



PROFESSIONAL ETHICS

INDEPENDENCE AND NONAUDIT SERVICES

In August 2000 the Panel on Audit Effectiveness of the Public Oversight Board¹ addressed the important issue of the effect of nonaudit services on independence. The Panel on Audit Effectiveness reported the following shift in revenues of the then Big 5 CPA firms.

	1990 All Clients	1990 SEC Clients	1999 All Clients	1999 SEC Clients
Accounting and Auditing	53%	71%	34%	48%
Tax	27%	17%	22%	20%
Consulting	20%	12%	44%	32%
Total	100%	100%	100%	100%

During this nine-year period of time, the ratio of accounting and auditing fees to consulting fees for SEC clients changed from 6 to 1 to 1.5 to 1. This change led then SEC chairman Arthur Levitt to testify before the Panel on Audit Effectiveness as follows: "Is the audit merely a conduit to the cross-selling of other, more lucrative firm services? ... I have grave concerns that the audit process, long rooted in independence and forged through professionalism, may be diminished—perhaps even sacrificed—in the name of more financial and commercial opportunities."

At the other end of the spectrum, Dan Goldwasser, a member of the American Bar Association's law and accounting committee, stated that "Nonaudit services allow a firm to gain greater understanding of a company. The more an auditor knows about the company, the better."

Staff for the Panel on Audit Effectiveness performed its own in-depth review of the quality of audit work performed in a sample of 126 audits performed for public companies. Of these 126 audit engagements, 37 also included significant consulting engagements for the client. The staff did not identify any engagements in which providing nonaudit services had a negative effect on the audit, and they concluded that in about a quarter of these engagements the performance on nonaudit services had a positive impact on the audit. Based on its findings and testimony before the panel, they agreed that:

- Independence is essential for promoting public confidence in the audit process and must be monitored continuously.
- As long as auditors provide nonaudit services to audit clients, there will be at least an issue with respect to the appearance of independence.

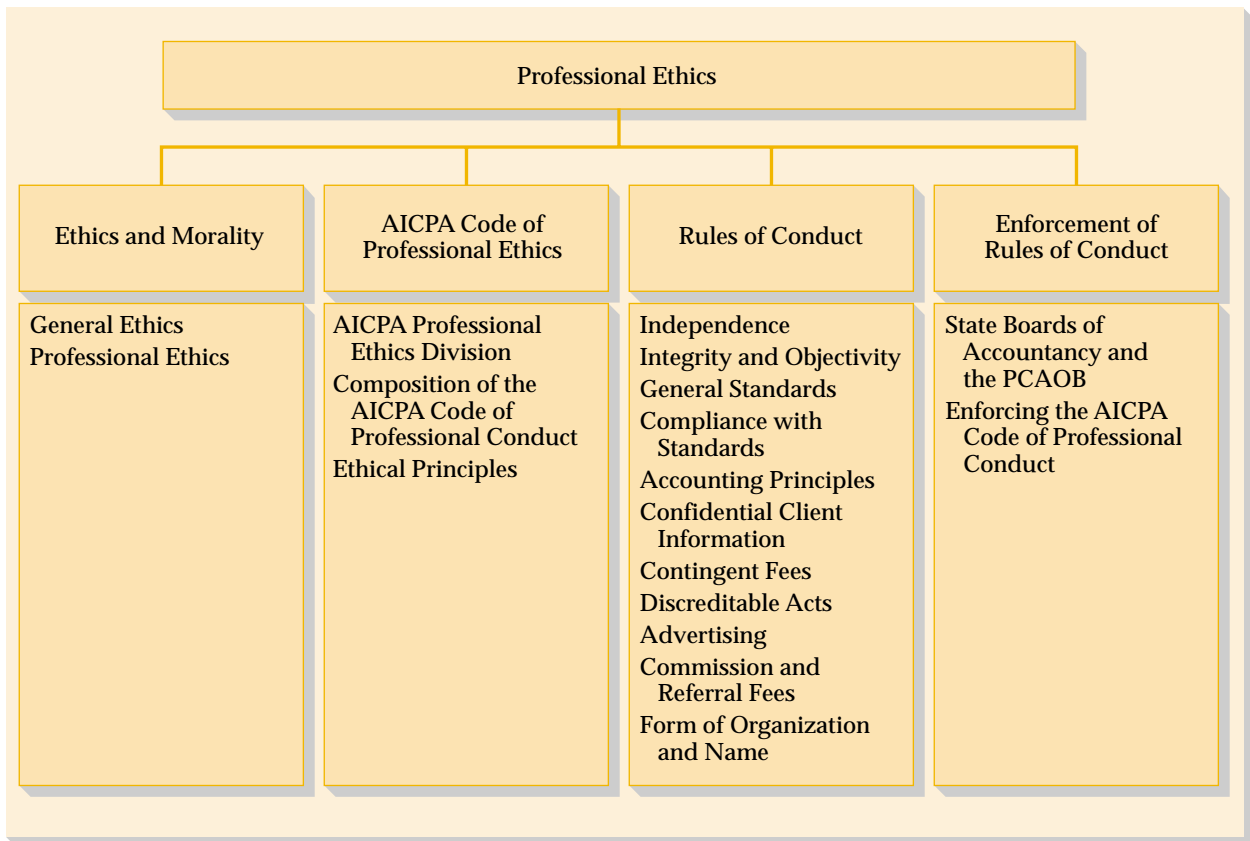
¹ Students can learn more about the Public Oversight Board (POB) at <http://www.publicoversightboard.org/about.htm>. The POB was formed in 1977 to oversee the SEC Practice Section of the AICPA and functioned as an important component of the accounting self-regulatory structure until it was dissolved in 2002.

- There has been an explosive growth in nonaudit services in recent years, to the point where many large firms' revenues from these services exceed their audit revenues.
- In their zeal to emphasize the array of services that CPAs offer, audit firms and the AICPA scarcely acknowledge auditing services in the public images that they portray. This serves to exacerbate the independence issue and to downplay the importance of auditing.

However, the Panel was split in its final conclusions about whether auditors of SEC registrants should be prohibited from performing nonaudit services. Readers can view the entire report and its arguments at www.pobauditpanel.org. The debate was partially resolved when the Sarbanes-Oxley Act of 2002 prohibited auditors of public companies from performing various nonaudit services. This matter is discussed further in this chapter in the section "Independence" and "Nonattest Services."

[PREVIEW OF CHAPTER 3]

One of the distinguishing characteristics of any profession is the existence of a code of professional conduct or ethics for its members. Ethical behavior requires consideration of more than a few results of conduct and regulatory activities. No professional code of ethics or regulatory framework can anticipate all the situations that might arise requiring professional judgments about ethical behavior. Accordingly, we begin this chapter with a brief discussion of general ethics before moving on to the subject of professional ethics. We then examine the AICPA's *Code of Professional Conduct* in considerable detail. The following diagram provides an overview of the chapter organization and content.



Chapter 3 addresses the following aspects of the auditor's knowledge and focuses on several important audit decisions related to a CPA Code of Professional Ethics.

focus on auditor knowledge

After studying this chapter you should understand the following aspects of an auditor's knowledge base:

- K1.** Know the nature of general ethics.
- K2.** Understand the purpose of professional ethics.
- K3.** Know the components of the AICPA Code of Professional Conduct and related pronouncements.
- K4.** Understand the essence of the Code's six ethical principles.
- K5.** Know the organizations and procedures involved in enforcing the Rules of Conduct.

focus on audit decisions

After studying this chapter you should understand the factors that influence the following audit decisions.

- D1.** What must a CPA do to comply with the Rules of Conduct regarding independence, integrity, and objectivity?
- D2.** What must a CPA do to comply with the Rules of Conduct regarding general standards and accounting principles?
- D3.** What must a CPA do to comply with the Rules of Conduct regarding responsibilities to clients?
- D4.** What must a CPA do to comply with the Rules of Conduct regarding other professional responsibilities and practices?

ETHICS AND MORALITY

Ethics is derived from the Greek word *ethos*, meaning “character.” Another term for ethics is **morality**, which comes from the Latin *mores*, meaning “custom.” Morality focuses on the “right” and “wrong” of human behavior. Thus, ethics deals with questions about how people act toward one another. Philosophers and ethicists have developed numerous theories of ethical conduct.

GENERAL ETHICS

People are constantly confronted with the need to make choices that have consequences for both themselves and others. Too often, an **ethical dilemma** arises where what is good for one party affected by a choice is not good for another party affected by the same choice. In some cases, individuals are confronted by competing ethical values. It has been said that in such situations, individuals should ask two questions: “What good do I seek?” and “What is my obligation in this circumstance?”

General ethics attempts to deal with these questions by defining what is good for the individual and society, and by trying to establish the nature of obligations

Auditor Knowledge 1

- Know the nature of general ethics.

or duties that individuals owe themselves and each other. But the inability to agree on what constitutes that “good” and “obligation” has led philosophers to divide into two groups. One group, the *ethical absolutists*, maintain that there are universal standards that do not change over time and that apply to everyone. The other group, the *ethical relativists*, says that people’s ethical judgments are determined by the changing customs and traditions of the society in which they live. Some argue that both groups are right—that every individual makes numerous life choices that must be guided by unchanging universal standards, and many other choices that are subject to the changing mores of society.

Because no universal set of standards or changing codes of ethics can clearly point to the correct choice of behavior in all situations, some ethicists have worked on developing frameworks for general ethical decision making. Following is one such six-step framework.

1. Obtain the facts relevant to the decision.
2. Identify the ethical issues from the facts.
3. Determine who will be affected by the decision and how.
4. Identify the decision maker’s alternatives.
5. Identify the consequences of each alternative.
6. Make the ethical choice.

This framework is particularly helpful when clear choices are not available such as when ethical rules of conduct or the application of accounting principles require significant professional judgment, or in situations where there may be competing ethical values.

PROFESSIONAL ETHICS

Professional ethics represent a commitment by a profession to ethical principles and rules of conduct. A commitment to ethical behavior is a key element that separates recognized professions from other occupations. They usually represent standards of behavior that are both idealistic and practical in purposes. Although codes of ethics may be designed in part to encourage ideal behavior, they must also be both practical and enforceable. To be meaningful they must strike a balance of being above the law but below the ideal.

States often grant professions exclusive rights to practice a professional activity. In most states CPAs are the only professionals that can sign an audit report. In return for this monopoly, professionals have an obligation to act in the public interest. A profession imposes professional ethics on its members who voluntarily accept standards of professional behavior that are more rigorous than those required by law. In many states, state boards of accountancy impose similar ethical standards. A code of ethics significantly affects the reputation of a profession and the confidence in which it is held.

In 1999 the forward-looking CPA Vision Project acknowledged that the profession must be recognized more for its values than for its services. The CPA Vision Project identified the following five core values associated with the CPA profession.

- Integrity
- Objectivity

Auditor Knowledge 2

- Understand the purpose of professional ethics.

- Competence
- Continuing education and lifelong learning
- Attuned to broad business issues

In aggregate, these values are important to earning the public's trust. Auditors deliver value to shareholders and other investors when they have the competence to identify potential material misstatements in financial statements, and they also have the integrity to expect the client to revise the financial statements or receive a qualified opinion on those statements.

LEARNING CHECK

- 3-1 How do general ethics guide human behavior?
- 3-2 What is the difference between the ethical absolutists and ethical relativists schools of thought?
- 3-3 a. What are the six steps in the general framework for ethical decision making?
b. Develop an example of when these six steps would be helpful to CPAs.
- 3-4 a. What is the purpose of professional ethics?
b. How are professional ethics imposed?
- 3-5 a. State the core values identified in the CPA Vision Project.
b. Explain why each of these values is important to the public's confidence in the public accounting profession.

KEY TERMS

Ethical dilemma, p. 103
 Ethics, p. 103
 General ethics, p. 103

Morality, p. 103
 Professional ethics, p. 104

AICPA CODE OF PROFESSIONAL ETHICS

We now turn our attention to the AICPA's Code of Professional Conduct, which governs AICPA members and is administered by the AICPA Professional Ethics Team. Students should be particularly aware that many state boards of accountancy have adopted their own code of ethics that applies to all CPAs who hold a license from the state board. Most state boards of accountancy have adopted rules that are similar to the AICPA code, but they may differ in unique respects. If an auditor is auditing a public company, he or she must also conform to SEC and PCAOB regulations and rules that are discussed later in this chapter. The AICPA Code is discussed here as it governs over 350,000 members in every state and jurisdiction in the United States.

AICPA PROFESSIONAL ETHICS DIVISION

Professional ethics are so important to the accounting profession that the bylaws of the AICPA provide that there shall be a Professional Ethics Division. The mission of the Professional Ethics Division is to (a) develop and maintain standards of ethics and effectively enforce such standards, thereby ensuring that the public interest is protected, (b) increase the public awareness of the value of the CPA; and (c) provide timely and quality guidance to enable members to be the premier value providers in their field. The division consists of a relatively small full-time staff, active volunteer members, and ad hoc investigatory volunteers, as needed. The Professional Ethics Division performs the following major functions to accomplish its mission.

- **Standard setting:** The Professional Ethics Executive Committee interprets the AICPA Code of Professional Conduct and proposes amendments to the code of conduct.
- **Ethics enforcement:** The Professional Ethics Team investigates complaints of potential disciplinary matters involving members of the AICPA and state CPA societies through the Joint Ethics Enforcement Program (JEEP).
- **Technical inquiry services (“ethics hotline”):** The professional Ethics Team educates members and promotes the understanding of ethical standards contained in the AICPA Code of Professional Conduct by responding to member inquiries on the application of the AICPA Code of Professional Conduct to specific areas of practice.

The Professional Ethics Division also publishes a quarterly newsletter. You can learn more about the AICPA Professional Ethics Division at <http://www.aicpa.org/members/div/ethics/index.htm>.

COMPOSITION OF THE AICPA CODE OF PROFESSIONAL CONDUCT

The **AICPA’s Code of Professional Conduct (the Code)** defines the ethical responsibilities for AICPA members. In 1988 the AICPA members adopted two sections of the AICPA’s Code of Professional Conduct:

- **Principles** that express the basic tenets of ethical conduct and provide the framework for the Rules.
- **Rules of Conduct** that establish minimum standards of acceptable conduct in the performance of professional services.

As expressions of the ideals of professional conduct, the Principles are not set forth as enforceable standards. In contrast, the Rules of Conduct establish minimum standards of acceptable conduct and are enforceable.

In addition to these two sections of the Code, the Professional Ethics Division’s Executive Committee issues the following pronouncements:

- **Interpretations of the Rules of Conduct** that provide guidelines about the scope and applicability of specific rules.
- **Ethical Rulings** that indicate the applicability of the Rules of Conduct and Interpretations to a particular set of factual circumstances.

Auditor Knowledge 3

■ Know the components of the CPA’s Code of Professional Conduct and related pronouncements.

Figure 3-1 ■ AICPA Code of Professional Conduct Sections and Related Pronouncements

	Component	Nature	Enforceable?
Code Section:	Principles	Express the basic tenets of ethical conduct and provide a framework for the Rules.	No
	Rules of Conduct	Establish minimum standards of acceptable conduct in the performance of professional services.	Yes
Related Pronouncement:	Interpretations of Rules of Conduct	Provide guidelines about the scope and applicability of specific rules.	The CPA must be prepared to justify any departures.
	Ethical Rulings	Indicate the applicability of the rules and interpretations to particular factual circumstances.	The CPA must be prepared to justify any departures.

Members who depart from the interpretations or ethical rulings must justify such departures in disciplinary hearings. A summary of the Code sections and related pronouncements is presented in Figure 3-1.

ETHICAL PRINCIPLES

Auditor Knowledge 4

■ Understand the essence of the Code's six ethical principles.

In the code of Professional Conduct, the following six principles express the basic tenets of ethical conduct and provide the framework for the Rules of Conduct:

- Responsibilities
- The public interest
- Integrity
- Objectivity and independence
- Due care
- Scope and nature of services

Responsibilities

In carrying out their **responsibilities** as professionals, members should exercise sensitive professional and moral judgments in all their activities.²

CPAs render important and essential services in our free enterprise system. All members have responsibilities to those who use their professional services. In addition, members have an ongoing responsibility to cooperate with other members to (1) improve the art of accounting, (2) maintain the public's confidence in

² All definitions of principles and rules are from applicable ethics sections of the *AICPA Professional Standards*, Volume 2 (New York: AICPA, 2005).

the profession, and (3) carry out the self-regulatory activities described in this chapter. The overall objective in meeting this principle is to maintain and enhance the stature of the public accounting profession.

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.

The **public interest** is defined as the collective well-being of the community of people and institutions that CPAs serve. The CPA's public interest includes clients, creditor grantors, governmental agencies, employees, stockholders, and the general public. A distinguishing mark of any profession is acceptance of its responsibility to the public.

CPAs are expected to meet professional standards in all engagements. In serving the public interest, members should conduct themselves in a manner that shows a level of professionalism consistent with the principles of the code.

Integrity

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

Integrity is a personal characteristic that is indispensable in a CPA. It is the benchmark by which members must ultimately judge all decisions made in an engagement. **Integrity** is measured in terms of what is right and just. Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Moreover, integrity requires that service and the public trust should not be subordinated to personal gain and advantage. Integrity can permit inadvertent error and the honest difference of opinion; however, it cannot tolerate intentional distortion of facts or subordination of judgment. 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.

Objectivity and Independence

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

Objectivity is a state of mind. Although this principle is not precisely measurable, it nevertheless is held up to members as an imperative. **Objectivity** means being impartial and unbiased in all professional matters. CPAs often serve multiple interests in many different capacities and must demonstrate their objectivity in varying

circumstances. CPAs in public practice render attest, tax, and management advisory services. Some CPAs also prepare financial statements in the role of CFO or Controller, and other CPAs work as internal auditors. Regardless of service or capacity, CPAs should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment. Irrespective of whether a CPA is an auditor or a member of management, CPAs owe a duty of remaining impartial and unbiased.

Independence precludes relationships that may appear to impair a member's objectivity in rendering attestation services. For example, a CPA's objectivity may be impaired if the auditor's spouse has an ownership interest in an audit client. No matter how competent CPAs may be in performing auditing and other attest services, their opinions will be of little value to those who rely on their reports unless they are independent. In rendering attest services, members must be **independent in fact**; this means that members should act with integrity and objectivity. Members must also be **independent in appearance**. To meet this test, members should not have a financial interest or a key business relationship with a client. For example, CPAs who perform attest engagements should not be part of management or serve on the client's board of directors. Members in public practice should continuously assess their relationship with clients to avoid situations that may appear to, or in fact, impair their independence.

Due Care

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.

The principle of due care is at the center of the profession's ongoing quest for excellence in the performance of professional services. **Due care** requires each member to discharge his or her professional responsibilities with competence and diligence.

Competence is the product of education and experience. Education begins with preparation for entry to the profession. It extends to continuing professional education throughout a member's career. Experience involves on-the-job training and acceptance of increased responsibilities during a member's professional life.

Diligence involves steady, earnest, and energetic application and effort in performing professional services. It also means that a member should (1) be thorough in his or her work, (2) observe applicable technical and ethical standards, and (3) complete the service promptly.

Due care extends to the planning and supervision of engagements for which a member is responsible. For example, each member is expected to properly supervise any assistants participating in an engagement.

Scope and Nature of Services

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

This principle applies only to a member who renders services to the public. In deciding whether to provide specific services in a given situation, a member should consider all of the preceding principles. If any principle cannot be met, the engagement should be declined. In addition, a member should:

- Practice only in a firm that has implemented internal quality control procedures.
- Determine whether the scope and nature of other services requested by an audit client would create a conflict of interest in providing audit services for that client.
- Assess whether the requested service is consistent with the role of a professional.

LEARNING CHECK

- 3-6 What are the major functions of the AICPA's Professional Ethics Division?
- 3-7 a. Identify the two sections of the AICPA's Code of Professional Conduct and the two types of pronouncements related to them.
b. Explain the enforceability of each of the section and related pronouncements.
- 3-8 a. What is the significance of the Principles of the AICPA's Code of Professional Conduct?
b. Explain the essence of the six principles in the Code.

KEY TERMS

Code of Professional Conduct, p. 106	Objectivity, p. 108
Due care, p. 109	Principles, p. 106
Ethical rulings, p. 106	Public interest, p. 108
Ethics enforcement, p. 106	Responsibilities, p. 107
Independent in appearance, p. 109	Rules of Conduct, p. 106
Independent in fact, p. 109	Standard setting, p. 106
Integrity, p. 108	Technical inquiry services, p. 106
Interpretations of the Rules of Conduct, p. 106	The public interest, p. 108

RULES OF CONDUCT

The AICPA Rules of Conduct guide a CPA in determining the appropriate professional behavior. For example, when a CPA finds financial fraud, who should be told? Management? The Board of Directors? The SEC? Shareholders? Creditors? Or what would be the impact on independence if an auditor's parents owned shares in an audit client? Can a consulting partner help the owner of a private

company sell his business and take a fee as a percentage of the sales price? These are the types of issues the Rules of Conduct are intended to sort out.

The Rules of Conduct consist of 11 enforceable rules, as categorized in Figure 3-2. In formulating the rules, the AICPA strives to serve the best interests of the public, the profession, and its members. The rules are modified from time to time to recognize evolving norms of ethical conduct and other influences such as changes mandated by government agencies. For example, the independence Rules of Conduct and interpretations were modernized in 2002 to meet the public and SEC expectations regarding nonaudit services and to address challenges associated with having many professionals in international accounting firms that do not influence audits. The new rules also address many of the challenges of dual-career families where a spouse might earn compensation in an employee stock option or stock purchase plan from an audit client.

The AICPA's bylaws require that members adhere to the Rules of Conduct. The rules are applicable to all members (in public practice and in industry) and to all professional services performed (attest, tax, etc.) except when (1) the wording indicates otherwise (several rules indicate that they apply only to members in

Figure 3-2 ■ AICPA Rules of Conduct

Section	Rule	Applicability	
		All Members	Members in Public Practice
Section 100	Independence, Integrity, and Objectivity		
101	Independence		✓
102	Integrity and objectivity	✓	
Section 200	General Standards and Accounting Principles		
201	General standards	✓	
202	Compliance with standards	✓	
203	Accounting principles	✓	
Section 300	Responsibilities to Clients		
301	Confidential client information		✓
302	Contingent fees		✓
Section 400	Responsibilities to Colleagues		
	(No currently effective rules in this section.)		
Section 500	Other Responsibilities and Practices		
501	Acts discreditable	✓	
502	Advertising and other forms of solicitation		✓
503	Commission and referral fees		✓
505	Form of organization and name		✓

public practice) and (2) a member is practicing outside the United States and conforms to the host country’s rules of the organized accounting profession. CPAs must also adhere to relevant state and SEC ethical rules.

A member in public practice may be held responsible for compliance with the rules of all persons under the member’s supervision or those who are the member’s partners or shareholders in the practice. In addition, a member cannot permit others to carry out acts on his or her behalf that, if carried out by the member, would violate the rules.

The following discussion states each rule and explains essential features of the rules.

RULE 101—INDEPENDENCE

Rule 101—Independence. A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.

Audit Decision 1

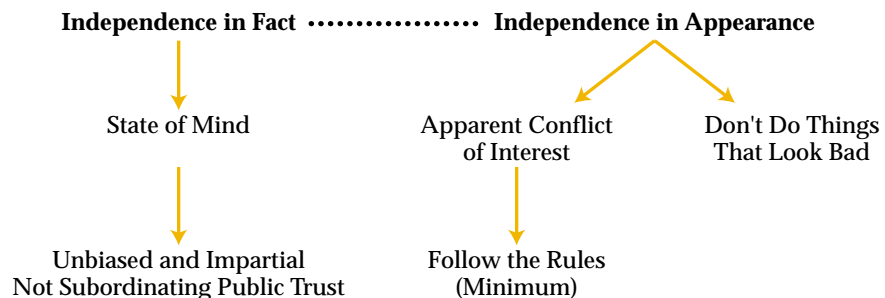
■ What must a CPA do to comply with the Rules of Conduct regarding independence, integrity, and objectivity?

Independence is the cornerstone of the auditing profession. It is so important that every auditor’s report is entitled “Independent Auditor’s Report.” Financial statement users need to know that auditors are independent of the entities that they audit.

Auditors frequently think about independence in two ways; independence in fact and the appearance of independence. These facets of independence are depicted in Figure 3-3. Being **independent in fact** can be defined as acting with integrity and objectivity. Independence in fact is about being honest, about not subordinating the public trust to personal gain and advantages, and about being unbiased and impartial when performing attest services. Independence in fact is difficult for others to observe, but it is nevertheless the cornerstone upon which audit services provide value.

Being **independent in appearance** addresses a number of potential conflicts of interest that can be observed. An auditor’s (or immediate family member’s) having ownership interest in an audit client, participating in a joint venture with an attest client, having litigation threatened by an attest client, or having a loan from

Figure 3-3 ■ Independence in Fact vs. Appearance



an audit client are examples of the types of activities that impair the appearance of independence for an audit firm.

Independence in fact is a state of mind, and it is impossible to observe what a CPA is thinking when performing attest services. In spite of the fact that it is difficult to observe independence in fact, *it is essential that the auditor approach every audit decision in an unbiased fashion*. The *appearance of independence* is observable and subject to enforcement under the Rules of Conduct. Rule 101 specifies a number of circumstances that can impair the appearance of independence to guide members in observable aspects of ethical conduct. The common factor of the issues raised in Rule 101 is that they are targeted at situations where CPAs appear to have a conflict of interest, such as having loans from clients or providing certain consulting services to clients. In addition, CPAs must use their common sense and avoid situations that look bad to the public, which relies on the CPAs independence.

Rule 101 incorporates into the Code, by reference, the independence requirements in technical standards issued by the AICPA. The bodies that have issued standards that include a requirement that the CPA be independent are the Auditing Standards Board and the Accounting and Review Services Committee. For example, a member must be independent in performing attest services such as a financial statement audit, an examination of prospective financial statements, and a review of the financial statements of a nonpublic entity. A member is not required to be independent in rendering nonattest services such as accounting, tax, and consulting services.

General Independence Rules

In November 2000 the SEC adopted the first changes in its independence rules since 1983, and the AICPA adopted similar rules in 2001. This discussion addresses the underlying drivers that caused the SEC and the AICPA to amend their independence rules, followed by a discussion of the new AICPA interpretations of the independence rules.

The accounting industry changed dramatically in the 1990s following the consolidation of many international CPA firms, the increasing globalization of accounting firms, and these firms' offerings of a wide range of multidisciplinary services. Today CPA firms have many professionals all over the globe, along with their family members, who have no influence over an audit. CPA firms have also seen an increase in the number of dual-career families who potentially have independence problems when an accounting professional's spouse receives compensation through stock options or other stock ownership schemes from an employer who is also an audit client. The growth of nonaudit services raises questions about the ability of CPA firms to remain independent while providing services that may result in professional fees that are larger than those provided by the independent audit. The following discussion addresses the independence rules as they apply to members of an accounting firm's professional staff and their family members. The discussion of interpretation 101-3 addresses the AICPA rules regarding nonaudit services.

An Engagement-Based Approach

The new independence rules follow an engagement-based approach and define a level of accounting professional—a covered member—who is a person in a position to potentially influence audit decisions or the outcome of an audit. The independence rules are particularly strict for a professional who falls under the *covered*

member rules. These key independence terms are summarized in Figure 3-4. **Covered members** are defined as:

- Members of the engagement team, including any professional who spends even a few minutes performing work on an attest engagement.
- Partners and managers with consultation, oversight, or review responsibilities related to the engagement. These could be regional audit partners with review responsibilities for all the audit engagements in their region, or partners with industry specialization who regularly consult with other partners on audit matters.
- Direct supervisors of the engagement partner, including all successive senior levels. This would include any direct supervisor of the engagement partner, all the way up to the senior partner in the accounting firm.
- Professionals who perform (or expect to perform) more than 10 hours of nonattest services for the client. For example, a professional who performs only 8 hours of tax services would not be considered someone who could influence the audit. However, once a tax or consulting professional delivers 10 or more hours of professional services to an audit client, he or she is considered to be a covered member.
- Partners who are in the same office as the lead partner on the engagement. Other partners in an office may have influence over compensation issues or other management decisions in the office, and hence they may be in a position to influence the audit even though they are not on the audit team. They therefore need to be independent of all audit engagements associated with the office. The term *office* is also broadly defined and represents the substance of work relationships, not just a physical location.
- The firm, its benefit plans, and entities controlled by covered members. Hence, the firm or its benefit plan cannot invest in an audit client. Furthermore, a covered member cannot control an entity that invests in an audit client.
- Those who evaluate partners' performance and compensation, including members of compensation committees. This means other partners who have significant influence over the lead partner on an audit engagement.
- Individuals who consult with the audit team regarding technical or industry-related issues that are specific to the engagement. This is intended to include individuals who are authorized to give advice to the audit team and there is no minimum hours test. This will usually include partners and managers who may be called upon for specialized accounting or auditing advice.
- Individuals who participate in quality control activities for the firm. These are usually partners and managers who conduct internal peer reviews and evaluate audit quality.

The *covered member* standard is one that includes a wide variety of individuals in an accounting firm who are in a position to influence audit decisions. However, it does not result in every professional in the firm having to meet the same standard.

Prohibited Activities

In order to preserve the appearance of independence, covered members are prohibited from the following activities. A *covered member* cannot:

- Have a direct, or material indirect, investment in the audit client. Hence, a covered member cannot have any direct investment in an audit client. A

Figure 3-4 ■ Key Independence Terms

Covered Members

- Any member of the engagement team
- Partners and managers with consultation, oversight, or review responsibilities related to the engagement.
- Direct supervisors of the engagement partner, including all successive senior levels
- Professionals who perform (or expect to perform) more than 10 hours of nonattest services for the client.^a
- Partners who are in the same office as the lead partner on the engagement.^a
- The firm, its benefit plans, and entities controlled by covered members
- Those who evaluate partners' performance and compensations, including members of compensation committees
- Individuals who consult with the audit team regarding technical or industry-related issues specific to the engagement. This is intended to include individuals who are authorized to give advice to the audit team, and there is no hours test.
- Individuals who participate in quality control activities for the firm.

Covered Members' Immediate Family

- Spouse
- Spousal equivalent
- Dependents

Covered Members Close Relatives

- Parents
- Nondependent children
- Brothers and sisters

All Other Professional Employees and Their Immediate Family Members

Prohibited Activities

- Cannot have a direct, or a material indirect, investment in the audit client.
- Cannot be a trustee or a trust or executor of an estate who invests directly in an audit client. (The AICPA and SEC permit an exception for a trustee who lacks authority to make investment decisions.)
- Cannot have a joint, closely held investment that is material to the covered member.
- Cannot have loans to or from the audit client. (There are some very limited exceptions.)

Prohibited Activities

- Exactly the same as for a covered member.
- Cannot be employed in a "key position" with an audit client.
 - In a position to exercise influence over the financial statement, such as CEO, CFO, member of the board of directors, or treasurer.
 - Prepares, or supervises others who prepare, (1) the financial statements or (2) material accounting records.
 - Involved in accounting decision making.

Prohibited Activities

- May not hold a key position with an audit client.
- May not hold a material financial interest in an audit client, or have significant influence over an audit client (APB 18).

Prohibited Activities

- Cannot have a direct investment of 5% or more in an audit client.
- Cannot have a business or key position employment relationship with an audit client.
- Cannot be a trustee, director or officer of an audit client, or a client's pension or profit-sharing trust.

^a Certain covered members, nonattest partners and managers, and other partners in the office of the lead engagement partners may have an immediate family member who works for an audit client as long as they are not in a "key position." Immediate family members may participate in an employee benefit plan that includes employee stock ownership plans or employee stock option plans as long as benefits are offered equitably to all similar employees.

covered member can, however, own shares in a mutual fund that owns shares in the audit client, as long as the investment is immaterial to the covered member.

- Be a trustee of a trust or executor of an estate who invests directly in an audit client. Both the AICPA and SEC permit an exception for a trustee who lacks authority to make investment decisions.
- Have a joint, closely held investment that is material to the covered member. Hence, a covered member cannot form a joint business venture with an audit client. A covered member also cannot form such business ventures with officers and directors of audit clients.
- Cannot have loans to or from the audit client. There are some very limited exceptions to this rule, but the general rule is that a covered person cannot accept a loan from an audit client or loan money to an audit client. The limited exceptions allow for some loans that were permitted prior to the existing rules to remain in place. The exceptions to the rule also allow for automobile loans and leases collateralized by the automobile; loans fully collateralized by the cash surrender value of an insurance policy; loans fully collateralized by cash deposits at the same financial institution (e.g., “passbook loans”); and credit cards and cash advances where the aggregate outstanding balance on the current statement is reduced to \$5,000 or less by the payment due date.

Immediate Family Members

An **immediate family member** of a covered member would be the covered member’s spouse, spousal equivalent, or dependent. A dependent could be a child, a parent, or another person who is dependent upon the covered person. An immediate family member is prohibited from the same activities that are prohibited for a covered member. The relationship is considered to be so close that any relationship between an immediate family member and an audit client is equivalent to the relationship between a covered member and the audit client.

In addition, an audit client cannot employ an immediate family member in what is defined as a **key position**. A key position would include a position where an immediate family member could exercise influence over the financial statement, such as CEO, CFO, member of the board of directors, or treasurer. In addition, a key person would be someone who prepares, or supervises others who prepare, (1) the financial statements or (2) material accounting records, or is involved in accounting decision making. Hence, an immediate family member could hold a position in marketing or management for an audit client, as long as that person was not in a position to exercise influence over the preparation of the financial statements.

An important issue for many spouses is their ability to participate in stock compensation plans. Today, it is common for many employees to be compensated with equity securities in addition to cash. A spouse of an accounting firm professional who is not a covered member can participate in an employee benefit plans that include employee stock ownership plans or employee stock option plans as long as the benefits are offered equitably to all similar employees. The same benefits are also extended to a limited group of covered members, nonattest partners and managers, and other partners in the office of the lead engagement partners may have an immediate family member who works for an audit client as long as they are not in a *key position*.

Close Relatives

A **close relative** of a covered member is defined as parents, nondependent children, and brothers and sisters. Independence is impaired for an audit firm if a close family member of a covered member (1) holds a key position with an audit client, or (2) holds a direct investment in the audit client that is material to the close relative, or (3) holds an investment that enables a close family member to have significant influence over an audit client.

Other Professionals and Their Immediate Family Members

A number of professionals (particularly tax and management advisory professionals) in an accounting firm are not considered covered members with respect to an audit engagement under the new standards. These professionals who are not in a position to influence the outcome of an audit, and their immediate family members, are allowed to have a direct investment in an audit client as long as the investment does not exceed 5 percent of the outstanding equity securities. For example, a tax partner in Cleveland, or her spouse, may have an investment in an audit client in San Francisco as long as the tax partner does not spend more than 10 hours a year performing nonaudit services for the client. Remember, independence would be impaired if the tax partner performed even one hour of audit services for the client. In addition, other professionals cannot have a business or an employment relationship with an audit client, and they cannot be a trustee, director, or officer of an audit client or a client's pension or profit-sharing trust.

Independence Interpretations

Since independence is critical to a variety of attest services, the AICPA has published 14 interpretations pertaining to Rule 101. These are summarized in Figure 3-5. A link to the actual ethical interpretations can be found at <http://www.aicpa.org/about/code/index.htm>. Several themes run through these interpretations. These include the effect of employment relationships with an attest client, nonaudit services, litigation, and unpaid fees for professional services on independence.

Employment or Association with an Attest Client

When a partner or professional employee of a CPA firm leaves the firm and is subsequently employed by an audit client, independence can be impaired inasmuch as the partner or professional employee may have continuing relationships, such as the payout of a pension plan, with the CPA firm. Furthermore, if a professional employee goes to work for an audit client, that employee may be familiar with the audit plan and/or staff working on the engagement, and there is a risk that the former employee could influence the engagement. These are important risks that may impair an audit firm's independence.

The rules are different for public and for private companies. With respect to public companies, Section 206 of the Sarbanes-Oxley Act of 2002 states that the CEO, Controller, CFO, Chief Accounting Officer, or person in an equivalent position cannot have been employed by the company's audit firm during the one-year period preceding the audit.

Figure 3-5 ■ Interpretations of Rule 101 on Independence

101-1—Interpretation of Rule 101: This interpretation defines a covered person and addresses financial interests and other relationships that impair independence.

101-2—Employment or association with attest clients: Addresses circumstances in which the partner or professional employee leaves a firm and subsequently becomes employed by or associated with an audit client, and specifies the conditions that must exist to maintain independence.

101-3—Performance of nonattest services: Often members assist clients by providing nonattest services including bookkeeping and financial statement preparation. This interpretation outlines important responsibilities that the client's management must take responsibility for in order to preserve independence, and it identifies activities that impair independence.

101-4—Honorary directorships and trusteeships of not-for-profit organization: Provides guidance when a member is asked to serve as an honorary director or trustee for an attest client.

101-5—Loans from financial institution clients and related terminology: A member's independence would normally be impaired if the covered member has any loan to or from an audit client or any officer, director, or principal stockholder of the client. This interpretation explains some specific exceptions to this general rule.

101-6—The effect of actual or threatened litigation on independence. Explains circumstances in which independence may be considered to be impaired as a result of litigation or the expressed intention to commence litigation.

[101-7]—[Deleted]

101-8—Effect on independence of financial interests in nonclients having investor or investee relationships with a member's client: Explains various ways in which a financial interest in a nonclient that has a significant influence on a client may impair independence with respect to a client.

[101-9]—[Deleted]

101-10—The effect on independence of relationships with entities included in the governmental financial statements: In general, a member issuing a report on a governmental client's general-purpose financial statements must be independent of the client. However, independence is not required with respect to a related organization if the client is not financially accountable for the organization and the required disclosure does not include financial information (for example, the ability to appoint or the appointment of governing board members).

101-11—Modified application of Rule 101 for certain engagements to issue restricted-use reports under the Statements on Standards for Attestation Engagements: Provides guidance on independence for engagements that are restricted for use only by identified parties.

101-12—Independence and cooperative arrangements with clients. In general, 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 joint business activity with the client that was material to the CPA's firm or to the client.

101-13—[Deleted].

101-14—The effect of alternative practice structures on the applicability of independence rules: Because of changes in the manner in which CPAs are structuring their practices, this interpretation provides guidance on how various alternatives to "traditional structures" affect independence.

With respect to private companies, a firm's independence will be considered impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by the client in a key position, unless all of the following conditions are met.

1. Amounts due to the former partner or professional employee for his or her previous interest in the firm and for unfunded, vested retirement benefits are not material to the audit firm, and the underlying formula used to calculate the payments remains fixed during the payout period. Retirement benefits may also be adjusted for inflation, and interest may be paid on amounts due.
2. The former partner or professional employee is not in a position to influence the accounting firm's operations or financial policies.
3. The former partner or professional employee does not participate or appear to participate in, and is not associated with the firm, whether or not compensated for such participation or association, once employment or association with the client begins. An appearance of participation or association results from such actions as:
 - The individual provides consultation to the firm.
 - The firm provides the individual with an office and related amenities (for example, secretarial and telephone services).
 - The individual's name is included in the firm's office directory.
 - The individual's name is included as a member of the firm in other membership lists of business, professional, or civic organizations, unless the individual is clearly designated as retired.
4. The ongoing attest engagement team considers the appropriateness or necessity of modifying the engagement procedures to adjust for the risk that, by virtue of the former partner or professional employee's prior knowledge of the audit plan, audit effectiveness could be reduced.
5. The firm assesses whether existing attest engagement team members have the appropriate experience and stature to effectively deal with the former partner or professional employee and his or her work, when that person will have significant interaction with the attest engagement team.
6. The subsequent attest engagement is reviewed to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former partner or professional employee, when the person joins the client in a key position within one year of disassociating from the firm and has significant interaction with the attest engagement team. The review should be performed by a professional with appropriate stature, expertise, and objectivity and should be tailored based on the position assumed at the client, the position he or she held at the firm, the nature of the services he or she provided to the client, and other relevant facts and circumstances. Appropriate actions, as deemed necessary, should be taken based on the results of the review.

A partner or a professional employee merely seeking employment with an audit client may also impair independence. Rule 101-2 states that when a member of the attest engagement team or an individual in a position to influence the attest

engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. The purpose of this rule is to avoid situations where a person's integrity or objectivity might be compromised. If a professional is seeking a job from an audit client, it is important to avoid a situation where the person might be tempted to take an aggressive stance in favor of the client on a matter of professional judgment while seeking the favor of a client by way of a job offer.

When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the audit firm. Furthermore, the appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that person was performed with objectivity and integrity as required under Rule 102.

Nonattest Services

A major issue that the auditing profession has faced in the last decade is whether the performance of **nonattest services** (such as accounting services or financial statement design and implementation) impairs an auditor's integrity and objec-

PCAOB
Public Companies
Accounting Oversight Board

PCAOB, public companies and nonattest services

The Sarbanes-Oxley Act of 2002 makes it "unlawful" to perform audit services for a public company and also perform the following **nonattest services**:

- Bookkeeping or other services related to the accounting records or financial statements of the audit client.
- Financial information systems design and implementation.
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
- Actuarial services.
- Internal audit outsourcing services.
- Management functions or human resources.
- Broker or dealer, investment advisor, or investment banking services.
- Legal services and expert services unrelated to the audit.
- Any other service that the PCAOB determines, by regulation, is impermissible.

Many of these services put the auditor in a position where they might have to audit their own work, thereby creating the potential to impair independence. In addition, the audit committee of a public company must preapprove other nonattest services provided to public companies, and those services must be disclosed in periodic reports to investors.

tivity. Critics wonder whether an auditor can be objective with respect to audit issues when fees from nonattest services exceed fees from attest services. Can an auditor objectively evaluate the design and operation of internal controls when the auditor received substantial fees for information system design and implementation?

When an auditor considers the rules related to nonattest services and independence, he or she needs to understand that a different set of rules applies to auditors of public companies and auditors of private companies. Both the SEC and the Sarbanes-Oxley Act of 2002 set out the public company guidelines. The AICPA and state boards of accountancy have rules appropriate to private companies. The AICPA and many state boards of accountancy allow activities for private companies that are not allowed for public companies because many private companies (e.g., owner-managed business and small not-for-profit organizations that require audits) do not have the resources to internalize services that are often performed within public companies. The rules for public companies are presented on p. 120. The following discussion outlines the appropriate rules for nonattest services as they relate to private companies.

Private Companies

AICPA Rule 101-3 allows a member of his or her firm to perform nonattest services for attest clients under certain conditions. In each case the CPA must evaluate the effect of nonattest services on independence. In general, a CPA should not perform management functions or make management decisions for the attest client. However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions. In addition, the client must agree to perform the following functions in connection with the engagement to perform nonattest services:

- Make all management decisions and perform all management functions.
- Designate a competent employee, preferably within senior management, to oversee the services.
- Evaluate the adequacy and results of the services performed.
- Accept responsibility for the results of the services.
- Establish and maintain internal controls, including monitoring ongoing activities.

Rule 101-3 indicates that before performing nonattest services, the member should establish, and document in writing, an understanding with the client regarding (1) the objectives of the engagement, (2) the services to be performed, (3) the client's acceptance of its responsibilities, (4) the CPA's responsibilities, and (5) any 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 nonattest services.

The purpose of the AICPA rule is to allow CPAs to assist many small business clients who may not have within the company a CPA, or a person with important expertise that may reside within a CPA firm. These businesses often need outside professional expertise that the CPA firm can provide. Nevertheless, a number of general activities would be considered to impair a CPAs firm's independence when auditing nonpublic companies. These include:

- 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.

Figure 3-6 provides examples of how the performance of these general activities would impair a CPA firm's independence, or how the client could take appropriate responsibilities to allow the CPA firm to assist the client without impairing independence.

Interpretation 101-3 provides a number of specific examples of activities that would or would not impair independence. For example, CPAs can perform various accounting and bookkeeping services for a client. Independence would be impaired if a CPA firm determined or changed journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval; authorized or approved transactions; prepared source documents; or made changes to source documents without client approval. Independence would not be impaired if the CPA recorded transactions for which management had determined or approved the appropriate account classification, posted coded transactions to a client's general ledger, prepared financial statements based on information in the trial balance, posted client-approved entries to a client's trial balance, or proposed standard, adjusting, or correcting journal entries or other changes affecting the financial statements of the client. The client should review the entries and the member should be satisfied that management understands the nature of the proposed entries and the impact of the entries on the financial statements. Students can read the actual interpretation for additional discussion related to payroll and other disbursements, benefit plan administration, investment-advisory services, corporate finance-consulting and advisory services, executive or employee search, business risk consulting, or information systems design, implementation, or integration.

Litigation

Litigation involving CPAs and their clients raises questions about a member's independence. In general, independence is impaired whenever the existence or expressed threat of litigation has significantly altered, or is expected to materially change, the normal relationship between a client and a CPA. Litigation that results in an adversary position between a client and a CPA, or that links management and the CPA as co-conspirators in withholding information from stockholders, would impair the CPA's independence. In contrast, litigation brought by stockholders against a CPA would not necessarily affect independence.

Figure 3-6 ■ Independence and Nonaudit Services for Nonpublic Clients

Examples Where Independence Is Impaired	General Activities That Will Impair Independence	Examples Where Independence Is Not Impaired
<p>A CPA may not accept responsibility to authorize payment of client funds, or accept responsibility to sign or cosign client checks, even if only in emergency situations.</p> <p>In a consulting engagement, a CPA may not act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents.</p> <p>In an accounting service engagement for a nonpublic client, a CPA may not determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval. A CPA may not prepare source documents or originate data or make changes to source documents without client approval.</p> <p>When performing payroll services, benefit plan administration, or other financial advisory services, a CPA may not have custody of client assets or maintain custody of client securities.</p> <p>In an information system engagement, a CPA may not supervise client personnel in the daily operation of a client's information system.</p> <p>In an investment advisory engagement with an attest and tax client, a CPA cannot make investment decisions on behalf of client management or otherwise have discretionary authority over a client's investments.</p> <p>In a consulting engagement, present business proposals to the board on the behalf of management.</p> <p>In an investment advisory engagement, a CPA may not execute a transaction to buy or sell a client's investment or have custody of client assets, such as taking temporary possession of securities purchased by a client.</p>	<p>Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so</p> <p>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)</p> <p>Having custody of client assets</p> <p>Supervising client employees in the performance of their normal recurring activities</p> <p>Determining which recommendations of the member should be implemented</p> <p>Reporting to the board of directors on behalf of management.</p> <p>Serving as a client's stock transfer or escrow agent, registrar, general counsel, or its equivalent</p>	<p>When assisting a small business client with payroll using payroll time records provided and approved by the client, the CPA can generate unsigned checks or process the client's payroll.</p> <p>In a consulting engagement, a CPA may assist in identifying or introducing the client to possible sources of capital that meet the client's specifications or criteria.</p> <p>In an accounting service engagement for a nonpublic client, a CPA may record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client's general ledger and prepare financial statements based on information in the trial balance.</p> <p>No examples are relevant.</p> <p>In an information system engagement, a CPA may design, install, or integrate a client's information system, provided the client makes all management decisions.</p> <p>In an investment advisory engagement with an attest and tax client, a CPA can 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, and so on.</p> <p>In an assurance engagement, provide recommendations for improving the system for monitoring business risks.</p> <p>In an investment advisory engagement, a CPA may 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.</p>

Unpaid Fees

The existence of unpaid fees for professional services has been deemed to assume the characteristics of a loan from the member to the client within the meaning of Rule 101 and its interpretations. Therefore, independence of the member's firm is considered to be impaired if, when the CPA's report on the client's current year is issued, fees remain unpaid, whether billed or unbilled, for professional services provided more than one year prior to the date of the report. This ruling does not apply to fees outstanding from a client in bankruptcy.

Examples of additional circumstances dealt with in other interpretations and ethics rulings on independence are presented in Figure 3-5.

RULE 102—INTEGRITY AND OBJECTIVITY

Rule 102—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.

Rule 102 is a wide sweeping rule regarding integrity and objectivity that extends to all professional services (attest services, taxation, and financial planning services, etc.) and to all members (CPAs who are employed, for example, as CFOs, controllers, or internal auditors as well as CPAs in public practice). For example, in dealing with his or her employer's external accountant, a member in industry must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. Furthermore, if a member in industry or in public practice has a disagreement or dispute with a supervisor relating to an accounting or auditing issue that is of significance to the financial statements or auditor's report, the member should take steps to ensure that the situation does not constitute a subordination of judgment. Such steps should include determining whether the supervisor's position represents an acceptable alternative under GAAP. If so, the member need do nothing further; if not, the member should bring the matter to the attention of someone at a higher level in the organization, such as the supervisor's superior. Ultimately, if the disagreement is not resolved satisfactorily to the member, he or she should consider (1) documenting the situation and (2) whether to continue his or her relationship with the employer. In addition, a member in public practice should not subordinate his or her judgments concerning the application of technical standards to the directives of clients. The public expects auditors to form their own independent judgments. Finally, a member performing a professional service for a client or employer should not have a significant relationship with another person, entity, product, or service that could be viewed as impairing the member's objectivity.

RULE 201—GENERAL STANDARDS

Rule 201—General standards. A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

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

- B. *Due Professional Care.* Exercise due professional care in the performance of professional services.
- C. *Planning and Supervision.* Adequately plan and supervise the performance of professional services.
- D. *Sufficient Relevant Data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

Audit Decision 2

■ What must a CPA do to comply with the Rules of Conduct regarding general standards and accounting principles?

These general standards should not be confused with the three general standards of GAAS introduced in the last chapter. The four general standards in Rule 201 apply to all members, including those not in public practice, and to all types of professional services, not just to audits.

Rule 201A, Professional Competence, involves not only the technical qualifications of the member and the member's staff, but also the CPA's ability to supervise and evaluate the quality of the work performed by others. This part of Rule 201 is specifically directed at the member's decision-making process when the CPA is deciding whether to accept or decline an engagement. If, on the basis of facts known at the time, the CPA believes he or she has the capability to complete the assignment in accordance with professional standards, it is ethically permissible to accept the engagement. However, if, for example, neither the CPA nor the firm has the computer expertise required to audit a client with a sophisticated electronic data processing system and cannot acquire the necessary knowledge, it is not ethical to accept the engagement.

Due professional care, planning and supervision, and sufficient relevant data codify practices that must be followed in performing any service. Adherence to these requirements contributes to the quality of performance of professional engagements for the benefit of the public and the profession.

RULE 202—COMPLIANCE WITH STANDARDS

Rule 202—Compliance with standards. A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by AICPA Council.

Currently, the technical standards that fall under this rule are those issued by the Auditing Standards Board, the Accounting and Review Services Committee, the Management Consulting Services Executive Committee, and the Tax Executive Committee. In addition, for purposes of this rule, Council has designated three bodies to promulgate standards of disclosure for financial information. They are the PCAOB, the FASB, the GASB, and the Federal Accounting Standards Advisory Board (FASAB).

RULE 203—ACCOUNTING PRINCIPLES

Rule 203—Accounting principles. A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to

(continues)

be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

What were the ethical requirements for CPAs who prepared the financial statements for Enron and WorldCom when it came to applying the rules of generally accepted accounting principles? Rule 203 of the Code of Conduct applies to all members, whether or not in public practice, who perform the acts described. Such acts will occur, for example, in (1) preparing or auditing financial statements, (2) performing an examination of prospective financial statements, or (3) reviewing interim financial information. The rule covers all services for which standards have been promulgated regarding GAAP, including engagements to report on a comprehensive basis other than GAAP. As noted above, Council has designated three groups to promulgate accounting principles: (1) the GASB for state and local government entities, (2) the FASAB for federal governmental entities, and (3) the FASB for all other entities.

RULE 301—CONFIDENTIAL CLIENT INFORMATION

Rule 301—Confidential client information. A member in public practice shall not disclose any confidential client information without the specific consent of the client.

This rule shall not be construed (1) to relieve a member of his or her professional obligations under rules 202 [ET section 202.01] and 203 [ET section 203.01], (2) to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or board of accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or board of accountancy.

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

Audit Decision 3

■ **What must a CPA do to comply with the Rules of Conduct regarding responsibilities to clients?**

It is fundamental that a CPA in public practice hold in strict confidence all information about a client's business affairs. Confidentiality is indispensable in establishing a basis of mutual trust between CPA and client.

Rule 301 requires the member to obtain the specific consent of the client before disclosing confidential client information. Preferably, the consent should be in

writing. Consent is not required when any of the four exceptions stated in the rule are applicable.

The exceptions to Rule 301 enable the member to fulfill both professional and legal responsibilities. For example, in issuing an audit report, the member may disclose information required under GAAP that is not included in the financial statements.

The Rule 301 requirement to maintain confidentiality should be distinguished from the legal concept of **privileged communication**. Federal and state statutes grant privileged communication in certain relationships such as those between attorney and client, doctor and patient, and priest and parishioner. In these cases, communications between the professional and the client cannot be revealed even to a court unless the client waives privilege. No federal statute extends privileged communication status to CPA–client relationships. However, state statutes related to privileged CPA–client communication exist in 18 states.³

Rule 301 is the source of a number of ethical dilemmas for CPAs. For example, suppose in auditing Client A, an auditor discovers A is overcharging Client B for inventory purchases.⁴ In addition, in the absence of a legislative or regulatory mandate, whistleblowing by auditors in cases involving illegal client acts runs counter to Rule 301.

RULE 302—CONTINGENT FEES

Rule 302—Contingent fees. A member in public practice shall not

- (1) Perform for a contingent fee any professional services for, or receive such a fee from a client for whom the member or the member’s firm performs,
 - (a) an audit or review of a financial statement; or
 - (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member’s compilation report does not disclose a lack of independence; or
 - (c) an examination of prospective financial information;

or

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

The prohibition in (1) above applies during the period in which the member or the member’s firm is engaged to perform any of the services listed above and the period covered by any historical financial statements involved in any such listed services.

Except as stated in the next sentence, a **contingent fee** is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. Solely for purposes of this rule, fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.

A member’s fees may vary depending, for example, on the complexity of services rendered.

³ The states with CPA–client privileged communication statutes are Arizona, Colorado, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maryland, Michigan, Missouri, Montana, Nevada, New Mexico, Pennsylvania, Tennessee, and Texas. Puerto Rico also has such a statute.

⁴ For an actual case of this type, see write-up of *Fund of Funds, Ltd. v. Arthur Andersen & Co.* in Chapter 4.

Consider the following three situations:

1. Can a CPA perform an audit for a stated fee, but where no fee is received unless the client receives a bank loan using the financial statements?
2. Can a CPA in a management advisory service practice help a client sell a business for a stated fee, but where no fee is received unless the business is sold?
3. Can a CPA in a tax practice prepare an amended tax return for a new client, where the fee is a percentage of the refund received by the client?

Prior to being amended in 1990, this rule contained a general prohibition against members accepting contingent fees in connection with any service for any client. In 1990, the AICPA changed the rule to comply with an order from the U.S. Federal Trade Commission (FTC), which deemed the former rule to be in restraint of trade. In its current form, the rule represents a compromise between the AICPA, which wanted to retain the general prohibition, and the FTC, which wanted the rule eliminated in its entirety.

The rule does not prohibit a member from charging a fee based on the complexity or number of hours or days needed to complete the service. A member may also elect to lower per diem billing rates for a financially troubled client or perform services without charge for a charitable organization.

In response to the three situations discussed above, contingent fee engagements impair independence, so none of these engagements can be performed for a client where the CPA also performs attest services. However, the second case involving the sale of a business could be performed for a business that was not an attest client. In the third case, a CPA cannot prepare an amended tax return for a contingent fee for any client, irrespective of whether the CPA performs attest services for the client.

RULE 501—ACTS DISCREDITABLE

Rule 501—Acts discreditable. A member shall not commit an act discreditable to the profession.

Audit Decision 4

■ **What must a CPA do to comply with the Rules of Conduct regarding other responsibilities and practices?**

Under Rule 501, **acts discreditable** are actions by a member that may damage or otherwise impinge on the reputation and integrity of the profession. This rule enables disciplinary action to be taken against a member for unethical acts not specifically covered by other rules. Discreditable acts generally include acts committed in a person's professional capacity. In interpretations, the following acts are designated as discreditable: (1) retention of client records and auditor working papers, such as adjusting entries, necessary to complete the client's records; (2) discrimination and harassment in employment practices; (3) failure to follow standards and/or other procedures or other requirements in governmental audits; (4) negligence in the preparation of financial statements or records; (5) failure to follow requirements of governmental bodies, commissions, or other regulatory agencies in performing attest or other similar services; (6) solicitation or disclosure of CPA examination questions and answers; and (7) failure to file a tax return or pay a tax liability. Failure to file a personal tax return or pay a personal tax liability is also considered discreditable act. A member who commits a discreditable act usually is suspended or expelled from the AICPA.

RULE 502—ADVERTISING AND OTHER FORMS OF SOLICITATION

Rule 502—Advertising and other forms of solicitation. A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited.

The rules on advertising were modified significantly in 1990 to comply with a Federal Trade Commission order. The rule on advertising is enforced to prevent members from engaging in falsehood or deception. The rule cannot be used to prevent or discourage members from (1) soliciting potential clients by any means, including direct solicitation, and (2) using advertising that includes self-laudatory or comparative claims, testimonials, or endorsements.

Interpretation 502-5 points out that members are often asked to render professional services to clients of third parties who may have obtained the clients as the result of their own advertising and solicitation efforts. Members are permitted to enter into such engagements. However, the member has the responsibility to ascertain that all promotional efforts are within the bounds of the Rules of Conduct. In short, members must not do through others what they are prohibited from doing themselves by the Rules of Conduct.

Some state boards of accountancy have rules against direct solicitation of clients and some forms of advertising.

RULE 503—COMMISSIONS AND REFERRAL FEES

Rule 503—Commissions and referral fees.

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

- (a) an audit or review of a financial statement; or
- (b) a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member's compilation report does not disclose a lack of independence; or
- (c) an examination of prospective financial information.

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

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

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

This rule was also modified significantly in 1990 to comply with a FTC order. The former rule contained a general prohibition against members accepting any commission, even when disclosed to, and approved by, the client. The FTC deemed the former rule to be in restraint of trade.

When the FTC order leading to the amendment of Rule 503 was imposed in 1990, CPAs in 50 of the 54 jurisdictions nonetheless remained subject to state statutes or state board of accountancy regulations that barred them from accepting contingent fees and commissions. Now, most of these jurisdictions have eliminated or reduced limits on these arrangements for nonattest services. However, students should be aware that some states may bar contingent fees and commissions either through state board regulations or through state statutes. Some states may permit contingent fees but not commissions, or they may permit CPAs to accept, but not pay, commissions and referral fees.

Under the current rule, a CPA may accept a disclosed commission. For example, a CPA may accept a disclosed commission from a computer manufacturer based on equipment purchased by a client on the CPA's recommendation, except when the CPA performs any of the services described in the rule for the same client. Payments by a CPA to obtain a client are now permitted provided disclosure is made to the client.

RULE 505—FORM OF ORGANIZATION AND NAME

Rule 505—Form of organization and name. A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council.

A member shall not practice public accounting under a firm name that is misleading. Names of one or more past owners may be included in the firm name of a successor organization.

A firm may not designate itself as “Members of the American Institute of Certified Public Accountants” unless all of its CPA owners are members of the Institute.

Prior to being amended in 1997, Rule 505 mandated that members practice public accounting only in the form of a proprietorship, partnership, or professional corporation. The rule also closely regulated the name of the member's practice. Today accounting firms can take advantage of any form of organization permitted by state law or regulation and as the organization's characteristics conform to resolutions of Council. One important resolution of Council includes a requirement that CPAs own the majority (greater than 50 percent) of the financial interests in an attest firm.

Interpretation 505-3 states that the overriding focus of the AICPA Council Resolution was that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. Interpretation 505-3 requires:

- Compliance with all aspects of applicable state law or regulation.
- Enrollment in an AICPA-approved practice-monitoring program.
- Membership in the SEC Practice Section if the attest work is for SEC clients (as defined by Council).
- Compliance with the independence rules prescribed by Rule 101, Independence.

- Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, Compliance with Standards [ET section 202.01]) and all other provisions of the Code of Conduct.

LEARNING CHECK

- 3-9 a. What authority underlies the Rules of the Code of Conduct?
b. To whom, and in what circumstances, do the Rules apply?
- 3-10 What trends influenced the adoption of an engagement-based approach to independence by the SEC and the AICPA?
- 3-11 a. What individuals would be “covered persons” under Rule 101-1, and what activities impair independence for “covered persons?”
b. What individuals would be “immediate family members” under Rule 101-1, and what activities impair independence for “immediate family members?”
c. What individuals would be “close relatives” under Rule 101-1, and what activities impair independence for “close relatives?”
d. What individuals would be “other professional employees” under Rule 101-1, and what activities impair independence for “other professional employees?”
- 3-12 a. Explain the circumstances under which a partner or professional employee of an audit firm could accept a job with a public company audit client for the firm.
b. Explain the circumstances under which a partner or professional employee of an audit firm could accept a job with a private company audit client for the firm.
- 3-13 a. Identify the nonattest services that impair independence for a public company audit client.
b. Identify the general activities that impair independence when performing nonattest services for a private company audit client.
- 3-14 What are the AICPA ethical standards that apply to a CPA who is a CFO for a company?
- 3-15 a. State the essence of Rule 201—General Standards.
b. Enumerate the four subcategories of this rule.
- 3-16 a. Explain five circumstances when a CPA could ethically disclose confidential client information.
b. Explain the circumstances in which contingent fee arrangements are prohibited under Rule 302.
- 3-17 Explain the acts that are prohibited under:
a. Rule 501—Acts Discreditable.
b. Rule 502—Advertising and Other Forms of Solicitation.
c. Rule 503—Commissions and Referral Fees.
- 3-18 a. Identify the forms of organization or practice units permitted under Rule 505.
b. What requirements must be met for a CPA to practice in any of these forms?

[KEY TERMS]

Accounting principles, p. 125	Form of organization and name, p. 130
Acts discreditable, p. 128	General standards, p. 124
Advertising and other forms of solicitation, p. 129	Immediate family member, p. 116
Close relative, p. 117	Independence, p. 112
Commissions and referral fees, p. 129	Independent in appearance, p. 112
Compliance with standards, p. 125	Independent in fact, p. 112
Confidential client information, p. 126	Integrity and objectivity, p. 124
Contingent fee, p. 127	Key position, p. 116
Covered member, p. 114	Nonattest services, p. 120
	Privileged communication, p. 127

[ENFORCEMENT OF THE RULES OF CONDUCT]

STATE BOARDS OF ACCOUNTANCY AND PUBLIC COMPANIES ACCOUNTING OVERSIGHT BOARD

Auditor Knowledge 5

■ Know the organizations and procedures involved in enforcing the Rules of Conduct.

Many states have written ethical rules into state accountancy statutes or state accountancy laws. In most cases these rules are similar to the AICPA Code of Conduct. Violation of the ethical statutes or rules is usually evaluated through due process provided by the board of accountancy. The sanctions available to many boards of accountancy are significant and can range from requiring continuing professional education to suspension or revocation of a license to practice as a CPA. A CPA must be aware of how the state accountancy law addresses ethical matters.

The Public Companies Accounting Oversight Board (PCAOB) has authority over audit firms that audit public companies and their professionals. The authority of the PCAOB is particularly relevant in the context of their rules regarding nonattest services. The PCAOB, through the SEC, has the authority to levy fines against firms and prohibit firms or individuals from auditing public companies.

ENFORCING THE AICPA CODE OF PROFESSIONAL CONDUCT

An AICPA member can only be charged with a violation of the Rules of the Code of Professional Conduct. However, in the event of an alleged violation of a rule, a member may have to justify any departures from applicable Interpretations of the Rules of Conduct and Ethics Rulings. Enforcement actions may be initiated as a result of (1) complaints by members and nonmembers, (2) review of newspapers and publications, such as the SEC *Docket* and the *IRS Bulletin*, by personnel in the Professional Ethics Division, and (3) transmittal of possible violations to the AICPA by state and federal agencies.

Enforcement of the Rules rests with two groups: the AICPA and state societies of CPAs. Both have the authority to undertake investigations of complaints, conduct hearings, and impose sanctions on those who have violated the Rules.

The AICPA's enforcement machinery resides in its Professional Ethics Division and a **joint trial board**. The maximum sanction that the AICPA can impose is to expel the member from the Institute.

State society enforcement is achieved through each state's Ethics Committee and the joint trial board. As in the case of the AICPA, the most severe sanction to be imposed by a state society is loss of membership in the society.

Joint Ethics Enforcement Procedures

In an effort to make enforcement of the Rules of Conduct more effective and disciplinary action more uniform, the AICPA has developed a **Joint Ethics Enforcement Program (JEEP)**. Under JEEP, complaints against a member may be filed with either the AICPA or the state society. Normally, the AICPA has jurisdiction over cases involving (1) more than one state, (2) litigation, and (3) issues of broad national concern. The jurisdictional groups may act independently or jointly.

JEEP also provides for increased liaison between the AICPA and state society ethics committees. The Professional Ethics Division holds frequent meetings with state societies in an effort to improve the overall handling of ethics matters and to consult with the states on ways to increase the amount of resources devoted to ethics enforcement. The Professional Ethics Division reports semiannually to the membership of the AICPA on ethics cases processed under JEEP.

Joint Trial Board Procedures

There is a single **joint trial board** consisting of at least 36 AICPA members elected by Council from present or former Council members. The trial board becomes involved only when earlier enforcement procedures have found the complaint to be serious or the member involved has refused to cooperate. Trial board hearings are generally held by subboards comprised of at least five board members appointed to maximize representation from the general area in which the member resides. A member may request the full trial board to review the subboard's decision.

The joint trial board may take one of the following **disciplinary actions**:

- Admonish the member.
- Suspend the member for a period of no more than two years.
- Expel the member.

When the deficiency is attributable to a departure from the profession's technical standards, the trial board has the authority to impose additional requirements. For example, the board may require the member to complete specified professional development courses and report to the trial board upon their completion. The joint trial board must notify the Professional Ethics Division of its decision in each case.

Automatic Disciplinary Provisions

The bylaws (BL 7.3.1) of the AICPA include **automatic disciplinary provisions** that mandate suspension or termination of membership without a hearing in certain situations. Suspension results when the Secretary of the Institute is notified that a judgment or conviction has been imposed on a member for

- A crime punishable by imprisonment for more than one year.
- Willful failure to file any income tax return that the member, as an individual taxpayer, is required by law to file.

- The filing of a false or fraudulent income tax return on the member's or a client's behalf.
- Willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client.

Termination of membership occurs when the member has exhausted all legal appeals on the judgment or conviction.

Under the automatic disciplinary provisions of the bylaws, membership in the AICPA shall be terminated without a hearing should a member's certificate as a CPA be revoked, withdrawn, or canceled as a disciplinary measure by any governmental agency. This provision also applies when a member's last or only certificate is revoked by a state board of accountancy for failing to meet continuing professional education requirements, unless the member is retired or disabled.

LEARNING CHECK

- 3-19 What is the possible role of a state board of accountancy in ethical matters? What rules would a state board of accountancy use when evaluating ethical behavior, and what is the maximum sanction that a state board of accountancy might be able to take against a CPA?
- 3-20 What is the possible role of the PCAOB in ethical matters? What rules would a PCAOB use when evaluating ethical behavior, and what sanctions are available for the PCAOB to take against a CPA or a CPA firm?
- 3-21 Identify the two groups that are responsible for enforcement of the AICPA Rules of Conduct and indicate the maximum sanction that can be imposed by each.
- 3-22 What is the purpose of the Joint Ethics Enforcement Program, and how does it operate?
- 3-23 What is the composition of the joint trial board, when does it become involved, and what disciplinary actions can it take?
- 3-24 Explain the automatic disciplinary provision of the AICPA and the action by members that results in application of the provisions.

KEY TERMS

Automatic disciplinary provisions, p. 133	Joint Ethics Enforcement Program (JEEP), p. 133
Disciplinary actions, p. 133	Joint trial board, p. 132

FOCUS ON AUDITOR KNOWLEDGE AND AUDIT DECISIONS

This chapter discusses professional ethics for CPAs. Figures 3-7 and 3-8 summarize the important components of auditor knowledge and key audit decisions discussed in this chapter. Page references are provided to where these issues are discussed in more detail.

Figure 3-7 ■ Summary of Auditor Knowledge Discussed in Chapter 3

Auditor Knowledge	Summary	Chapter References
K1. Know the nature of general ethics.	General ethics attempts to deal with these questions by defining what is good for the individual and society, and by trying to establish the nature of obligations or duties that individuals owe themselves and each other. The book suggests a six-step framework for dealing with ethical dilemmas, which includes the following: (1) obtain the facts relevant to the decision, (2) identify the ethical issues from the facts, (3) determine who will be affected by the decision and how, (4) identify the decision maker's alternatives, (5) identify the consequences of each alternative, and (6) make the ethical choice.	pp. 103–104
K2. Understand the purpose of professional ethics.	Professional ethics represent a commitment by a profession to ethical principles and rules of conduct. A commitment to ethical behavior is a key element that separates recognized professions from other occupations. In most states CPAs are the only professionals that can sign an audit report. In return for this monopoly, CPAs have an obligation to act in the public interest. The willingness of CPAs to voluntarily subscribe to the Code has contributed significantly to the stature and reputation of the profession.	pp. 104–105
K3. Know the components of the AICPA Code of Professional Conduct and related pronouncements.	The AICPA Code of Professional Conduct is divided into four major components: (1) principles that express the basic tenets of ethical conduct and provide the conceptual framework for the rules, (2) Rules of Conduct that establish minimum standards of acceptable conduct in the performance of professional services, (3) Interpretations of the Rules of Conduct that provide guidelines about the scope and applicability of specific rules, and (4) ethical rulings that indicate the applicability of the Rules of Conduct and interpretations to a particular set of factual circumstances. Figure 3-1 summarizes the nature and enforceability of each component of the Code of Professional Conduct.	pp. 106–107
K4. Understand the essence of the Code's six ethical principles.	The following six principles express the basic tenets of ethical conduct and provide the framework for the Rules of Conduct: (1) responsibilities, (2) the public interest, (3) integrity, (4) objectivity and independence, (5) due care, and (6) scope and nature of services. The essence of these six ethical principles is discussed in detail in the chapter.	pp. 107–110
K5. Know the organizations and procedures involved in enforcing the Rules of Conduct.	The AICPA and state societies of CPAs cooperate in a Joint Ethics Enforcement Program that provides mechanisms for investigating complaints of unethical conduct, and imposing sanctions on members who violate the Rules of Conduct. CPAs should also be aware of how state boards of accountancy may enforce ethical rules that are part of state accountancy laws, and how the PCAOB and SEC may enforce its own ethical rules.	pp. 132–134

Figure 3-8 ■ Summary of Audit Decisions Discussed in Chapter 3

Audit Decision	Factors that Influence the Audit Decision	Chapter References
D1. What must a CPA do to comply with the Rules of Conduct regarding independence, integrity, and objectivity?	<p>Being independent in fact can be defined as acting with integrity and objectivity, which refers to being free of conflicts of interest, not knowingly misrepresenting facts, and not subordinating judgment.</p> <p>The AICPA independence rules follow an engagement-based approach. The rules identify a number of individuals who might be in a position to influence the outcome of an attest engagement who must be strictly independent from an attest client. Figure 3-4 summarizes the general guidance regarding important decisions about auditor independence. Figure 3-6 summarizes some important criteria for remaining independent while performing nonattest services for private company clients. It should be noted that the issues surrounding independence are so important that the SEC and the Sarbanes-Oxley Act of 2002 have established higher standards for auditors of public companies than the AICPA rules that are applicable to private companies.</p>	pp. 112–124
D2. What must a CPA do to comply with the Rules of Conduct regarding general standards and accounting principles?	<p>The general standards are important because they apply to all CPAs, not just CPAs in public practice. They also apply to CPAs who perform a variety of professional services in addition to audit services. The rules on general standards address four general standards of behavior (professional competence, due professional care, planning and supervision, and sufficient relevant data) that guide a CPA's work. The rules on compliance with standards outline a variety of AICPA standards that should be followed when performing professional service engagements. The accounting principle standards outline the accounting standards that should be followed in professional practice.</p>	pp. 124–126
D3. What must a CPA do to comply with the Rules of Conduct regarding responsibilities to clients?	<p>Responsibilities to clients relate to a CPA's responsibility with respect to confidential client information and to contingent fee arrangements. In general, CPAs should not disclose confidential information without the client's permission. Contingent fee arrangements reflect situations where no fee is charged unless a specific finding or result is obtained. A CPA cannot perform services for a contingent fee and remain independent with respect to the client nor can a CPA prepare a tax return for a contingent fee.</p>	pp. 126–128
D4. What must a CPA do to comply with the Rules of Conduct regarding other professional responsibilities?	<p>Other responsibilities address issues of discreditable acts (Rule 501), advertising and other forms of solicitation (Rule 502), commission and referral fees (Rule 503), and the form of organization and name (Rule 505). The essence of each rule is discussed in detail in the chapter.</p>	pp. 128–131

objective questions

Objective questions are available for the students at www.wiley.com/college/boynton

comprehensive questions

- 3-25 **(General and professional ethics)** The membership of the AICPA has adopted the Code of Professional Conduct that is administered by the Institute's Professional Ethics Division.

Required

- With the many general theories of ethics developed by philosophers and ethicists, why is it necessary or desirable for the profession to adopt such a Code?
- In what respects, if any, does the AICPA's Code reflect the ethical absolutist and the ethical relativist schools of thought?
- Identify an ethical dilemma that an auditor might face where answers to the questions "What good do I seek?" and "What is my obligation in this circumstance?" would be relevant.
- According to the Preamble to the AICPA's Code, to what three groups does the CPA have obligations or responsibilities?

- 3-26 **(Framework for ethical decision making)** Assume that you are the audit partner on an engagement for a client that has had a string of operating losses. The company still has a positive net worth, but you are worried that the company might have to close down within the next year or so. When you tell the client's management that it should make full disclosure in the footnotes concerning substantial doubt about the entity's ability to continue as a going concern, management says, "Hogwash! There's no substantial doubt. The probability of our having to close down is remote. We'll make no such disclosure. To do so would only make our customers and creditors nervous, possibly making such a disclosure a self-fulfilling prophecy. Our competitors are as bad off as we are, and their auditors aren't making them send out a distress signal." You agree that the determination of "substantial doubt" is a judgment call.

Required

Apply the six-step general framework for ethical decision making to this dilemma.

- 3-27 **(Sections of the Code)** Ethical standards for the profession have been published in the form of the AICPA's Code of Professional Conduct.

Required

- Identify and distinguish between the two sections of the Code.
- Are both sections enforceable? Explain.
- State each principle of the Code.
- For each principle, identify two courses of action that will enable the member to meet the principle.
- Explain the applicability of the Rules to the members of the AICPA.

- 3-28 **(Independence)** An auditor must not only appear to be independent; he or she must also be independent in fact.

Required

- a. Explain the concept of an “auditor’s independence” as it applies to third-party reliance on financial statements.
- b.
 1. What determines whether or not an auditor is independent in fact?
 2. What determines whether or not an auditor appears to be independent?
- c. Explain how an auditor may be independent in fact but not appear to be independent.
- d. Would a CPA be considered independent for an audit of the financial statements of a:
 1. Church for which he or she is serving as treasurer without compensation? Explain.
 2. Country club for which his or her spouse is serving as treasurer-bookkeeper if he or she is not to receive a fee for the audit? Explain.

AICPA (adapted)

- 3-29 **(Independence)** The attribute of independence has been traditionally associated with the CPA’s function of auditing and expressing opinions on financial statements.

Required

- a. What is meant by “independence” as applied to the CPA’s function of auditing and expressing opinions on financial statements? Discuss.
- b. CPAs have imposed on themselves certain rules of professional conduct that induce their members to remain independent and to strengthen public confidence in their independence. Which of the Rules of Conduct are concerned with the CPA’s independence? Discuss.
- c. The Wallydrug Company is indebted to a CPA for unpaid fees and has offered to issue to the CPA unsecured interest-bearing notes. Would acceptance of these notes have any bearing on the CPA’s independence with respect to Wallydrug Company? Discuss.
- d. The Rocky Hill Corporation was formed on October 1, 20X0, and its fiscal year will end on September 30, 20X1. You audited the corporation’s opening balance sheet and rendered an unqualified opinion on it. A month after rendering your report, you are offered the position of secretary of the company because of the need for a complete set of officers and for convenience in signing various documents. You will have no financial interest in the company through stock ownership or otherwise, will receive no salary, will not keep the books, and will not have any influence on its financial matters other than occasional advice on income tax matters and similar advice normally given a client by a CPA.
 1. Assume that you accept the offer but plan to resign the position prior to conducting your annual audit with the intention of again assuming the office after rendering an opinion on the statements. Can you render an independent opinion on the financial statements? Discuss.
 2. Assume that you accept the offer on a temporary basis until the corporation has gotten under way and can employ a secretary. In any event, you would permanently resign the position before conducting your annual audit. Can you render an independent opinion on the financial statements? Discuss.

AICPA

- 3-30 **(Rules of conduct)** There currently are 11 rules in the Code of Professional Conduct. Listed below are circumstances pertaining to these rules.

1. A member shall not express an opinion that the financial statements are presented in conformity with GAAP unless the pronouncements of the FASB have been followed.

2. A member shall not discriminate in employment of assistants.
3. A member shall not include self-laudatory statements that are not based on verifiable facts in advertisements.
4. A member shall not accept a commission for a referral to a client of products or services of others.
5. A member's fees may vary depending on the complexity of the service rendered.
6. A member is not precluded from responding to an inquiry by a trial board of the AICPA.
7. A member may not serve as a trustee for any pension trust of the client during the period covered by the financial statements.
8. A member shall adequately plan and supervise an engagement.
9. A member may not have or be committed to acquire any direct financial interest in the client.
10. A member shall not practice under a misleading firm name.
11. A member shall not knowingly subordinate his or her judgment to others.
12. A member shall follow the technical standards of the Auditing Standards Board in an audit engagement.
13. A member bases the fee on the findings determined by the IRS in a tax audit case.
14. A member discloses confidential information in a peer review of the firm's practice.
15. A member issues an unqualified opinion when a client departs from GAAP because of a conceptual disagreement with the FASB.

Required

- a. Identify the rule to which each circumstance relates.
- b. Indicate one other circumstance that pertains to each rule identified in (a) above.

3-31 **(Rules of conduct)** In the practice of public accounting, an auditor who is a member of the AICPA is expected to comply with the rules of the Code of Professional Conduct. Listed below are circumstances that raise a question about an auditor's ethical conduct.

1. The auditor has a bank loan with a bank that is an audit client.
2. An unqualified opinion is expressed when the financial statements of a county are prepared in conformity with principles established by the Governmental Accounting Standards Board.
3. An auditor retains the client's records as a means of enforcing payment of an overdue audit fee.
4. The auditor makes retirement payments to individuals who formerly were members of his firm.
5. An auditor sells her shares of stock in a client company in April prior to beginning work on the audit for the year ending December 31.
6. An auditor accepts an engagement knowing that he does not have the expertise to do the audit.
7. The auditor quotes a client an audit fee but also states that the actual fee will be contingent on the amount of work done.
8. The auditor's firm states in a newspaper advertisement that it has had fewer lawsuits than its principal competitors.

9. The auditor resigns her position as treasurer of the client on May 1, prior to beginning the audit for the year ending December 31.
10. The auditor discloses confidential information about a client to a successor auditor.
11. The auditor accepts an audit engagement when he has a conflict of interest.
12. An auditor prepares a small brochure containing testimonials from existing clients that he mails to prospective clients.
13. An auditor complies with the technical standards of the Accounting and Review Services Committee in reviewing the financial statements of a nonpublic entity.
14. An auditor examines the financial statements of a local bank and also serves on the bank's committee that approves loans.
15. An auditor pays a commission to an attorney to obtain a client.

Required

- a. Identify the rule of the Code of Professional Conduct that applies to each circumstance.
- b. Indicate for each circumstance whether the effect on the rule is (1) a violation, (2) not a violation, or (3) indeterminate. Give the reason(s) for your answer.

cases

- 3-32 **(Framework for ethical decision making)** Michael Harper is an audit partner in a local CPA firm who has a number of retail, wholesale, and manufacturing clients. In November of 20X6 Michael is nearing the completion of the audit of EFW, Inc., a wholesaler of exercise equipment who has a September 30th year-end. You are also performing planning and interim work for Sports and Fitness (S&F), a retailer of fitness equipment that has a January 31st year-end. S&F is a significant customer for EFW, Inc. In performing planning work on S&F, you discover that it is having financial difficulties and may not be able to pay its payable to the EFW from which it purchases product.

Required

- a. What is your ethical dilemma?
 - b. Are there competing ethical rules here? If so, identify the rules and explain the conflict.
 - c. If you were the partner, how would you resolve the ethical dilemma? Apply the six-step general framework for ethical decision making to this dilemma and support your reasoning.
- 3-33 **(Independence)** Jones and Jones, CPA, has a manufacturing client, Wigit Technologies, Inc. (WTI), that is a small, owner-managed business with annual revenues of approximately \$8 million. WTI employs a bookkeeper but is not large enough to employ a CPA in-house. WTI regularly asks Margaret Jones, the partner on the engagement, for advice on accounting issues, and Jones and Jones drafts the financial statements for the company. The client reviews the financial statements before they are printed by Jones and Jones with an audit opinion attached.

During the current year WTI asked Jones and Jones to assist the company by rendering a business valuation service. WTI is asking Jones and Jones to (1) estimate the value of WTI and (2) consult with WTI in the form of making recommendations on steps that WTI can take that will grow the value of the business.

Required

- a. Since Jones and Jones is preparing the financial statements for WTI, is Jones and Jones independent with respect to WTI? What conditions, if any, must Jones and Jones meet in order to be independent with respect to WTI?
- b. Would your answer to (a) be the same if WTI was a public company subject to SEC rules and regulations?
- c. Can Jones and Jones take on the business valuation services and consulting engagement and remain independent with respect to WTI? Explain your reasoning.
- d. Would your answer to (c) be the same if WTI was a public company subject to SEC rules and regulations?

- 3-34 **(Ethical issues)** Gilbert and Bradley formed a corporation called Financial Services, Inc., each taking 50 percent of the authorized common stock. Gilbert is a CPA and a member of the American Institute of CPAs. Bradley is a CPCU (Chartered Property Casualty Underwriter). The corporation performs auditing and tax services under Gilbert's direction and insurance services under Bradley's supervision. The opening of the corporation's office was announced by a three-inch, two-column ad in the local newspaper.

One of the corporation's first audit clients was the Grandtime Company. Grandtime had total assets of \$600,000 and total liabilities of \$270,000. In the course of the audit, Gilbert found that Grandtime's building with a book value of \$240,000 was pledged as security for a 10-year term note in the amount of \$200,000. The client's statements did not mention that the building was pledged as a security for the note. However, as the failure to disclose the lien did not affect either the value of the assets or the amount of the liabilities and the audit was satisfactory in all other respects, Gilbert rendered an unqualified opinion on Grandtime's financial statements. About two months after the date of the opinion, Gilbert learned that an insurance company was planning a loan to Grandtime of \$150,000 in the form of a first-mortgage note on the building. Realizing that the insurance company was unaware of the existing lien on the building, Gilbert had Bradley notify the insurance company of the fact that Grandtime's building was pledged as security for the term note.

Shortly after the events described above, Gilbert was charged with a violation of professional ethics.

Required

Identify and discuss the ethical implication of those acts by Gilbert that were in violation of the AICPA Code of Professional Conduct.

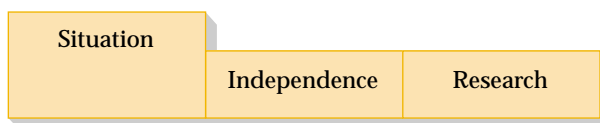
- 3-35 **(Ethical issues)** The following situations involve Herb Standard, staff accountant with the regional CPA firm of Cash & Green:
1. The bookkeeper of Ethical Manufacturing Company resigned two months ago and has not yet been replaced. As a result, Ethical's transactions have not been recorded and the books are not up to date. To comply with terms of a loan agreement, Ethical needs to prepare interim financial statements but cannot do so until the books are posted. Ethical looks to Cash & Green, its independent auditors, for help and wants to borrow Herb Standard to perform the work. Ethical wants Herb because he did its audit last year.
 2. Herb Standard discovered that his client, Ethical Manufacturing Company, materially understated net income on last year's tax return. Herb informs his supervisor about this, and the client is asked to prepare an amended return. The client is unwilling to take corrective measures. Herb informs the Internal Revenue Service.
 3. While observing the year-end inventory of Ethical Manufacturing Company, the plant manager offers Herb Standard a fishing rod, which Ethical manufactures, in appreciation for a job well done.

4. Herb Standard’s acquaintance, Joe Lender, is chief loan officer at Local Bank, an audit client of Cash & Green. Herb approaches Joe for an unsecured loan from Local Bank and Joe approves the loan.
5. Herb Standard is a member of a local investment club composed of college fraternity brothers. The club invests in listed stocks and is fairly active in trading. Last week the club purchased the stock of Leverage Corp., a client of another Cash & Green office. Herb has no contact with the members of this office.

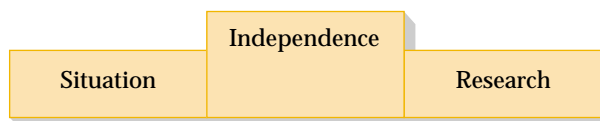
Required

For each situation, (a) identify the ethical issues that are involved and (b) discuss whether there has or has not been any violation of ethical conduct. Support your answers by reference to the rules of the Code of Professional Conduct.

professional simulation



Sharon Langdale is the audit partner in a large Midwest office of a national accounting firm. She has just delivered a proposal to the audit committee of EquipCo, a large, privately held manufacturing company to perform the company’s annual audit. The company is considering going public in the next 2-3 years and now wants a large CPA firm to perform their audit. EquipCo has multiple locations that will involve several offices around the world in the annual audit.



In planning for the audit, Langdale instructed Robert Benson, an assistant on the engagement, to draft a list of individuals who would need to be independent so that they could be assigned to the engagement. Indicate whether the following individuals would cause independence problems if they owned stock in EquipCo.

- | | <i>Independence Problem?</i> |
|---|------------------------------|
| 1. A tax partner in Sharon Langdale’s office. | <input type="radio"/> |
| 2. A consulting partner in another office where work on the EquipCo audit is performed. However, the partner performed no work for EquipCo. | <input type="radio"/> |
| 3. The spouse of a staff accountant who works on the EquipCo audit works as a financial analyst for EquipCo. | <input type="radio"/> |
| 4. The audit firm’s benefit plan owns EquipCo stock. | <input type="radio"/> |
| 5. A manager in another office who regularly is involved in internal quality control functions. | <input type="radio"/> |
| 6. A parent of a staff accountant who works on the EquipCo audit, holds an immaterial investment in EquipCo. | <input type="radio"/> |

7. The spouse of an audit partner in an office that performs work for EquipCo (the audit partner does not perform any work for EquipCo and is not in the chain of command for the audit).
8. A tax manager in an office that performs work for EquipCo performs five hours of work on the audit of the tax accrual.
9. The Midwest regional audit partner who performs no work on the EquipCo audit.
10. An audit manager in Asia who performs no work on the EquipCo audit.
11. An audit partner in Sharon's office finds that a mutual fund that he owns in his investment portfolio has an immaterial investment in EquipCo.

		Research
Situation	Independence	

While EquipCo is still a private company, it approaches Monica Lee, a tax manager in Sharon Langdale's office and offers her a job in EquipCo's tax department. Cut and paste the AICPA ethical standard sections that apply to Monica's situation.