



CPENATION

# ***Ethics and Conduct for Nevada CPAs***

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Walter G. Austin, Ph.D., CPA



## ***Ethics and Conduct for Nevada CPAs*** **OVERVIEW**

### **INTRODUCTION**

This interactive QAS self-study Ethics course taught by Associate Professor Emeritus at the University of Texas at El Paso, Walter G. Austin, Ph.D., CPA, provides a comprehensive understanding of professional Ethics and Conduct. To complete this course and receive credit, you must read the material and, during the course, to test your comprehension of each of the learning objectives, answer the review questions. After completing each section's review questions, you can evaluate your progress by comparing your answers to both the correct and incorrect answers and the reason for each. Once you have read all of the materials and completed the review questions, fully understanding the correct and incorrect answers, you can complete the final examination, of which you must score a 70 percent or higher in order to receive CPE credit.

### **AUTHOR**

Walter G. Austin, Ph.D., CPA, is an Associate Professor Emeritus of the University of Texas at El Paso. He has published self-paced learning materials for college accounting texts, a computerized audit practice set, audit sampling templates, and several articles in journals. He has written and presented numerous continuing professional education courses for state and local CPA chapters. In addition, Dr. Austin is a regular speaker for various professional and academic organizations, such as the National Association of Accountants, the American Accounting Association, and local CPA chapters. He has received numerous teaching awards and is a former Senior Auditor in the financial services industry with KPMG Peat Marwick.

### **COURSE DESCRIPTION**

This comprehensive course introduces and explains the ethical standards for the CPA, whether employed in public, governmental, or private accounting. Applications of these are discussed in a professional context. The concepts of integrity and objectivity are discussed. When broad guidelines are used, interpretations are necessary in many cases due to the fact that guidelines are non-specific. Applications of these are discussed in a professional context. This course explains the issues, developments, and problems addressed by recent AICPA, Independence Standards Board, and SEC Ethics pronouncements and updates. The issues discussed are based on the American Institute of Certified Public Accountants (AICPA) Code of Professional Conduct, which is the standard for all CPAs. The last unit compares the AICPA Code of Ethics with ethics for attorneys and internal auditors.

### **TOPICS COVERED**

- Purpose of the Code of Ethics
- Principles of the Code of Ethics
- Rules of Ethics
- Interpretations of the Code of Ethics

### **FIELD OF STUDY**

Ethics

### **PUBLICATION/REVISION DATE**

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*Please Note: This course must be completed within 1 year of date of receipt of the course for CPE credit.*



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## ***Ethics Principles and Conduct for Nevada CPAs***

### **LEARNING OBJECTIVES**

#### **Chapter 1: Purpose of the Code of Ethics**

Completion of this chapter will enable you to:

- Define the practice of Ethics and Professional Ethical Behavior.
- Recognize the Trust Function in our society.
- Investigate the Role of the CPA in our society.
- Evaluate the purpose of the AICPA Code of Ethics.
- Differentiate the sections of the Code of Ethics.
- Comprehend Ethics Rulings and Interpretations.

#### **Chapter 2: Principles of the Code of Ethics**

Completion of this chapter will enable you to:

- Classify the professional responsibilities of the CPA.
- Analyze the terms used in the Code of Ethics.
- Evaluate the need for Integrity, Objectivity, and Independence.
- Determine the SEC Auditor Independence Requirements.
- Summarize Alternative Practice Structures.
- Interpret Professional Due Care.

#### **Chapter 3: The Rules of Ethics**

Completion of this chapter will enable you to:

- Differentiate Independence in Appearance and Fact.
- Analyze the rules of the Code of Ethics.
- Apply the Standards of the rules of Ethics.
- Implement the GAAP rules.
- Determine client confidentiality rules.
- Summarize acts that are discreditable to the profession.

#### **Chapter 4: Interpretations of the Code of Ethics**

Completion of this chapter will enable you to:

- Evaluate the impact of former employees and family members on Independence.
- Examine the impact of Investment or Management Advisory Services on Independence.
- Be familiar with possible conflicts of interest.
- Understand the role of CPAs as employees.



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## Chapter 1 Purpose of the Code of Ethics

### Learning Objectives

Completion of this chapter will enable you to:

- Define the practice of Ethics and Professional Ethical Behavior.
- Recognize the Trust Function in our society.
- Investigate the Role of the CPA in our society.
- Evaluate the purpose of the AICPA Code of Ethics.
- Differentiate the sections of the Code of Ethics.
- Comprehend Ethics Rulings and Interpretations.

### 1.1. Introduction

*"A man should be upright, not kept upright."* Marcus Aurelius

A distinguishing feature of any profession is a rigorous code of ethics. As Marcus Aurelius stated in the above quotation, the code of ethics should not be needed for anything other than to provide guidelines for behavior. Unfortunately, it may be needed for some to keep them upright. The true professional will be willing to stay upright by adhering to the set of ethical principles and standards adopted by his or her profession.

Ethics are a cornerstone of the CPA profession. Indeed, part of what makes a CPA special is the adherence to a code of professional ethics designed to safeguard clients and ensure integrity. This course covers the AICPA Code of Ethics and other professional codes of ethics. When this course refers to *members*, it only is binding to the members of the AICPA. However the federal and state courts correctly consider this as the minimum standard of conduct for any CPA in the United States of America whether they are a member or not.

### 1.2. Ethics Defined

An **Ethic** may be defined as a principle of right or good conduct, or a body of such principles. It may also be defined as a standard of behavior. **Ethics** may be defined as the moral system or code of a particular body or profession. Or, it also may be defined as the rules or standards governing the conduct of the members of a profession. **Ethical** has to do with standards of right and wrong, or in behaving in accordance with rules of the right or wrong conduct of a group. The professional's ethical standards or principles should be on a higher plane than those of the average citizen since he or she is claiming to be an expert in a particular field that provides an important service to society.

The individual *member* of the professional society should look at the ethics of the profession as the minimum standards, not the "get by" standards.



## 1.3 A View of Ethics

Socrates believed that knowledge could provide a system of virtue. He also believed that virtue is knowledge. These foundational concepts support the belief that a knowledgeable and virtuous person is incapable of performing evil deeds. Unfortunately, knowledge does not necessarily make virtuous people. John Austin wrote in the nineteenth century in his "The Province of Jurisprudence Determined" that all laws should conform to Divine law. Some call these "natural laws." His premise is that if man's laws do not follow natural laws, man will be punished. Laws contradicting natural laws are not really laws since all "laws," by definition, must conform to "God's Laws" or "Natural Laws" as they are the highest ranking "laws."

The terms "ethics" and "morals" assume that there is a "natural law" for actions or lack of actions. Rules of professional conduct pertaining to accountants are believed by the public to be a guide for ethical conduct. Unfortunately, not all accountants are virtuous, ethical, and moral. Sometimes selfishness rules their actions more than does their knowledge of ethics. Greed has shown its ugly head in much, if not all, of the 2009 problems that took all of the US and global society into economic chaos. Take for instance, Bernie Madoff's CPA. He reportedly sold his certificate – and soul – for around \$150,000 per year.

What motivates people to act in ethical ways? In the simplest analysis, it is easy to say that people comply with ethical rules because they are moral or virtuous. Why, then, must we have laws? Not all people are ethical. But, even given the tendency among some not to be ethical, rules may keep them "ethical in actions," because if they do not abide by them, punishment will be imposed. Their fear of punishment is greater than their desire to be unethical. That fear, however, does not keep all people honest, ethical, or moral.

Some people often think that they have a "right" to do anything they want. The "right" to do anything one desires stops when it harms others in a society. Where the harm occurs is a gray area. Some issues in this gray area may never be resolved, but that does not mean we should not learn all we can to help lessen issues.

Another word that is quite often used is *fair*. The Auditing Opinion Letter uses the expression "fairly presented." Fair to whom?

This is a major question in the minds of many, including CPAs; following recent economic occurrences, which indicate to some that what was stated was only fair to a certain group, not the public in general.

Sometimes the pressures of being *fair* are immense. Perhaps the definition in Auditing of *fairly presented* should be revisited and more clearly defined.

The “right” of the business owner to report the financial statements in a way that he thinks is *fair* to him may not result in it being *fair* to the consumer of the statements, be that of a stockholder, creditor, or others. If the owner does not present fairly to the bankers, it can a significant impact on the public. This was evident during the banking and economic crisis of 2009.

## 1.4 Can Ethics be Taught?

Many believe that “Ethics, Morals, or Virtues” can only be taught to young people, but not to adults. There is a belief that adult values are set in stone. To me, a university professor for 35 years, that is preposterous. You can teach all types of knowledge to adults. Societal skills can be learned, and how to interact in difficult situations in society can be learned, at any age. The knowledge of consequences to other people produced by not being ethical, moral, or virtuous can impact people’s view of their own feelings. Feelings of selfishness, indifference, greed, biases, and many other negative feelings related to negative actions that impact other members of society can be overcome with knowledge of the impact. Often, just the recognition of the impact of these feelings is enough to cause change in a person.

People can change when they want to, either by conviction or by consequences. Knowledge can expedite the process of change.

## 1.5 Need for a Code of Ethics

*“A rigorous code of ethics distinguishes professions from other occupations.”*  
Marcus Aurelius

The significance of the preceding quotation is that a code of ethics should be necessary only to provide guidelines for behavior. The true professional will be willing to stay upright by adhering to the set of ethical principles and standards adopted by his or her profession. Unfortunately, some may need a code to keep them upright.

If we were all not a part of a society, there would be no need for accounting or accountability, and the question of ethical behavior would be a moot point. However, when we are a part of a society, accountability to each other in financial transactions is a must. If ethical behavior is not practiced, eventually the society will be damaged to the point that some drastic measure would need to be taken. The reason we have laws is to protect the majority from those that do not have others’ best interest at heart.

In order for our capitalistic society to work, we must have ethical behavior in our business transactions or else the capitalistic society will suffer. Without ethical behavior, our capitalistic society could not exist.

All of the wealth and power of the society would belong solely to a small group of people.

## 1.6 The Trust Function in our Society

Auditing and attest services are a unique service provided by the profession, in that the free capital market system is based on trust and a part of that trust function is supplied by the professional CPA. The trust function is the trust that has to exist for the "saver" to give over his or her savings to "users" or "management" in order for them to expand their business.

The obvious goal of the "savers" is to get their capital back along with a larger return than if they had invested in guaranteed securities. The trust function could not be served by the CPA, or anyone else, in our society without the high standards of ethical conduct of the profession. Society would not put that level of trust in any profession that does not adhere strictly to high ethical principles. If the profession does not respond to this trust, ultimately another group in society will eventually take over that trust position. If CPAs do not fulfill their needed role in society, then ultimately some other group will do so.

## 1.7 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. (AICPA).*

A distinguishing mark of a profession is acceptance of its responsibility to the public.

The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.

In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients and employers interests are best served.

Those who rely on Certified Public Accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. CPAs are expected to provide quality services,

enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, members should seek continually to demonstrate their dedication to professional excellence.

## 1.8 Other Aspects of Ethics

C. S. Lewis provided a list of quotes about moral law (ethics). If these sayings were observed to their fullest, we might not need the detailed Rules of Professional Conduct. But unfortunately, people interpret such sayings in their own manner and from their own background, creating different responses to each situation and requiring the application of ethics.

"Utter not a word by which anyone could be wounded." (Hindu)

"Never do to others what you would not like them to do to you." (ancient Chinese)

- "Men were brought into existence for the sake of men that they might do one another good." (Roman, Cicero)

"Has he drawn false boundaries?" (Babylonian)

"I have not stolen." (ancient Egyptian)

"Justice is the settled and permanent intention of rendering to each man his rights." (Roman, Justinian)

"Whoso takes no bribe . . . well pleasing is this to Samas." (Babylonian)

"A sacrifice is obliterated by a lie and the merit of alms by an act of fraud." (Hindu, Janet)

"The foundation of justice is good faith." (Roman, Cicero)

"There are two kinds of injustice—the first is found in those who do an injury, the second in those who fail to protect another from injury when they can." (Roman, Cicero)

## ***Rotary's Test***

Here is the Rotary's Four-Way Test—good questions to ask ourselves of all the things we think, say, or do:

1. Is it the truth?
2. Is it fair to all concerned?
3. Will it build goodwill and better friendships?
4. Will it be beneficial to all concerned?

## **1.9 Purpose of the Code of Ethics**

The Code was adopted by the membership on January 12, 1988 to provide guidance and rules to all members of the AICPA (those in public accounting practice, in private industry, in government, and in education) both in their actions and in the performance of their professional responsibilities to the public.

Compliance depends first on the understanding of the Code by members and their voluntary actions; second on reinforcement by peers and public opinion; and ultimately, when necessary, by disciplinary proceedings against members who do not comply with the Principles, Rules, Interpretations, and Rulings. Certified Public Accountants in public practice who are not AICPA members may also have to observe the Code as their guidelines since most courts consider the Code as the standard for the profession because most state codes of conduct add to the Code, rather than replace it.

## **1.10 Sections of the Code of Ethics**

The Code of Professional Conduct consists of two sections, Principles and Rules. The Principles provide the overall environment within which the Rules operate. The Rules are prescribed within the framework of the Principles, and are set up to govern the conduct of the members.

The *Council* of the AICPA is authorized to designate bodies to proclaim detailed technical standards under the Rules. The bylaws of the AICPA require adherence to both the Rules and those technical standards emanating from the Rules. The standards control the interpretations of the Rules.

Prior to adoption, Interpretations are exposed to state societies, state boards, practice units and other interested parties by the executive committee of the professional ethics division. Interpretations provide guidelines as to the scope and application of the Rules and are intended to explain rather than limit the scope or application of ethics.

Interpretations result from questions posed by AICPA members and are specific explanations of the applicability of Rules and Standards.

A member has the burden of justifying any departure from the interpretations.

## **1.11 Formal Ethics Rulings**

Formal Rulings made by the professional ethics division's executive committee have been exposed to state societies, state boards, practice units and other interested parties. These Rulings summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances.

A member who departs from such Rulings in similar circumstances will be requested to justify such departures.

## **1.12 Notification of Interpretations and Rulings**

Publication of an Interpretation or Ethics Ruling in The Journal of Accountancy constitutes notice to members. The effective date of the pronouncement is the last day of the month in which the pronouncement is published in The Journal of Accountancy.

The professional ethics division will take into consideration the time that would have been reasonable for the member to comply with the pronouncement.

*Please complete the review questions for Chapter 1 below. Please DO NOT begin Chapter 2 until you have answered the review questions and evaluated the material that needs to be re-studied. The Answer Key and Feedback are located at the end of the course on page 61. If you have any questions, please submit them to our faculty at the bottom of the course homepage.*

*\*Please note — you will also need to submit your answers on the course homepage before you can access and complete the Final Examination/Assessment.*

1. Which of the following is a synonym for "ethics"?
  - a. Moral practice.
  - b. Social values.
  - c. Decency.
  - d. All of the above.
  
2. Which of the following words is NOT a synonym of "ethical"?
  - a. Honest
  - b. Conscientious
  - c. Moral
  - d. Humane
  
3. The sections of the Code of Ethics consist of \_\_\_\_\_ and \_\_\_\_\_:
  - a. Principles and Standards.
  - b. Rules and Standards.
  - c. Principles and Rules.
  - d. Rules, Principles and Standards.
  
4. Which of the following is NOT considered a covered member?
  - a. An individual on the attest engagement team.
  - b. A Partner in an office in the same state.
  - c. An individual in a position to influence the attest engagement.
  - d. The firm, including the firm's employee benefit plans.

5. A member should consult, in addition to the Code of Professional Ethics, if applicable, the ethical standards of:
- a. The state society to which the member belongs.
  - b. The appropriate state board of accountancy.
  - c. The AICPA ethics division.
  - d. All of the above.



## Chapter 2 Principles of the Code of Ethics

### Learning Objectives

Completion of this chapter will enable you to:

- Classify the professional responsibilities of the CPA.
- Analyze the terms used in the Code of Ethics.
- Evaluate the need for Integrity, Objectivity, and Independence.
- Determine the SEC Auditor Independence Requirements.
- Summarize Alternative Practice Structures.
- Interpret Professional Due Care.

### 2.1 Overview

Principles of the Code of Professional Conduct for the Certified Public Accountant cover the responsibilities of the CPA to the public, to clients, and to colleagues. The obligation to serve the public, the level of integrity required, the importance of objectivity and independence, and the meaning of the term **due care** are all a part of the principles of the Code.

### 2.2 Professional Responsibilities of the CPA

*"In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities." (Article I of the AICPA Code of Professional Conduct)*

Certified Public Accountants perform an essential role in our society as members of a vital profession. Members of the AICPA, as a significant part of the profession, have responsibilities to all those that use their services and are impacted by those services. They have a continuing obligation to improve the profession, to advance the art of accounting, and to maintain the confidence and trust of the public.

As with other professions, members are responsible for self-governance of the profession. The purpose of self-governance is to fulfill the profession's responsibilities to society. All members must participate in efforts to maintain and enhance the traditions of the profession.

## 2.3 Definitions of AICPA Key Terms

Definitions of terms are needed in the AICPA Code to make sure that proper communications are occurring when the Code is being read and interpreted by the reader. Definitions are derived from use by the public, professionals, and the desire of the AICPA to communicate specific meanings to the professional and to the public when used in a professional context.

**Attest engagement.** An attest engagement is an engagement that requires independence as defined in AICPA Professional Standards.

**Attest engagement team.** The attest engagement team consists of individuals participating in the attest engagement, including those who perform concurring and second partner reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists as discussed in SAS No. 73, *Using the Work of a Specialist* [AU section 336], and individuals who perform only routine clerical functions, such as word processing and photocopying.

**Client.** A client is any person or entity, other than the member's employer, that engages a member or a member's firm to perform professional services or a person or entity with respect to which professional services are performed. For purposes of this paragraph, the term "employer" does not include:

Entities engaged in the practice of public accounting; or  
federal, state, and local governments or component units thereof provided the member performing professional services with respect to those entities:

- a. Is directly elected by voters of the government or component unit thereof with respect to which professional services are performed; or
- b. Is an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or
- c. Is appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

**Close relative.** A close relative is a parent, sibling, or nondependent child.

**Council.** The *Council* of the AICPA.

**Covered member.** A covered member is:

- a. An individual on the attest engagement team;
- b. An individual in a position to influence the attest engagement;

- c. A partner or manager who provides non-attest services to the attest client beginning once he or she provides ten hours of non-attest services to the 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 ten or more hours of non-attest services to the attest client on a recurring basis;
- d. A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- e. The firm, including the firm's employee benefit plans; or
- f. 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 (a) through (e) or by two or more such individuals or entities if they act together.

## 2.4 Definitions of Terms Continued

**Financial statements.** A presentation of financial data, including accompanying notes, if any, intended to communicate an entity's economic resources and/or obligations at a point in time or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Incidental financial data to support recommendations to a client or in documents for which the reporting is governed by Statements on Standards for Attestation Engagements and tax returns and supporting schedules do not, for this purpose, constitute financial statements. The statement, affidavit, or signature of preparers required on tax returns neither constitutes an opinion on financial statements nor requires a disclaimer of such opinion.

**Firm.** A firm is a form of organization permitted by law or regulation whose characteristics conform to resolutions of the *Council* of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting. Except for purposes of applying Rule 101: Independence [ET section 101.01], the firm includes the individual partners thereof.

**Holding out.** In general, any action initiated by a member that informs others of his or her status as a CPA or AICPA-accredited specialist constitutes holding out as a CPA. This would include, for example, any oral or written representation to another regarding CPA status, use of the CPA designation on business cards or letterhead, the display of a certificate evidencing a member's CPA designation, or listing as a CPA in local telephone directories.

**Immediate family.** Immediate family is a spouse, spousal equivalent, or dependent (whether or not related).

**Individual in a position to influence the attest engagement.** An individual in a position to influence the attest engagement is one who:

- a. Evaluates the performance or recommends the compensation of the attest engagement partner;
- b. Directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm's chief executive;
- c. Consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement; or
- d. Participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement.

**Institute.** The American Institute of Certified Public Accountants.

**Interpretations of rules of conduct.** Pronouncements issued by the division of professional ethics to provide guidelines concerning the scope and application of the rules of conduct.

**Joint closely held investment.** A joint closely held investment is an investment in an entity or property by the member and the client (or the client's officers or directors, or any owner who has the ability to exercise significant influence over the client) that enables them to control (as defined by GAAP for consolidation purposes) the entity or property.

**Key position.** A key position is a position in which an individual:

- a. Has primary responsibility for significant accounting functions that support material components of the financial statements;
- b. Has primary responsibility for the preparation of the financial statements; or
- c. Has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, 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 any equivalent position.

For purposes of attest engagements not involving a client's financial statements, a key position is one in which an individual is primarily responsible for, or able to influence the subject matter of the attest engagement, as described above.

## 2.5 Definition of Terms - Three

**Loan.** A loan is a financial transaction, the characteristics of which generally include, but are not limited to, an agreement that provides for repayment terms and a rate of interest. A loan includes, but is not limited to, a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment.

**Manager.** A manager is a professional employee of the firm who has either of the following responsibilities:

- a. Continuing responsibility for the overall planning and supervision of engagements for specified clients.
- b. Authority to determine that an engagement is complete subject to final partner approval if required.

**Member.** A member, associate member, or international associate of the American Institute of Certified Public Accountants.

**An office** is a reasonably distinct subgroup within a firm, whether constituted by formal organization or informal practice, where personnel who make up the subgroup generally serve the same group of clients or work on the same categories of matters. Substance should govern the office classification. For example, the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than an individual's physical location.

**Partner.** A partner is a proprietor, shareholder, equity or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned.

**Period of the professional engagement.** The period of the professional engagement begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, either by the member or the client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement.

**Practice of public accounting.** The practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPA(s), of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by *Council*, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements.

However, a member or a member's firm, while holding out as CPA(s), is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph.

**Professional services.** Professional services include all services performed by a member while holding out as a CPA.

**Significant influence.** The term significant influence is as defined in Accounting Principles Board Opinion No. 18 [AC section 182] and its interpretations.

## 2.6 Obligations to the Public

*"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." (Article II of the Code of Professional Conduct)*

As discussed in Chapter One, the unique characteristic of this profession that sets it apart from the rest of society is its acceptance of the concept of responsibility to the public. Society as a whole is comprised of the recipients, either directly or indirectly, of the work of the profession. Society includes clients, credit grantors, the government, employers, investors, the business and financial community, and others who rely on the results provided by the objectivity and integrity of CPAs to maintain an orderly functioning of business. This reliance places a significant public interest responsibility on CPAs. *"The public interest is defined as the collective well-being of the community of people and institutions the profession serves." ( See Article II of Code of Professional Conduct.)*

In performing their duties, members may receive pressures from groups with conflicting interests. In the resolution of these conflicts, members should use integrity and know that when the public interest is served, the interests of clients and employers are also best served.

Integrity, objectivity, due professional care, and a genuine concern for the public interest are expected by those that rely on CPA services. The high level of professional service described in the Code of Professional Conduct is expected in the quality of services and fee arrangements of CPAs.

It is imperative to understand that all CPAs who voluntarily accept membership into the AICPA commit to honoring the public trust. In honoring that public trust, members should show their dedication to professional excellence.

## 2.7 Integrity – Section 54 Article III

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

**01** – Integrity is an element of character fundamental to professional recognition. It is the quality from which the public trust derives and the benchmark against which a member must ultimately test all decisions.

**02** – Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.

**03** – Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: "Am I doing what a person of integrity would do? Have I retained my integrity?" Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

**04** – Integrity also requires a member to observe the principles of objectivity and independence and of due care.

### **Case:**

Shirley Smith, CPA, was an excellent accounting major with a 3.6 GPA. During her last semester she had a team project to complete and needed to submit it following her final exam in a social science course. Before the final exam, Shirley had a consistent A average in the course. Immediately after her last final, but before she could finish her project, she became seriously ill. Her illness lasted several months. Completing the project became nearly impossible after she fell ill and her team had finished without her. Consequently, Shirley was unable to graduate because she failed her social science course.



Shirley lived in a state that allowed her to complete the CPA exam before finishing her degree. She subsequently moved to Texas and applied for a reciprocal certificate. On her application she listed a degree, since Texas required the degree, which she had not completed. It was not important to her because she had passed the CPA exam and was a successful practitioner. Has Shirley has violated the Code?

Yes. Shirley has used deceit in obtaining a certificate as a certified public accountant, or in obtaining registration under the Texas Act. Even though she could practice in the state where she resided, she made a false statement to the Texas State Board of Public Accountancy in order to obtain a reciprocal certificate.

### **2.8 Objectivity and Independence – Section 55 – Article IV**

*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.*

**01** – Objectivity is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services.

**02** – Members often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. Members in public practice render attest, tax, and management advisory services. Other members prepare financial statements in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government.

They also educate and train those who aspire to gain admission into the profession. Regardless of service or capacity, members should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

**03** – For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact, and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.



**04** – Although members not in public practice cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services.

Members employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as members in public practice, and must be scrupulous in their application of the Generally Accepted Accounting Principles. Members must also be candid in all of their dealings with members in public practice.

A *member* may provide investment advisory services for an attest client for a fee provided *all* of the following conditions are met:

1. The fee is determined as a specified percentage of the client's investment portfolio.
2. The dollar amount of the portfolio on which the fee is based is determined at the beginning of each quarterly period (or longer) and is adjusted only for additions or withdrawals made by the client during the period.
3. The fee arrangement is not renewed with the client more frequently than on a quarterly basis.

### 2.9 Revision of the SEC's Auditor Independence Requirements

The following is taken from the Summary of the pronouncement of ***Final Rule: Revision of the Commission's Auditor Independence Requirements***.

We are adopting amendments to our current rules regarding auditor independence. The Final Rules advance our important policy goal of protecting the millions of people who invest their savings in our securities markets and thus rely on financial statements that are prepared by public companies and other issuers. As required by Congress this is audited by independent auditors. We believe the Final Rules strike a reasonable balance among commenters' differing views about the proposals, while achieving our important public policy goals.

Independent auditors have an important public trust to uphold. Investors must be able to rely on issuers' financial statements. It is the auditor's opinion that furnishes investors with critical assurance that the financial statements have been subjected to a rigorous examination by an objective, impartial, and skilled professional. And that investors, therefore, can rely on the financial statements. If investors do not believe that an auditor is independent of a company, they subsequently derive little confidence from the auditor's opinion and will be far less likely to invest in that public company's securities.

One of the many missions of a CPA is to protect the reliability and integrity of the financial statements of public companies. To do so, and to promote investor confidence, CPAs must ensure that auditor independence requirements remain

relevant, effective, and fair, in light of significant changes in the profession, structural reorganizations of accounting firms, and demographic changes in society.

More and more individual investors participate in business markets, either directly, or through mutual funds, pension plans, and retirement plans. Nearly half of all American households have investments in the stock market. As technology has advanced, investors increasingly have direct access to financial information, and they act decisively upon relatively small changes in an issuer's financial results. These and other market changes highlight the importance to the market and to investor confidence of financial information that has been audited by an auditor whose only master is the investing public.

As discussed below, the accounting industry has been transformed by significant changes in the structure of the largest firms. Accounting firms have woven an increasingly complex web of business and financial relationships with their audit clients. The nature of the non-audit services that accounting firms provide to their audit clients has changed, and the revenues from these services have dramatically increased. In addition, there is more mobility of employees and an increase in dual-career families.

We proposed changes to our auditor independence requirements in response to these developments. As discussed more in depth below, rules are continually being adopted and modified, in response to almost 3,000 comment letters received, written and oral testimony from four days of public hearings (about 35 hours of testimony from almost 100 witnesses), academic studies, surveys, and other professional literature.

### **2.10 Revision of the SEC's Auditor Independence Requirements – Continued**

The Independence Standard. Independence is generally understood to refer to a mental state of objectivity and lack of bias. The amendments retain this understanding of independence and provide a standard for ascertaining whether an auditor has the requisite state of mind. The first prong of the standard is direct evidence of the auditor's mental state: independence "in fact."

The second prong recognizes that generally, mental states can be assessed only through observation of external facts; it thus provides that an auditor is not independent if a reasonable investor, with knowledge of all relevant facts and circumstances, would conclude that the auditor is not capable of exercising objective and impartial judgment. The proposed amendments to Rule 2-01 included in the Rule, are four principles for determining whether an accountant is independent of its audit client. While some commenters supported the inclusion of the four principles in the Rule, others expressed concerns about the generality of the principles and raised questions concerning their application to particular circumstances.

In response, the four principles have been included in a Preliminary Note to Rule 2-01 as factors that the Commission will consider. In the first instance, when making independence determinations in accordance with the general independence standard in Rule 2-01(b).

The amendments identify certain relationships that render an accountant not independent of an audit client under the standard in Rule 2-01(b). The relationships addressed include, among others, financial, employment, and business relationships between auditors and audit clients, and relationships between auditors and audit clients where the auditors provide certain non-audit services to their audit clients.

Financial and Employment Relationships. Current requirements attribute to an auditor ownership of shares held by every partner in the auditor's firm, certain managerial employees, and their families. Independence will be protected and the Rules will be more workable by focusing on those persons who can influence the audit, instead of all partners in an accounting firm. Accordingly, it was proposed to significantly narrow the application of these Rules. Commenters generally supported our efforts to modernize the current rules because they restrict investment and employment opportunities available to firm personnel and their families in ways that may no longer be relevant or necessary for safeguarding auditor independence and investor confidence. Not all commenters agreed with all aspects of the proposals. The proposal has been modified in some respects, but the final Rule, like the proposal, significantly lessens the circle of firm personnel whose investments are imputed to the auditor. The Rule also limits the circle of family members of auditors and former firm personnel whose employment with an audit client impairs the auditor's independence.

### **2.11 Revision of the SEC's Auditor Independence Requirements – Continued**

Non-Audit Services. There has been increasing concern on the part of the Commission and users of financial statements about the effects on independence when auditors provide both audit and non-audit services to their audit clients. Dramatic changes in the accounting profession and the types of services that auditors are providing to their audit clients, as well as increases in the absolute and relative size of the fees charged for non-audit services, have exacerbated these concerns. As the Panel on Audit Effectiveness (the "O'Malley Panel") recently recognized, "The potential effect of non-audit services on auditor objectivity has long been an area of concern. That concern has been compounded in recent years by significant increases in the amounts of non-audit services provided by audit firms."

A full range of alternatives have been considered to address these concerns. The proposed amendments identified certain non-audit services that, when rendered to an audit client, impair auditor independence.

The proposed restrictions on non-audit services generated more comments than any other aspect of the proposals. Some commenters agreed with the proposals. Others believed that the proposals were not restrictive enough and recommended a total ban on all non-audit services provided by auditors to their audit clients. Still other commenters opposed any Commission rule on non-audit services.

After careful consideration of the arguments on all sides, and for the reasons discussed below, it was determined not to adopt a total ban on non-audit services, despite the recommendations of some, and instead to identify certain non-audit services that, if provided to an audit client, render the auditor not independent of the audit client.

In response to public comments, in several instances the restrictions have been conformed to the formulations set forth in the professional literature. The final Rule was modified to better describe, and in some cases narrow, the types of services restricted. For example, the final Rule does not ban all valuation and appraisal services; its restrictions apply only where it is reasonably likely that the results of any valuation or appraisal, individually or in the aggregate, would be material to the financial statements, or where the results will be audited by the accountant. The Rule also provides several exceptions from the restrictions, such as when the valuation is performed in the context of certain tax services, or the valuation is for non-financial purposes and the results of the valuation do not affect the financial statements. These changes are consistent with the approach to adopt only those regulations that are believed to be necessary to preserve investor confidence in the independence of auditors and the financial statements they audit.

It is recognized that not all non-audit services pose the same risk to independence. Accordingly, under the final Rule, accountants will continue to have the ability to provide a wide variety of non-audit services to their audit clients. In addition, they of course will be able to provide any non-audit service to non-audit clients.

Quality Controls. The quality controls of accounting firms play a significant role in helping to detect and prevent auditor independence problems. The final Rule recognizes this role by providing accounting firms a limited exception from being deemed not independent for certain independence impairments that are cured promptly after discovery, provided that the firm has certain quality controls in place.

Disclosure of Non-Audit Services. Finally, it is believed that disclosures which shed light on the independence of public companies' auditors assist investors in making investment and voting decisions. Accordingly, requirements for disclosures that are deemed useful to investors were developed and included in the final Rule.

## **2.12 Certain Independence Implications of Audits of Mutual Funds and Related Entities – Independence Standards Board Standard No 2.**

This Independence Standard:

- A. Requires** the audit firm, certain of its retirement plans, the audit engagement team and those in a position to influence the audit, when the firm is auditing mutual funds, to be independent of all sister funds and all related non-fund entities. In addition, when auditing a related non-fund entity, independence would be required by the same entities and individuals of all funds in the mutual fund complex.
- B. Permits:**
  - I. Direct investment in non-audit client sister funds by all other partners and employees of the firm.
  - II. Spouses and dependents of partners, other than of the audit engagement team and in a position to influence the audit, to invest through an employee benefit plan in mutual funds that are audit clients is effective with respect to audits of financial statements for periods beginning after June 15, 2000. However, certain rules of the SEC are more restrictive, and compliance with those rules are necessary. Where provisions in this Standard are more restrictive, those provisions are to be complied with as of the effective date.

## **2.13 Employment with Audit Clients – Independence Standards Board Standard No. 3**

This standard describes safeguards that firms should implement when their professionals join firm audit clients. These safeguards are designed to assist in ensuring that:

- professionals who are broadly evaluating their career options will exercise an appropriate level of skepticism while performing audits prior to their departure from the firm;
- a former firm professional now employed by the client cannot circumvent the audit because of familiarity with its design, approach, or testing strategy; and

- the remaining members of the audit team maintain objectivity when evaluating the work and representations of a former firm professional now employed by the audit client.

The procedures should be adopted depending on several factors, including whether the professional served as a member of the audit team, the positions he or she held at the firm, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.

The standard also specifies the circumstances under which capital and retirement balances owed to the departing professional should be liquidated or settled to preserve the firm's independence.

The standard's requirements are effective for employment with audit client situations arising after December 31, 2000.

### **2.14 Alternative Practice Structures (APS)**

In many "nontraditional structures," a substantial (the non-attest) portion of a member's practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled by the member. All such structures must comply with Rule 505 above. In complying with state laws, state regulations, and rule 505, many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA *Council*-designated bodies and an approved practice-monitoring program.

Finally, and most importantly, the members are responsible, financially and otherwise, for all of the attest work performed. These rules are intended to be conceptual and applicable to all structures where the "traditional firm" engaged in attest services is closely aligned with another organization, public or private, that performs other professional services.

Because of the close alignment in many APSs between persons and entities, to ensure the protection of the public interest, the Professional Ethics Executive Committee believes that it is appropriate to require restrictions beyond those required in a traditional firm structure. Those restrictions are divided into two groups:

1. Direct Superiors; and
2. Indirect Superiors and Other Public Entities – Indirect Superiors are those persons who are one or more levels above persons included in the Direct Superior category.

The rules for Indirect Superiors and Other Public Entities are as follows:

- A. Indirect Superiors may NOT have a relationship contemplated by interpretation 101-1A regarding investments, loans, etc. with an attest client.
- B. Financial relationships of Indirect Superiors should not allow such persons or entities to exercise significant influence over the attest client.
- C. Neither Public Entities nor any of their employees may be connected with an attest client as a promoter, underwriter, voting trustee, Director, or officer.
- D. Except as noted above, Indirect Superiors may provide services to an attest client that would impair independence if performed by member.

For more details see INTERPRETATION 101-14.

## **2.15 Professional Due Care – Section 56 – Article V**

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

**01** – The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of a member's ability with concern for the best interest of those for whom the services are performed and consistent with the profession's responsibility to the public.

**02** – Competence is derived from a synthesis of education and experience. It begins with a mastery of the common body of knowledge required for designation as a certified public accountant. The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a member's professional life. It is a member's individual responsibility in all engagements to achieve a level of competence that will assure that the quality of the member's services meets the highest level of professionalism required by these Principles.

**03** – Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a member to render services with facility and acumen. It also establishes the limitations of a member's capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member's firm. Each member is responsible for assessing his or her own competence—of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed.

**04** – Members should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility to render



services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.

**05** – Due care requires a member to plan and supervise adequately any professional activity for which he or she is responsible.

## **2.16 Scope and Nature of Services – Section 57 Article VI**

*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.*

**01** – The public interest aspect of certified public accountants' services requires that such services be consistent with acceptable professional behavior for certified public accountants. Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and independence require that members be free from conflicts of interest in discharging professional responsibilities. Due care requires that services be provided with competence and diligence.

**02** – Each of these Principles should be considered by members in determining whether or not to provide specific services in individual circumstances. In some instances, the Principles may represent an overall constraint on the non-audit services that might be offered to a specific client. No hard-and-fast rules can be developed to help members reach these judgments, but they must be satisfied that they are meeting the spirit of the Principles in this regard.

**03** – In order to accomplish this, members should:

- (1) Practice in firms that have in place, internal quality-control procedures to ensure that services are competently delivered and adequately supervised.
- (2) Determine, in their individual judgments, whether the scope and nature of other services provided to an audit client would create a conflict of interest in the performance of the audit function for that client.
- (3) Assess, in their individual judgments, whether an activity is consistent with their role as professionals.

## **2.17 Applicability of the AICPA Code of Ethics**

The bylaws of the American Institute of Certified Public Accountants require that members adhere to the Rules of the Code of Professional Conduct. And as such, members must be prepared to justify departures from these Rules.



For purposes of the applicability section of the Code, a "member" is a member or international associate of the American Institute of CPAs.

The Rules of Conduct that follow apply to all professional services performed except:

- (a) where the wording of the rule indicates otherwise; and
- (b) to a member who is practicing outside the United States. He or she will not be subject to discipline for departing from any of the Rules stated herein as long as the member's conduct is in accord with the Rules of the organized accounting profession in the country in which he or she is practicing.

However, where a member's name is associated with financial statements under circumstances that would entitle the reader to assume that United States practices were followed, the member must comply with the requirements of rules 202.01. and 203.01.

A member shall not knowingly permit a person, whom the member has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the Rules. Further, a member may be held responsible for the acts of all persons associated with him or her in the practice of public accounting whom the member has the authority or capacity to control.

A member (as defined in interpretation 101-9) may be considered to have his or her independence impaired, with respect to a client, as the result of the actions or relationships of certain persons or entities, (as described in rule 101.01) whom the the member does not have the authority or capacity to control. Therefore, this section should not lead one to conclude that the member's independence is not impaired solely because of his or her inability to control the actions or relationships of such persons or entities.

*Please complete the review questions for Chapter 2 below. Please DO NOT begin Chapter 3 until you have answered the review questions and evaluated the material that needs to be re-studied. The Answer Key and Feedback are located at the end of the course on page 63. If you have any questions, please submit them to our faculty at the bottom of the course homepage.*

*Please note — you will also need to submit your answers on the course homepage before you can access and complete the Final Examination/Assessment.*

**1. Which one of the following definitions is NOT correct?**

- a. *Council*: the *Council* of the AICPA.
- b. *Member*: a member, associate member, or international associate of the AICPA.
- c. *Professional services*: all services performed by a member while performing public accounting services.
- d. *Institute*: the American Institute of Certified Public Accountants.

**2. Which of the following items completes the following sentence?**

***Independence in fact:***

- a. involves impartiality.
- b. indicates that the member has abstained from relationships that appear to prevent objectivity.
- c. is a state of mind.
- d. involves freedom from conflicts of interest.

**3. The unique characteristics of the accounting profession that set it apart from the rest of society is its acceptance of its responsibility to:**

- a. Its clients.
- b. The government and its agencies.
- c. The public.
- d. Investors.

4. Which of the following statements is NOT correct? A Key position is a position in which an individual:
- a. Has primary responsibility for significant accounting functions that support material components of the financial statements.
  - b. Has responsibility for the sales force.
  - c. Has primary responsibility for the preparation of the financial statements.
  - d. Has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors.
5. Which of the following statements is the BEST answer? "All groups of society are recipients of the work of the accounting profession. Society includes which of the following \_\_\_\_\_.
- a. Clients & credit grantors
  - b. Governments
  - c. Employers & investors
  - d. All of the above

## Chapter 3 The Rules of Ethics

### Learning Objectives

Completion of this chapter will enable you to:

- Understand the professional responsibilities of the CPA.
- Examine the terms used in the Code.
- Understand the need for Integrity, Objectivity, and Independence.
- Be familiar with the SEC Auditor Independence Requirements.
- Examine Alternative Practice Structures.
- Understand Professional Due Care.

### 3.1 Overview

The Code of Professional Conduct and some of the interpretations of the Rules address the basic actions that would cause independence to be considered impaired. Included in this chapter are the following: (1) The concepts of integrity and objectivity should be applied to professional practice and causes an awareness of the General Standards of the Rules of Ethics and the requirements for compliance with them. (2) Knowing when a member in public practice can receive a contingent fee or commission and the acts considered discreditable to the profession are necessary for the certified public account to adhere to.

### 3.2 Independence in Appearance and Fact

A member in public practice shall remain independent in fact, and in appearance.

Independence will be considered to be impaired if either of two basic situations occur:

- A. Financial Interest in the client: (1) had or was committed to acquire any direct financial interest in the client; and/or (2) had or was committed to acquire a material indirect financial interest in the client.
- B. Made Significant Decisions for the client through any position.

Financial interest would be considered to be present if any position or legal form used would in substance be considered by an independent party to be a financial interest. Examples are: trustee, executor, creditor, (or closely associated with any principal of client) or loans (except for grandfathered loans). Indirect interests result from a direct interest by a nondependent close relative. A spouse or dependent person, whether or not a relative, is considered a direct interest.

Decision-making could come from holding any position that would authorize such action. The source of the ability to make decisions is not the important part; it is the fact that decision making for the client has occurred.

### 3.3 Maintenance of Integrity and Objectivity

In the performance of any professional service the member shall maintain objectivity and integrity. The member shall not knowingly misrepresent facts, have conflicts of interest, or subordinate his or her judgment to others.

Integrity is doing what is right and just. Objectivity is being free of any kind of bias. Conflicts of interest arise when a significant relationship exists outside the client that could be viewed as causing bias in the member's dealing with the client. If the client knows of the conflict of interest and consents to the member's service, the member may perform the professional services. The member should be careful to adhere to the rules concerning confidential client information.

### 3.4 General Standards of the Rules of Ethics

A member shall comply with the following standards and interpretations:

- *Professional Competence.* A member should undertake only those professional services that can reasonably be expected to be completed with professional competence. When a member accepts an engagement it is assumed that the individual or the firm has the competence to complete the service while complying with all applicable standards.
- *Due Professional Care.* A member shall exercise due professional care in all professional services performed. This includes the use of the appropriate education, skills, and proficiencies possessed by the member.
- *Planning and Supervision.* The engagement shall be planned and assistants, if any, shall be properly supervised in the performance of the service.
- *Sufficient Relevant Data.* A member shall obtain enough relevant and reliable data in order to provide a reasonable basis for any conclusions or recommendations made in the performance of the engagement.

- A member who performs auditing, review, compilation, consulting, tax, or other professional services shall comply with the applicable standards promulgated by the bodies designated by the *Council*.

**Case:**

C. C. Chen, CPA, a recognized tax expert, is a partner at a local firm with two other CPA partners. He has not participated in an audit. The audit partner dies of a heart attack, leaving Chen and another tax partner. One of their best tax clients had just decided to have an audit and asked Chen to perform the audit. Chen decides that he is smart enough to catch up on auditing in the next day or two, so he agrees to complete the audit for his client. Chen's assistants have very little experience auditing. Should Chen complete the audit?

No, Chen should not complete the audit. A day or two of study will not make Chen an auditor. Chen needs more experience and training in order to reasonably expect to complete the audit with due professional competence, including compliance with Auditing Standards, Accounting Principles, and other Professional Standards.

### 3.5 Generally Accepted Accounting Principles

*Section 203.01 —*

A member shall not state that financial data is in conformity with Generally Accepted Accounting Principles, or state that the member is not aware of any material misstatements, if the financial data contains a material departure from a generally accepted accounting principle.

However, if the material departure, due to unusual circumstances, would present fairly the financial situation when GAAP would be misleading, then the member may express an opinion, as long as the justification is explained. Acceptable Unusual Circumstances are those that could not have been foreseen.

The Financial Accounting Standards Board is the designated body for Generally Accepted Accounting Principles. Accounting Research Bulletins and Accounting Principles Board opinions that have not been superseded are also considered accounting principles. Accounting principles that are not specifically covered by any of the above groups rest upon their general acceptance and usage.

Employees shall not state to anyone that GAAP has been applied to any financial statements when, to their knowledge, there is a material misstatement.

## 3.6 Disclosure of Confidential Client Information – ET Section 301.01

Confidential client information may not be disclosed by a member without the specific consent of the member's client. However, a CPA does not have privileged information status, as does a religious minister, attorney, or a medical doctor. This means that the member may be compelled to disclose confidential information, without the consent of the client, in certain specific situations delineated below.

### ***Exceptions to client confidentiality are as follows:***

- A member must comply with applicable AICPA Standards and Generally Accepted Accounting Principles. One of the standards of GAAP may require either disclosure of information or the withdrawal from the engagement in case the client disagrees.
- A member must comply with a valid subpoena of a court.
- A member must allow review by an appropriate AICPA or state CPA society.
- A member may initiate a complaint or respond to one of a recognized investigative body.
- A client's name is considered non-confidential information, and therefore may be revealed as long as it does not present potential harm to the client.

Members of a recognized investigative, review, or disciplinary body cannot use such information to their own advantage or disclose information that could not be disclosed by the member.

### ***Case:***

Joe Jones, CPA, was auditing an insurance company's mortgage loan portfolio. When reviewing a loan he discovered that the client who owned most of the stock of the insurance company was buying property in a run-down part of another major city with which he was acquainted. When he encountered a second similar loan he inquired about why this was happening. He was told that the majority owner was planning on renovating the area, and building a skyscraper once all of the property needed. was acquired The loans were perfectly legal and valid.

*May Joe Jones talk about the skyscraper plans since that is not part of the audit and does not pertain to the financial statements of the insurance company?*

No. Jones may not discuss the skyscraper for any reason. Joe Jones could severely hurt the majority owner financially by informing anyone in the area of the plans. Property prices would probably climb considerably and maybe even make the project not feasible.

An auditor should not discuss anything that was learned in an audit unless required to do so by a court of law.

### 3.7 Tax Adviser – Confidentiality Rules

The 1998 Internal Revenue Service Restructuring and Reform Act created a new confidentiality privilege between clients and CPAs who represent them **in non-criminal federal tax matters**. This law extends the common-law attorney-client confidentiality privilege to most **tax advice** furnished to a client by any individual authorized under federal law to practice before the IRS. This includes CPAs.

Tax advice is advice given by a CPA within the scope of authority of his or her practice with respect to matters under the Internal Revenue Code. Direct tax advice given to a client and tax advice documents should be protected. The privilege **is available only in matters brought before the IRS** or proceedings in Federal Court brought by or against the United States. This does not include state or local tax matters. However, most states have their own rules governing this.

This privilege applies only when the practitioner advises the client on legal matters. It does not apply when the tax practitioner acts in another capacity. Tax return preparation is not covered, even if the member is also an attorney.

### 3.8 Fees Contingent upon the Results of a Service – Section 302

A Contingent Fee is one that will be received for services, the amount of which is dependent upon the specific finding resulting from that service. It is received when the performance of the service is complete and the fee or commission is determined.

A member in public practice shall not:

Receive or perform, for a contingent fee, professional services for a client when the member or member's firm performs:

- An audit or review of financial statement(s).
- A compilation of a financial statement a third party might use, except when the lack of independence is disclosed.
- An examination of prospective financial information.
- The preparation of a tax return, original or amended, or a claim for refund.



Fees are not contingent in this context if determined by the courts or other judicial proceedings. In tax matters, fees based on the findings of governmental agencies are not considered contingent. The period covered by the above rules is the historical time period of the financial statements.

### **3.9 Acts Discreditable to the Profession**

*Section 500.01—A member shall not commit an act discreditable to the profession.*

Examples of discreditable acts are:

- Retention of client records after they have been requested
- Discrimination and harassment on the basis of race, color, religion, age, national origin, or sex in hiring, promotion, or salary policies
- Failure to follow standards, procedures, or other requirements in governmental audits, attest engagements, or similar services
- The preparation of misleading financial statements with full knowledge of that fact, or negligence.

The audit working papers are the auditor's, but if any of the working papers are the sole source of documentation for a part of the client's financial statements, then the client has a right to those working papers or a copy thereof.

When a member agrees to perform an attest or similar service for the purpose of reporting to a regulatory agency, the member should follow their regulations and requirements.

### **3.10 Advertising or Other Forms of Solicitation**

*Section 502.01—A member must be truthful and honest in advertising. Advertising cannot be false, misleading, or deceptive to the public.*

A member cannot through advertising or other forms of solicitation:

- Create false expectations of favorable results.
- Imply the ability to favorably influence an agency, or other body, to which the client is responsible in some way.
- Give false or probably false expectations of the amount of fees for services.
- Cause a reasonable person to misunderstand or be deceived.

When agreeing to do work for a third party's clients, a member must ascertain if the Rules of Conduct were followed in obtaining the client.

**Case:**

Jesus Garcia, CPA, CFP, is an independent financial planner. He has studied and practiced diligently, and has thus been successful in helping his clients make a very good return on their investments, averaging in the top 5 percent of market returns over the last three years. Jesus decided to expand his practice by doing a little more aggressive advertising, but being conservative in his predictions. He made the following advertisement in the Yellow Pages. "Because I have access to excellent research material, I can assure you that you will have a portfolio that will be in the top 10 percent of market returns."

*Was Garcia's advertisement permissible because he promised lower returns than his record for the last three years?*

No, Garcia's advertisement is not permissible. Garcia's statement of returns has no reasonable assurance that his clients returns will stay in the top 25 percent, let alone the top 10 percent. An advertisement that is likely to create false or unjustified expectations of favorable results is a false or misleading advertisement. Garcia should expound on his credentials and experience, rather than on a financial promise that he may not be able to keep.

### **3.11 Commissions on Products or Service**

*Section 503.01—A member in public practice shall not:*

Receive or perform for a commission, on any product or service when the member or member's firm performs:

- An audit or review of financial statement(s).
- A compilation of a financial statement a third party might use, except when the lack of independence is disclosed.
- An examination of prospective financial information.

Disclosure of commissions or anticipated commissions to any person or entity to whom the member recommends a product or service is required for those members in public practice who are not covered by the above rules. Referral fees, either receipt or payment thereof, must be disclosed to the client, pursuant to the AICPA Commissions and Referral Fees Rule.

The period covered by the above rules is the period in which the CPA is engaged to perform any of the above services, and the historical time period of the financial statements.

## 3.12 Form of an Organization and Name

*Section 505.01 -A member may practice public accounting only in a form permitted by the state law or regulation if the form conforms to resolutions of Council. The firm name cannot be misleading. A sole surviving partner can continue to practice under the same firm name for up to two years. In order for the firm to designate itself as members of the AICPA all owners must be members of the AICPA.*

A member may have an unlimited investment in a permitted accounting organization. If the accounting corporation is not permitted in that state, a member may still invest in the corporation, but only as an investment, and may have no significant influence over the corporation. A member may participate in one, two, or more public accounting practice units as long as the Rules of Conduct are followed in each of them.

*Please complete the review questions for Chapter 3 below. Please DO NOT begin Chapter 4 until you have answered the review questions and evaluated the material that needs to be re-studied. The Answer Key and Feedback are located at the end of the course on page 65. If you have any questions, please submit them to our faculty at the bottom of the course homepage.*

*Please note — you will also need to submit your answers on the course homepage before you can access and complete the Final Examination/Assessment.*

**1. In which of the following situations would a CPA be considered independent?**

- a. The CPA was the temporary staff training instructor during the initial portion of the period.
- b. The CPA had or was committed to acquire a small direct interest in the client.
- c. The CPA had or was committed to acquire a large but indirect interest in the client.
- d. The CPA was the controller for the firm during the initial portion of the period.

**2. A member who performs auditing, review, compilation, consulting, tax, or other professional services shall comply with only:**

- a. All applicable standards promulgated by bodies designated by *Council*.
- b. The Code of Professional Ethics.
- c. Generally Accepted Accounting Principles.
- d. Internal Auditing Standards.

**3. Which one of the following professionals does NOT have a privileged information status with their client?**

- a. Medical doctors.
- b. Certified public accountants.
- c. Attorneys.
- d. Religious ministers.

4. Which kind of *working papers* may a client request, and have a right to receive from its auditor?
- a. Analysis and comments on management's strengths and weaknesses.
  - b. Papers that contain support for a client's journal entries and that the client does not have a copy of.
  - c. Auditor's comments and conclusions concerning materiality.
  - d. Both a & c.
5. Which one of the following groups does NOT require disclosure of commissions or anticipated commissions?
- a. To the AICPA Ethics Division.
  - b. To those members in public practice who do not perform an audit or review, examination of prospective statements, or compilation when independent.
  - c. To the client.
  - d. The State Board of the state in which the professional is practicing in.

## Chapter 4 Interpretations of the Code of Ethics

### Learning Objectives

Completion of this chapter will enable you to:

- Understand the impact of former employees and family members on Independence.
- Examine the impact of Investment or Management Advisory Services on Independence.
- Be familiar with possible conflicts of interest.
- Understand the role of CPAs as employees.

### 4.1 Overview

Even with a well-written document, there are always gray areas in the application of the rules. Independence, contingent fees and commissions, subordination of judgment, confidential client information, advertising, and many more areas covered by the code are not always completely clear, regardless of how well written.

Interpretations are the means used to explain the application of the spirit of a Principle or Rule to specific situations in which the Principle or Rule may not be sufficiently clear or explicit. When broad guidelines are used, interpretations are necessary in many cases due to the fact that the guidelines are non-specific.

Principles are broad guidelines for behavior and are not intended to be specific. As discussed previously, principles cover the concepts of responsibilities to the public, integrity, objectivity and independence, professional due care, as well as to whom the principles apply. Rules are enforceable guidelines that govern all services performed by the CPA in the practice of public accounting.

Following are some of the important interpretations of rules. Not all interpretations can be included in a course of this length.

### 4.2 Interpretations under Rule 101 – Independence

In the performance of professional services requiring independence, a member should consult the rules of:

- His or her state board of public accountancy.
- His or her state CPA society if applicable.
- The Independence Standards Board if the client is a registrant of the U.S. Securities and Exchange Commission.
- The U.S. Department of Labor (DOL) if the client or the client's sponsor is required to report to the DOL.
- Any other regulatory or private organization that issues or enforces standards of independence.

Such bodies may have independent interpretations or rulings that significantly differ from or are more restrictive than those of the AICPA.

## 4.3 Interpretation of Rule 101-1

*Independence shall be considered to be impaired if:*

- A. During the **period of the professional engagement** a **covered member**:
  - 1. Had or was committed to acquire any direct or material indirect financial interest in the **client**.
  - 2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client.
  - 3. Had a **joint closely held investment** that was material to the covered member.
  - 4. Except as specifically permitted in interpretation 101-5 [ET section 101.07], had any **loan** to or from the client, any officer or director of the client, or any individual owning ten percent or more of the client's outstanding equity securities or other ownership interests.
- B. During the period of the professional engagement, a **partner** or professional employee of the **firm**, his or her **immediate family**, or any group of such persons acting together owned more than five percent of a client's outstanding equity securities or other ownership interests.
- C. During the period covered by the **financial statements** or during the period of the professional engagement, a partner or professional employee of the firm was simultaneously associated with the client as a(n)
  - 1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;
  - 2. Promoter, underwriter, or voting trustee; or
  - 3. Trustee for any pension or profit-sharing trust of the client.

### Transition Period for Certain Business and Employment Relationships

A business or employment relationship with a client that impairs independence under interpretation 101-1.C above, and that existed as of November 2001, will not be deemed to impair independence provided such relationship was permitted under rule 101 [ET section 101.01], and its interpretations and rulings as of November 2001, and the individual severed that relationship on or before May 31, 2002.

## 4.4 Application of the Independence Rules to Covered Members Formerly Employed by or Associated With a Client

*101-1 — An individual who was formerly employed by or associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm's independence if the individual:*

1. Participated on the **attest engagement team** or was an **individual in a position to influence the attest engagement** for the client when the attest engagement covers any period that includes his or her former employment or association with that client; or
2. Provided ten or more hours of non-attest services to the client or was a **partner** in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement for the client unless the individual first disassociates from the client by:
  - Terminating any relationships with the client described in interpretation 101-1.C [ET section 101.02] (Section 2.3 above).
  - Disposing of any direct or material indirect financial interest in the client.
  - Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under interpretation 101-5.
  - Ceasing to participate in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis.
  - Liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty significant to the benefits is imposed upon liquidation or transfer.

## 4.5 Application of the Independence Rules to a Covered Member's Immediate Family

*101-1 — Except as stated in the following paragraph, a covered member's immediate family is subject to the independence rule, rule 101, and its interpretations and rulings.*

The exceptions are that independence would not be considered to be impaired solely as a result of the following:

An individual in a covered member's immediate family was employed by the client in a position other than a **key position**.



In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is sponsored by a client or that invests in a client (provided such plan is normally offered to all employees in similar positions):

- A partner or **manager** who provides ten or more hours of non-attest services to the client.
- Any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement.

For purposes of determining materiality under the independence rule, rule 101 [ET section 101.01] the financial interests of the covered member and his or her immediate family should be aggregated.

## 4.6 Application of the Independence Rules to Close Relatives

*101-1 Independence would be considered to be impaired if:*

1. An individual participating on the attest engagement team has a **close relative** who had
  - A. A key position with the client.
  - B. A financial interest in the client that:
    - Was material to the close relative and of which the individual has knowledge.
    - Enabled the close relative to exercise **significant influence** over the client.
2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had:
  - A. A key position with the client.
  - B. A financial interest in the client that:
    - Was material to the close relative and of which the individual or partner has knowledge; and
    - Enabled the close relative to exercise significant influence over the client.

## 4.7 Other Independence Issues

### Other Considerations – 101-1

It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. Members should consider whether personal and business relationships between the member and the client or an individual associated with the client 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.

### 4.8 101-3 Performance of Other Services

A member in public practice or his or her firm ("member") who performs for a client services requiring independence ("attest services") may also perform other non-attest services ("other services") for that client. Before a member performs other services for an attest client, he or she must evaluate the effect of such services on his or her independence. In particular, care should be taken not to perform management functions or make management decisions for the attest client, the responsibility for which remains with the client's board of directors and management.

Before performing other services, the member should establish an understanding with the client regarding the objectives of the engagement, the services to be performed, management's responsibilities, the member's responsibilities, and the limitations of the engagement. It is preferable that this understanding be documented in an engagement letter. In addition, the member should be satisfied that the client is in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to:

1. Designate a management-level individual or individuals to be responsible for overseeing the services being provided.
2. Evaluate the adequacy of the services performed and any findings that result.
3. Make management decisions, including accepting responsibility for the results of the other services.
4. Establish and maintain internal controls, including monitoring ongoing activities.

## **General Activities**

The following are some general activities that would be considered to impair a member's independence:

- Authorizing, executing or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so
- Preparing source documents or originating data, in electronic or other form, evidencing the occurrence of a transaction (for example, purchase orders, payroll time records, and customer orders)
- Having custody of client assets.
- Supervising client employees in the performance of their normal recurring activities.
- Determining which recommendations of the member should be implemented.
- Reporting to the board of directors on behalf of management.
- Serving as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent.

## **4.9 Independence – Investment – Advisory or Management**

*.05 – 101-3 – Following are some situations where independence may or may not be impaired.*

### ***Independence Would Not Be Impaired***

### ***Independence Would Be Impaired***

Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client's desired rate of return, risk tolerance, etc.

Perform record-keeping and reporting of client's portfolio balances including providing a comparative analysis of the client's investments to third-party benchmarks.

Review the manner in which a client's portfolio is being managed by investment account managers, including determining whether the managers are: (1) following the guidelines of the client's investment policy statement; (2) meeting the client's investment objectives; and (3) conforming to the client's stated investment styles.

Transmit a client's investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction.

Make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments.

Execute a transaction to buy or sell a client's investment.

Have custody of client assets, such as taking temporary possession of securities purchased by a client.

## **4.10 Independence – Corporate finance—Consulting or Advisory**

### ***Independence Would Not Be Impaired***

#### ***Independence Would Be Impaired***

- Assist in developing corporate strategies.
- Assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria.
- Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources.
- Assist in drafting an offering document or memorandum.
- Participate in transaction negotiations in an advisory capacity.
- Be named as a financial adviser in a client's private placement memoranda or offering documents.
- Commit the client to the terms of a transaction or consummate a transaction on behalf of the client.
- Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents.
- Maintain custody of client securities.

## **4.11 Independence – Information systems—Design, Installation or Integration**

### ***Independence Would Not Be Impaired***

#### ***Independence Would Be Impaired***

- Design, install or integrate a client's information system, provided the client makes all management decisions.
- Customize a prepackaged accounting or information system, provided the client makes all management decisions.
- Provide the initial training and instruction to client employees on a newly implemented information and control system.
- Supervise client personnel in the daily operation of a client's information system.
- Operate a client's local area network (LAN) system when the client has not designated a competent individual, preferably within senior management, to be responsible for the LAN.

## 4.12 Independence Situations

### ***101-12 Independence and cooperative arrangements with clients.***

Independence will be considered to be impaired if, during the period of a professional engagement or at the time of expressing an opinion, a member's firm had any cooperative arrangement with the client that was material to the member's firm or to the client.

### ***Participation in Health and Welfare Plan of Client***

A member who participates in or receives benefits from a health and welfare plan sponsored by a client would impair the independence of the member or member's firm with respect to the client sponsor and the Plan. However, if the participation arises out of permitted employment then independence would not be impaired.

## 4.13 Interpretation 102-2—Conflicts of Interest

A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, *Confidential Client Information* [ET section 301.01].

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under rule 101 [ET section 101.01], its interpretations, and rulings cannot be eliminated by such disclosure and consent.

The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.

- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs consulting services.
- A member serves on a city's board of tax appeals, which considers matters involving several of the member's tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).

The above examples are not intended to be all-inclusive.

#### **4.14 Obligations of a Member**

*—To his or her employer's external accountant. Interpretation 102-3 Under rule 102 [ET section 102.01], a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer's external accountant requests written representation.*

#### **4.15 Subordination of Judgment by a Member**

*Interpretation 102-4 — There is an old saying that "the boss is not always right but he is always the boss." Being the boss does not always make them right if there is the prospect of breaking Generally Accepted Accounting Principles by a member, even though that member is not in the practice of public accounting. What must a member do when he or she disagrees with the boss relative to an accounting matter?*

Rule 102 prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment.

The member should consider whether (a) the entry or failure to record a transaction in the records, or (b) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts.

If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.

If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate high level(s) of management within the organization. The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were disclosed.

If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.

The member should at all times be cognizant of his or her obligations under Interpretation 102-3, Obligations of a Member to His or Her Employer's External Accountant.

### **4.16 Integrity and Objectivity**

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.

Knowing misrepresentations in the preparation of financial statements or records – A member shall be considered to have knowingly misrepresented facts in violation of rule 102.01 when he or she knowingly:

1. Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records.
2. Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry.
3. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

## 4.17 Commission and Referral Fees and Client Services

*Rule 503 on Commissions and Referral Fees provides that when a member or the member's firm performs for a client a services such as audits, reviews, some compilations, examinations of prospective financial statements, the member may not recommend or refer to that client for a commission any product or service, or receive a commission for a recommendation or referral.*

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

If the products are referred on a commission basis to clients for which the member is not engaged to perform any of the services described in rule 503, rule 503 would not be violated as long as the commission is disclosed to the client. However, any subsequent performance or service of audits, reviews, some compilations, examinations of prospective financial statements during a period in which the commission was received would constitute a violation of rule 503.

## 4.18 Confidential Client Information

*Rule 301 — By the very nature of the services performed for a client, CPAs will know very much about their financial condition and results of their operations. Much of this information, if made known to certain groups, individuals, or the public, could be very harmful or embarrassing to their business interests, or result in a combination of negative things.*

This probability of harmful or embarrassing outcomes makes it imperative that information about the client not be made known by the CPA to anyone unless it falls into one of the exception categories discussed below.

1. Comply with Standards promulgated by bodies designated by Council.
2. Comply with a validly issued subpoena or summons.
3. Allow official review by AICPA, state CPA society, or state Board of Accountancy.
4. Filing a complaint with or responding to official investigative or disciplinary bodies of AICPA, state CPA society, or state Board of Accountancy.



## 4.19 Sarbanes-Oxley Act of 2002

Spurred by the Enron and the public's shaken confidence in the economy, Congress enacted - and President Bush signed into law on July 30, 2002 - sweeping legislation aimed at curtailing fraud and corruption in corporate America: the Sarbanes-Oxley Act of 2002, P.L. 107-204. Originally titled the Corporate and Auditing Accountability, Responsibility, and Transparency Act of 2002, this law makes corporate officers responsible for earnings reports, forbids accounting firms from acting as consultants to accounting clients, and stiffens penalties for fraud. The law imposes duties - and significant penalties for non-compliance - on public companies and their executives, directors, auditors, attorneys and securities analysts. Most of the provisions of this law only apply to public companies that file a form 10-K with the Securities and Exchange Commission their auditors and securities analysts.

## 4.20 PCAOB

Because the role of auditors in recent corporate collapses caused a questioning and a rejection of the existing system for policing of accounting, the Sarbanes-Oxley Act created the Public Company Accounting Oversight Board (PCAOB), a private-sector, non-profit corporation. This agency is now charged with overseeing the auditors of public companies in order to further the public interest in the preparation of informative, fair, and independent audit reports. To accomplish this mission, the Act new law charged the PCAOB with: a) registering accounting firms that audit public companies trading in U.S. securities markets; b) inspecting registered accounting firms; c) establishing standards for auditing, quality control, ethics, and independence for registered accounting firms; and d) investigating and disciplining registered accounting firms and their associated persons for violations of law or professional standards.

## 4.21 The Role of the Attorney in Our Society

As trustees of the law, attorneys play a vital role in the conservation of our society. The fulfillment of this role requires an understanding of their roles and functions within our legal system. Inherent in that role is the obligation of lawyers to maintain the highest standards of ethical conduct.

An attorney is a representative of the client's interests, an official of the legal system, and a citizen having special responsibility for the quality of justice. This is contrasted to the role of the auditor or attestor to financial statements as a Certified Public Accountant whose responsibility to the public is to perform the "trust" function between "savers"(providers) and "users" of financial information.

The Auditor or attestor does not take the client's view or the public's view, but represents the facts to both parties and to the public. The main concern is the fair presentation of the financial information on which they are reporting.

The legal profession has a responsibility to assure that its regulation is undertaken in the public interest rather than in self-interest. It also has the duty to see that every attorney meets the minimum standards of conduct for the profession. This is also true of the accounting profession.

### **4.22 The Attorney-Client Relationship**

Lawyers represent clients in various capacities such as an advisor, an advocate, a negotiator, a mediator, an evaluator, and in other ways. Each of these roles should be zealously pursued in the interests of the client. As an advisor, a lawyer provides a client with an enlightened comprehension of the client's legal rights and obligations while explaining the practical meaning and implications.

As an advocate, an attorney vigorously asserts the client's position within the rules of the adversary system. As a negotiator the lawyer tries to obtain an advantageous result for the client.

An attorney seeks to reconcile the clients' different interests as a mediator. In each of these and in other roles, acting in the client's interests should always be at the heart of the lawyer's actions.

The attorney shall have the competence to represent the client or have associated attorney(s) who are competent in the matter in the particular case. The lawyer should not neglect the client's legal matters.

### **4.23 Conflict of Interest**

A lawyer shall not represent opposing parties to the same litigation. In other situations, with some exceptions, a lawyer shall not represent a client if the representation:

Involves a substantially related matter to another client of the lawyer whose interests are materially and directly adverse to the client.

Reasonably appears to be adversely limited by responsibilities to another client.

A lawyer who has represented multiple parties shall not thereafter represent any of the parties in the dispute unless prior consent is obtained from all parties.

## **4.24 Attorney's Obligation to Those Who Cannot Afford Representation**

A lawyer should be cognizant of the legal needs of the poor and those that cannot afford satisfactory legal aid. The deficiencies in the administration of justice for these people should be noticed by a lawyer and professional time granted in their behalf.

An attorney should render public interest legal service. The basic responsibility for providing legal services for those unable to pay rests with the individual attorney. Every lawyer should participate or otherwise support the provision of legal services to the disadvantaged. This is a moral obligation.

The legal services to the disadvantaged can be provided without a fee or at a reduced rate. There is no such provision in the CPA's Code of Ethics. In fact, at least one state does not allow CPA services to be performed for fees that are less than direct labor costs, except for charitable organizations.

## **4.25 The Attorney's Confidentiality Rules**

Confidential information for the lawyer includes both "privileged information" and "non-privileged client information." Privileged information is the information of a client given to the lawyer that is protected from disclosure to anyone, including the courts. This gives the client the ability to discuss with a lawyer information that may be prejudicial if it were disclosed.

Non-privileged client information means all information relating to a client, other than privileged information, that is gathered in the course of representing a client.

Confidential client information shall not be disclosed without specific authorization from the client, except upon a valid order from the court or an authorized investigation by the legal profession. The lawyer cannot use confidential information to the disadvantage of the client, or a former client, without their consent. The lawyer may disclose confidential information when the lawyer has reason to believe it is necessary to do so in order to prevent the client from committing a criminal or fraudulent act.

## **4.26 The Amount of Fees Allowed an Attorney**

A lawyer shall not charge or receive an illegal fee or an unconscionable fee. A fee is unconscionable if a competent attorney could not form a reasonable belief that the fee is reasonable.

Factors considered, not all-inclusive, are:

- Time and difficulty of engagement and the professional skill required to perform the service.
- The opportunity cost of lost cases.
- Fees that are normally charged in the community.
- Whether the fee is fixed or contingent.

Fees may be contingent on the outcome of the matter except when a contingent fee is prohibited by law. A contingent fee shall be in writing and shall state the method by which the fee is to be determined.

## **4.27 The Purpose of the Internal Auditor's Code of Ethics**

The purpose of The Institute's *Code of Ethics* is to promote an ethical culture in the profession of internal auditing.

- *Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.*

A code of ethics is necessary and appropriate for the profession of internal auditing, founded as it is on the trust placed in its objective assurance about risk management, control, and governance. The Institute's *Code of Ethics* extends beyond the definition of internal auditing to include two essential components:

1. Principles that are relevant to the profession and practice of internal auditing;
2. Rules of Conduct that describe behavior norms expected of internal auditors. These rules are an aid to interpreting the Principles into practical applications and are intended to guide the ethical conduct of internal auditors.

The *Code of Ethics* together with The Institute's *Professional Practices Framework* and other relevant Institute pronouncements provide guidance to internal auditors serving others. "Internal auditors" refers to Institute members, recipients of or candidates for IIA professional certifications, and those who provide internal auditing services within the definition of internal auditing.

## **4.28 Independence Aspects of the Internal Auditor under the Institute of Internal Auditors' (IIA) Standards of Conduct**

Integrity, objectivity, confidentiality, and competence in the performance of their duties are a part of the Standards of Conduct for Internal Auditors and the AICPA's Code of Conduct.

The AICPA requires that members be independent of their clients in most of their services. If members are not independent, they must disclose this fact. The Code for internal auditors does not address the issue of independence in a direct way, but indirectly it gives direction as to where the internal auditor's loyalty lies. An internal auditor's loyalty lies with the employing organization.

The internal auditor's Statement of Responsibilities states that "Internal auditing is an independent appraisal function established within an organization." The main difference is that independence is the cornerstone of the accounting profession and is built upon a real separation from the client both in fact and in appearance, whereas internal auditing includes an independent appraisal function that operates within a business.

## **4.29 Loyalty of the Internal Auditor**

Internal auditors under the IIA code are required to demonstrate loyalty in all dealings regarding matters of their organization or to whomever they may be performing a service. This loyalty does not pertain to matters that are unlawful or inappropriate.

Members shall not intentionally engage in deeds that are discreditable to the profession or to their organization. Members also may not enter into anything that may be in conflict with the interests of their employer or which would bias them in doing their job objectively as stated above.

## **4.30 Acceptance of Gifts by the Internal Auditor**

The internal auditor shall not accept anything of value from an employee, client, customer, supplier, or business colleague of their employer that would bias or appear to prejudice their professional judgment. The purpose of this rule is to insure that the first Standard of Conduct - the exercise of honesty, objectivity, and diligence - will not be tainted.

This issue is not specifically addressed in either the AICPA Code of Ethics or the Lawyers Code of Ethics. Although the AICPA Code of Ethics Independence section does not deal with it directly, there is specific reference to gifts in the interpretations.

The interpretation is that independence would be considered to be impaired if an employee or partner accepts more than a token gift from a client.

### 4.31 Cases

Following are cases that deal with Non-Compete Contracts of CPAs, the use of the CPA title, and the form of organization allowed to issue attestation reports.

#### ***Ibanez v. Florida Board of Accountancy***

Ibanez was an attorney who also was a CPA and CFP. Her practice was purely legal work, but she wanted to put all three designations on her advertising in the yellow pages, business cards, and letterheads.

As most state boards at that time thought, the Florida Board of Accountancy believed that Ibanez was also in the practice of public accountancy since she was using the "CPA" designation. The board felt that she was under the Public Accountancy Act, and was violating advertising portion.

The U.S. Supreme Court, in 1994 ruled for Ibanez in that they said that the Constitutional protection of free speech extended to informing the public of one's CFP and CPA designations. Thus, she could include attorney, CFP, and CPA on her business cards and in her advertising.

#### ***American Express and the Texas State Board of Public Accountancy***

The Texas State Board of Public Accountancy brought a lawsuit in 1995 when it discovered that American Express was issuing compilation reports. The Board got a permanent injunction in 1997 barring American Express from issuing financial statements under reports that assert any expertise in accounting. The Court also ordered that American Express could issue bookkeepers' financial statements with safe harbor language, just like any other unlicensed company.

The Uniform Accountancy Act, a blueprint created by the American Institute of CPAs and the National Association of State Boards of Accountancy as the "ideal" public accountancy act, recommends that all states adopt this practice. The Texas Legislature added the safe harbor language to the state's Public Accountancy Act. American Express did not appeal the Board's permanent injunction.

Since 1997, the only dispute in the litigation was over counterclaims that American Express had filed.

The counterclaims asked for an order exempting CPAs employed by America Express from having to comply with accounting standards established by

national standard setting bodies, including the Financial Accounting Standards Board and the American Institute of Certified Public Accountants. American Express also sought a ruling that making CPAs comply with these standards violated the constitution.

The Board opposed these claims both because they were meritless, and because American Express could not raise them.

The District Court dismissed American Express' counterclaims in April 1997 without ruling on their merits. American Express appealed the dismissal and persuaded both the Third Court of Appeals and the Supreme Court that the counterclaims should go to trial. But, when the case was sent back to the District Court for a trial, American Express did nothing to press its claims. Finally, in October 2001, the case was dismissed.

### ***Enron and Arthur Andersen***

In the early 1970s The Equity Funding case, referred to as the Billion Dollar Bubble, was seen as a huge landmark case that would keep accountants on their toes and keep them from stepping on anymore big landmines. Greed by the company and its auditors and the auditor's failure to have sufficient knowledge of computers and the accounting system were the bottom line of that case.

What we learn from history is that we don't learn from history. Greed again raises its ugly head. Nothing new about greed, it's just the magnitude of that greed that staggers us.

Enron, an energy trading business among many other things, was the perpetrator and recipient of greed. They purchased Portland General Electric Corp. as part of their "normal" business in 1997. Then they began to get into areas that were new and non-conventional. Enron Online was formed in 1999 for the purpose of electronic commodities trading web site. In 2000 Enron and Blockbuster made a deal to provide video on demand to customers. There were other kind of transactions and affiliated companies set up to hide liabilities.

### ***"IN A WAY IT'S SIMPLE, IN A WAY IT'S NOT — William Thomas***

*On the surface, the motives and attitudes behind decisions and events leading to Enron's eventual downfall appear simple enough: individual and collective greed born in an atmosphere of market euphoria and corporate arrogance. Hardly anyone—the company, its employees, analysts or individual investors—wanted to believe the company was too good to be true.*

*So, for a while, hardly anyone did. Many kept on buying the stock, the corporate mantra and the dream. In the meantime, the company made many high-risk*



*deals, some of which were outside the company's typical asset risk control process."*

When Generally Accepted Accounting Principles are mainly rules-based, the chances of them adequately reporting new unforeseen methods of doing business are limited. Enron also deliberately used routine business forms, such as partnerships, to help hide the real world. This is especially true when the stakes are so high for Enron and Arthur Andersen. Enron had created a monster business scheme, then which partner at Arthur Andersen was going to "blow the whistle" on the scheme.

It takes at least two parties for a fraud to succeed. First, Enron, then Arthur Andersen and many others. Security analysts and the commercial and investment bankers sure cannot gloat about their work. Then finally the investors did not do their homework, they relied upon others doing their work for them while they followed the old greed syndrome. If it too good to be true, look at it closely.

Following is a quote from Dr. Jonathan Schiff, the head of Schiff Consulting Group as well as a former auditor and member of a corporate audit committee. The quote is from SmartPros' FMN Online course "**Auditing Practice – Enron – What Fueled its Collapse**" *"To me, the Enron collapse is a sad episode. It has many implications, but most important, at least as far as my constituency is concerned, the people I talk to, it really has taken down the appearance of integrity we all like to have in the finance and accounting community. We like to be viewed as folks who are critical, who understand risk, who are going to give early warning of something bad that's going to happen and be very frank and honest about it and have the highest degree of integrity. Unfortunately, this event has really taken that down a notch, and it's very hard to get back up again. It takes a long time to earn that reputation again. That, to me, is the biggest damage that's occurred in terms of the profession".*

Arthur Andersen was not able to earn that reputation again. Arthur Andersen was convicted of felony obstruction of Justice in federal court which caused the revocation of its accounting license in Texas and California and subsequent dissolution of the long-time international accounting firm. Unfortunately, whether it was greed or inaction, a once mighty accounting firm has lost its right to practice and no longer exists. The event has impacted the stock market and American business in a very negative way.

### ***Ponzi Schemes – Bernard Madoff – the biggest of them all***

"The three-person auditing firm that apparently certified the books of **Bernard Madoff Investment Securities**, the shuttered home of an alleged multibillion-dollar Ponzi scheme, is drawing new scrutiny.



Already under investigation by local prosecutors for its potential role in the scandal, the firm, **Friehling & Horowitz**, is now also being investigated by the American Institute of Certified Public Accountants, the prestigious body that sets U.S. auditing standards for private companies.

The problem: The auditing firm has been telling the AICPA for 15 years that it doesn't conduct audits." (Fortune Magazine)

The firm's name and signature appears on the "Statement of Financial Condition" for October 31, 2006.

The author and most others thought that Enron and Arthur Andersen problems would prevent such massive schemes from being successful.

Large brokerage firms are required to be audited by firms registered with the PCAOB. Yet the **SEC** provided a **temporary reprieve** to the rule for privately held brokerage firms and **extended it several times**." This allowed the massive fraud to continue unabated.

New York was one of only 6 states to not require peer review. Since this case occurred they have changed that status.

Industry experts said it was preposterous that that small firm was allowed to audit an operation the size of Madoff's.

The Public Company Accounting Oversight Board, (PCAOB) created under the Sarbanes-Oxley Act in 2002 does not have legal authority over the situation. Hopefully Congress will close that loophole.

There are a lot of people/organizations that could have prevented this from becoming so large, but the author is not going to issue judgment as to the guilty parties. He just hopes that the profession and society will continue to learn from our mistakes, but history doesn't give us much hope.

*Please complete the review questions for Chapter 4 below. Please DO NOT begin the Final Exam/Assessment until you have answered the Review Questions and evaluated the material that needs to be re-studied. The Answer Key and Feedback are located at the end of the course on page 67. If you have any questions, please submit them to our faculty at the bottom of the course homepage.*

*Please note — you will also need to submit your answers on the course homepage before you can access and complete the Final Examination/Assessment.*

**1. The attest engagement team includes all of the following EXCEPT:**

- a. The proprietor who participates in the acceptance or performance of the attest engagement.
- b. The partners who participate in the acceptance or performance of the attest engagement.
- c. Full- or part-time professional staff in another office of the same firm in the same state who did not participate in the attest engagement.
- d. The shareholders who participate in the acceptance or performance of the attest engagement.

**2. Upon determining that a supervisor's recommendation for treatment of financial information could result in a material misstatement, the first step in the CPA's ethical obligation is to:**

- a. Quit to avoid ethical violations.
- b. Communicate concerns to the external accountant and all regulatory agencies that may be involved.
- c. Report the disagreement to the supervisor's supervisor.
- d. Do sufficient research and consultation to determine if the supervisor is correct.

**3. When is a contingent fee or commission deemed to be received?**

- a. When money for services is first received.
- b. When services have been performed and the fee or commission is determined.
- c. When a client agrees to have a member perform a service for the client.
- d. When an initial sales contact is made with a client.

4. Which of the following statements is FALSE? When an Attest Function CPA performs "Other Services" the client must be in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to:
- a. Designate a staff member to be responsible for overseeing the services being provided.
  - b. Evaluate the adequacy of the services performed and any findings that result.
  - c. Make management decisions, including accepting responsibility for the results of the other services.
  - d. Establish and maintain internal controls, including monitoring ongoing activities.
5. Which of the following new loans to be obtained from a financial institution client where independence is required is NOT an "Other Permitted Loan"?
- a. Automobile loans and leases collateralized by the automobile.
  - b. Loans fully collateralized by the cash surrender value of an insurance policy.
  - c. Loans partially collateralized by cash deposits at the same financial institution.
  - d. Credit cards where the aggregate outstanding balance on the current statement is reduced to \$5,000 or less by the payment due date.

## Review Questions Reinforcement and Evaluative Feedback

### *Chapter 1 Feedback to Review Questions*

1. Which of the following is a synonym for “ethics”?
  - a. Incorrect. Moral practice is not the best answer.
  - b. Incorrect. Social values is not the best answer.
  - c. Incorrect. Decency is not the best answer.
  - d. **Correct. All of the above answers are synonyms for “ethics.”**
  
2. Which of the following best completes the sentence? A member who departs from Rulings in similar circumstances:
  - a. **Correct. A member that departs from a “Ruling” has to defend that position or be found guilty of violating the Code of Professional Ethics.**
  - b. Incorrect. Rulings are an official part of the Code of Professional Ethics.
  - c. Incorrect. Rulings summarize the application of Rules of Conduct.
  - d. Incorrect Interpretations to a particular set of factual circumstances.
  
3. Which of the following words is NOT a synonym of “ethical”?
  - a. Incorrect. Honest is being ethical.
  - b. Incorrect. Being Conscientious is being ethical.
  - c. **Correct. Moral may be ethical or not. The Mafia has their “moral code” which society does not consider ethical.**
  - d. Incorrect. Being Humane is being ethical.
  
4. The sections of the Code consist of \_\_\_\_\_ and \_\_\_\_\_:
  - a. Incorrect. Standards are not one of the sections.
  - b. Incorrect. Principles must to be one of the sections.
  - c. **Correct. The two sections are Principles and Rules.**
  - d. Incorrect. Standards are a subset of the Rules, not one of the sections.

5. A Covered Member is:

- a. Incorrect. An individual on the attest engagement team is a Covered Member.
- b. Correct. A Partner in an office in the same state is not necessarily a covered member. Other attributes must be present.**
- c. Incorrect. An individual in a position to influence the attest engagement is a Covered Member.
- d. Incorrect. The firm, including the firm's employee benefit plans, is a Covered Member.

6. A member should consult, in addition to the Code of Professional Ethics, if applicable, the ethical standards of:

- a. Incorrect. The state society to which the member belongs is not the best answer.
- b. Incorrect. The appropriate state board of accountancy is not the best answer.
- c. Incorrect. The AICPA ethics division is not the best answer.
- d. Correct. All of the above answers are appropriate.**

## Chapter 2 Feedback to Review Questions

### 1. Which one of the following definitions is NOT correct?

- a. Incorrect. *Council* is properly defined as "The *Council* of the AICPA." The Council is the governing body of the AICPA and is comprised of approximately 265 members and representatives from every state and U.S. Territory. Council meets twice a year, in May and October, and Regional Council meetings are held every year in March.
- b. Incorrect. Member is properly defined as "A member, associate member, or international associate of the AICPA."
- c. Correct. Professional services include all services performed by a member while holding out as a CPA, not just while performing public accounting services.**
- d. Incorrect. Institute is properly defined as "The American Institute of Certified Public Accountants."

### 2. Which of the following items completes the following sentence? Independence in Fact:

- a. Incorrect. Impartiality is connected with objectivity.
- b. Incorrect. Independence in appearance, not fact, involves actions such as abstaining from relationships.
- c. Correct. Independence, in fact is attitudinal, that is, a state of mind. Independence in appearance involves actions.**
- d. Incorrect. Objectivity involves actions such as freedom from conflicts of interest.

### 3. The unique characteristics of the accounting profession that set it apart from the rest of society is its acceptance of its responsibility to:

- a. Incorrect. A profession is responsible to its clients, but this is not the best answer.
- b. Incorrect. A profession is responsible to certain government agencies at times, but this is not the best answer.
- c. Correct. A profession is responsible to its public, which is unique.**
- d. Incorrect. A profession is responsible to investors sometimes, but this is not the best answer.

4. Which of the following statements is NOT correct? A Key position is a position in which an individual:

a. Incorrect. Having primary responsibility for significant accounting functions that support material components of the financial statements gives the possibility of adversely affecting the financial statements and they are therefore in a key position.

**b. Correct. Having responsibility for the sales force does NOT allow the person to impact adversely the financial statements.**

c. Incorrect. Primary responsibility for the preparation of the financial statements allows the individual to adversely impact the financial statements and makes them in a key position.

d. Incorrect. The ability to exercise influence over the contents of the financial statements in any capacity is a key position.

5. Which of the following statements is the BEST answer? "All sections of society are recipients ... of the work of the profession. Society includes:

a. Incorrect. Clients & credit grantors are most definitely a part of society; however, this is not the BEST answer.

b. Incorrect. Governments are most definitely a part of society; however, this is not the BEST answer.

c. Incorrect. Employers & investors are most definitely a part of society; however, this is not the BEST answer.

**d. Correct. All of the above are a part of Society**

## Chapter 3 Feedback to Review Questions

1. In which of the following situations would a CPA be considered independent?
  - a. **Correct.** The position of staff training instructor does not require decision making or indicate financial interest, which would cause the CPA to not be independent.
  - b. Incorrect. Acquisition of a small direct interest is specifically stated as one of the situations where the CPA is not considered to be independent.
  - c. Incorrect. Acquisition of a large but indirect interest in the client is specifically stated as one of the situations where the CPA is not considered to be independent.
  - d. Incorrect. The position of controller involves decision-making, which is specifically prohibited and affects independence.
2. A member who performs auditing, review, compilation, consulting, tax, or other professional services shall comply with only:
  - a. **Correct.** Members have to comply with the standards set for the particular service performed.
  - b. Incorrect. Members have to comply with more than the Code.
  - c. Incorrect. Members have to comply with more than Generally Accepted Accounting Principles.
  - d. Incorrect. Internal Auditors are the only ones required to comply with Internal Auditing Standards.
3. Which one of the following professionals does not have a privileged information status with their client?
  - a. Incorrect. A medical doctor has the privilege under our laws so that they may treat patients psychologically as well as physically.
  - b. **Correct.** For the most part, CPAs cannot disclose confidential information, but they are not protected by law or given privileged information status exempting them from being required to do so.
  - c. Incorrect. In order to be an advocate for their client, attorneys have the right to not disclose communications with them.
  - d. Incorrect. In order to minister adequately and appropriately to members or parishioners, ministers of religious orders have privilege.



**4. What kind of working papers may a client request, and have a right to receive from its auditor?**

a. Incorrect. Analyses of and comments on management's strengths and weaknesses are made to determine future work and do not have to be given to the client.

**b. Correct. Sole support for any part of the financial statements is the basis for the client having a right to the auditor's working papers.**

c. Incorrect. Auditor's comments and conclusions concerning materiality are made to determine future work and do not have to be given to the client.

d. Incorrect. Analyses of and comments on management's strengths and weaknesses are made to determine future work and do not have to be given to the client and auditor's comments and conclusions concerning materiality are made to determine future work and do not have to be given to the client.

**5. Which one of the following groups does NOT require disclosure of commissions or anticipated commissions?**

**a. Correct. No disclosure is required to the AICPA.**

b. Incorrect. A member in public practice who do not perform an audit or review, examination of prospective statements, or compilation when independent is required and is not an exception to the rules.

c. Incorrect. A professional is always required to disclose to their client.

d. Incorrect. A professional is not required to disclose commissions or anticipated commissions to the Board of the State in which they practice.

## *Chapter 4 Feedback to Review Questions*

**1. The attest engagement team includes all of the following except:**

- a. Incorrect. The proprietor has to remain independent in order to participate in the performance of the attest engagement.
- b. Incorrect. The partners have to remain independent in order to participate in the performance of the attest engagement.
- c. Correct. These staff members would not be required to be independent since they had nothing to do with the attest engagement and were not in the same office.**
- d. Incorrect. The shareholders have to remain independent in order to participate in the performance of the attest engagement.

**2. Upon determining that a supervisor's recommendation for treatment of financial information could result in a material misstatement, the first step in the CPA's ethical obligation is to:**

- a. Incorrect. This is the third step.
- b. Incorrect. This is the fourth step.
- c. Incorrect. This is the second step.
- d. Correct. Determining if the supervisor is correct is the first step of a CPA's ethical obligation in a matter of disagreement with a supervisor.**

**3. When is a contingent fee or commission deemed to be received?**

- a. Incorrect. The receipt of money for the first time is not the first time the fee could be deemed received.
- b. Correct. When the fee or commission can be determined is the time it is deemed received.**
- c. Incorrect. This is not the best time to consider a fee to be received.
- d. Incorrect. A fee has not yet been earned.

4. Which of the following statements is FALSE? When an Attest Function CPA performs "Other Services" the client must be in a position to have an informed judgment on the results of the other services and that the client understands its responsibility to:
- a. **Correct.** The company must designate a Management-level individual to be responsible for overseeing the services being provided, not a staff person.
  - b. Incorrect. The client is responsible for evaluating the adequacy of the services performed and any findings that result.
  - c. Incorrect. The client is responsible for making management decisions, including accepting responsibility for the results of the other services.
  - d. Incorrect. The client is responsible for establishing and maintaining internal controls, including monitoring ongoing activities.
5. Which of the following new loans to be obtained from a financial institution client where independence is required is NOT an "Other Permitted Loan"?
- a. Incorrect. Collateralized automobile loans are permitted.
  - b. Incorrect. Fully collateralized loans by an insurance policy are permitted.
  - c. **Correct.** Partially collateralized loans are not permitted, no matter the collateral.
  - d. Incorrect. Credit cards of \$5,000 or less are permitted.