mini-case “How Much Are Auditors Paid?” shown on page C23 and respond to questions 3 and 4.