5

CHAPTER

ETHICS AND THE AUDIT PROFESSION

LEARNING OBJECTIVES

After studying this chapter, you should be able to

5-1 Distinguish ethical from unethical behavior in personal and professional contexts.

5-2 Resolve ethical dilemmas using an ethical framework.

5-3 Explain the importance of ethical conduct for the accounting profession.

5-4 Describe the purpose and content of the AICPA *Code of Professional Conduct.*

5-5 Understand Sarbanes–Oxley Act and other SEC and PCAOB independence requirements and additional factors that influence auditor independence.

5-6 Apply the AICPA *Code* rules and interpretations on independence and explain their importance.

5-7 Understand the requirements of other rules under the AICPA *Code.*

5-8 Describe the enforcement mechanisms for CPA conduct.

Ethical Behavior

Jack works in an audit firm and he was posted to a client's office in Shanghai with his colleague Johnson. His colleague, Johnson, was another auditor in the same firm, and they were taking a break together in the client's canteen. "Jack, I heard that the audit manager on this audit job does not check the amount and the number of travel receipts you submit. My sister is coming to visit me this weekend and I bet if I submit my sister's travel allowance, the audit manager would not be able to tell the difference," Johnson excitedly said. "Johnson, I do not think that is ethical; it is not a valid receipt that relates to the audit job. That receipt would be a personal expense," Jack said, looking intently at Johnson. Johnson shrugged his shoulders. "Guess what?" Johnson said, hoping to change the topic. "My client from my previous audit job gave me a bottle of Acqua Di Gio, Giorgio Armani! I was so pleased! I've always wanted that perfume."

"Er, I think you might want to declare this gift before keeping it!" Jack said. Johnson's eyes opened wide. Jack continued, "Well, the amount might be less than $100, but it might cause a conflict of interest and a threat to your independence." Johnson gulped. He was not too pleased. But Jack had a point.

"Okay, okay. I'll declare the perfume as a gift and I won't claim my sister's travel allowance. You do have a point, Jack. It isn't worth risking unprofessional behavior after studying so hard to get the professional qualification," Johnson said.

In preceding chapters, audit reports and the demand for audit and other assurance services were discussed. The value of the audit report and the demand for audit services depend on public confidence in the independence and integrity of CPAs. This chapter discusses ethics and the independence and other ethical requirements for CPAs, including the AICPA *Code of Professional Conduct*, PCAOB standards, and international ethics standards. We begin the chapter with a discussion of general ethical principles and their application to the CPA profession.

WHAT ARE ETHICS?

OBJECTIVE 5-1

Distinguish ethical from unethical behavior in personal and professional contexts.

Ethics can be defined broadly as a set of moral principles or values. Each of us has such a set of values, although we may or may not have considered them explicitly. Philosophers, religious organizations, and other groups have defined in various ways ideal sets of moral principles or values. Examples of prescribed sets of moral principles or values include laws and regulations, church doctrine, codes of business ethics for professional groups such as CPAs, and codes of conduct within organizations.

An example of a prescribed set of principles is included in Figure 5-1. These principles were developed by the Josephson Institute of Ethics, a nonprofit membership organization for the improvement of the ethical quality of society.

It is common for people to differ in their moral principles and values and the relative importance they attach to these principles. These differences reflect life experiences, successes and failures, as well as the influences of parents, teachers, and friends.

Need for Ethics

Ethical behavior is necessary for a society to function in an orderly manner. It can be argued that ethics is the glue that holds a society together. Imagine, for example, what would happen if we couldn't depend on the people we deal with to be honest. If parents, teachers, employers, siblings, coworkers, and friends all consistently lied, it would be almost impossible to have effective communication.

The need for ethics in society is sufficiently important that many commonly held ethical values are incorporated into laws. However, many of the ethical values found in Figure 5-1, such as caring, cannot be incorporated into laws because they cannot be defined well enough to be enforced. That does not imply, however, that the principles are less important for an orderly society.

Why People Act Unethically

Most people define *unethical behavior* as conduct that differs from what they believe is appropriate given the circumstances. Each of us decides for ourselves what we consider unethical behavior, both for ourselves and others. It is important to understand what causes people to act in a manner that we decide is unethical.

FIGURE 5-1 **Illustrative Prescribed Ethical Principles**

The following are the six core ethical values that the Josephson Institute associates with ethical behavior:

Trustworthiness includes honesty, integrity, reliability, and loyalty. Honesty requires a good faith intent to convey the truth. Integrity means that the person acts according to conscience, regardless of the situation. Reliability means making all reasonable efforts to fulfill commitments. Loyalty is a responsibility to promote and protect the interests of certain people and organizations.

Respect includes notions such as civility, courtesy, decency, dignity, autonomy, tolerance, and acceptance. A respectful person treats others with consideration and accepts individual differences and beliefs without prejudice.

Responsibility means being accountable for one's actions and exercising restraint. Responsibility also means pursuing excellence, self-restraint, and leading by example, including perseverance and engaging in continuous improvement.

Fairness and justice include issues of equality, impartiality, proportionality, openness, and due process. Fair treatment means that similar situations are handled consistently.

Caring means being genuinely concerned for the welfare of others and includes acting altruistically and showing benevolence.

Citizenship includes obeying laws and performing one's fair share to make society work, including such activities as voting, serving on juries, conserving resources, and giving more than one takes.

There are two primary reasons why people act unethically: The person's ethical standards are different from those of society as a whole, or the person chooses to act selfishly. Frequently, both reasons exist.

Person's Ethical Standards Differ from General Society Extreme examples of people whose behavior violates almost everyone's ethical standards are drug dealers, bank robbers, and larcenists. Most people who commit such acts feel no remorse when they are apprehended because their ethical standards differ from those of society as a whole.

There are also many far less extreme examples when others violate our ethical values. When people cheat on their tax returns, treat other people with hostility, lie on resumes and employment applications, or perform below their competence level as employees, most of us regard that as unethical behavior. If the other person has decided that this behavior is ethical and acceptable, there is a conflict of ethical values that is unlikely to be resolved.

The Person Chooses to Act Selfishly The following example illustrates the difference between ethical standards that differ from general society's and acting selfishly. Person A finds a briefcase in an airport containing important papers and $1,000. He tosses the briefcase and keeps the money. He brags to his family and friends about his good fortune. Person A's values probably differ from most of society's. Person B faces the same situation but responds differently. He keeps the money but leaves the briefcase in a conspicuous place. He tells nobody and spends the money on a new wardrobe. It is likely that Person B has violated his own ethical standards, but he decided that the money was too important to pass up. He has chosen to act selfishly.

A considerable portion of unethical behavior results from selfish behavior. Political scandals result from the desire for political power; cheating on tax returns and expense reports is motivated by financial greed; performing below one's competence and cheating on tests typically arise from laziness. In each case, the person knows that the behavior is inappropriate but chooses to do it anyway because of the personal sacrifice needed to act ethically.

ETHICAL DILEMMAS

OBJECTIVE 5-2

Resolve ethical dilemmas using an ethical framework.

An **ethical dilemma** is a situation a person faces in which a decision must be made about the appropriate behavior. A simple example of an ethical dilemma is finding a diamond ring, which necessitates deciding whether to attempt to find the owner or to keep it. A far more difficult ethical dilemma to resolve is the following example. It is the type of case that might be used in an ethics course.

- A man was near death from a rare blood disease. There was one experimental drug that the doctors thought might save him, but the man was not admitted into the free experimental trial. The drug had recently been developed by a start-up pharmaceutical company. The drug was expensive to make, but the company was charging twenty times what it cost to make and develop. The sick man's wife went to everyone she knew to borrow the money to pay for the drug, but she could only get together about $10,000, which is half of what it cost. She told the company that her husband was dying and asked that they sell the drug for a lower price or let her pay later. But the company said: "We discovered the drug and need to make money for our shareholders who have invested in its development." The wife became desperate and broke into the treatment center to steal the drug for her husband. What do you think about the wife's actions?

Auditors, accountants, and other businesspeople face many ethical dilemmas in their business careers. Dealing with a client who threatens to seek a new auditor unless an unqualified opinion is issued presents an ethical dilemma if an unqualified opinion

is inappropriate. Deciding whether to confront a supervisor who has materially overstated departmental revenues as a means of receiving a larger bonus is an ethical dilemma. Continuing to be a part of the management of a company that harasses and mistreats employees or treats customers dishonestly is an ethical dilemma, especially if the person has a family to support and the job market is tight.

Rationalizing Unethical Behavior

There are alternative ways to resolve ethical dilemmas, but care must be taken to avoid methods that are rationalizations of unethical behavior. The following are rationalization methods commonly employed that can easily result in unethical conduct:

Everybody Does It The argument that it is acceptable behavior to falsify tax returns, cheat on exams, or sell defective products is commonly based on the rationalization that everyone else is doing it and therefore it is acceptable.

If It's Legal, It's Ethical Using the argument that all legal behavior is ethical relies heavily on the perfection of laws. Under this philosophy, one would have no obligation to return a lost object unless the other person could prove that it was his or hers.

Likelihood of Discovery and Consequences This philosophy relies on evaluating the likelihood that someone else will discover the behavior. Typically, the person also assesses the severity of the penalty (consequences) if there is a discovery. An example is deciding whether to correct an unintentional overbilling to a customer when the customer has already paid the full amount. If the seller believes that the customer will detect the error and respond by not buying in the future, the seller will inform the customer now; otherwise, the seller will wait to see if the customer complains.

Resolving Ethical Dilemmas

Formal frameworks have been developed to help people resolve ethical dilemmas. The purpose of such a framework is to help identify the ethical issues and decide an appropriate course of action using the person's own values. The six-step approach that follows is intended to be a relatively simple approach to resolving ethical dilemmas:

1. Obtain the relevant facts.
2. Identify the ethical issues from the facts.
3. Determine who is affected by the outcome of the dilemma and how each person or group is affected.
4. Identify the alternatives available to the person who must resolve the dilemma.
5. Identify the likely consequence of each alternative.
6. Decide the appropriate action.

An illustration is used to demonstrate how a person might use this six-step approach to resolve an ethical dilemma.

Ethical Dilemma

Bryan Longview has been working 6 months as a staff assistant for Barton & Barton, CPAs. Currently he is assigned to the audit of Reyon Manufacturing Company under the supervision of Charles Dickerson, an experienced audit senior. There are three auditors assigned to the audit, including Bryan, Charles, and a more experienced assistant, Martha Mills. During lunch on the first day, Charles says, "It will be necessary for us to work a few extra hours on our own time to make sure we come in on budget. This audit isn't very profitable anyway, and we don't want to hurt our firm by going over budget. We can accomplish this easily by coming in a half hour early, taking a short lunch break, and working an hour or so after normal quitting time. We just won't enter that time on our time report." Bryan recalls reading the firm's policy that working hours and not charging for them on the time report is a violation of Barton & Barton's employment policy. He also knows that seniors are paid bonuses, instead of overtime, whereas staff are paid for overtime but get no bonuses. Later, when discussing the issue with Martha, she says, "Charles does this on all of his jobs. He is likely to be our firm's next audit manager. The partners think he's great because his jobs always come in under budget. He rewards us by giving us good engagement

evaluations, especially under the cooperative attitude category. Several of the other audit seniors follow the same practice."

Resolving the Ethical Dilemma Using the Six-Step Approach

Relevant Facts There are three key facts in this situation that deal with the ethical issue and how the issue will likely be resolved:

1. The staff person has been informed that he will work hours without recording them as hours worked.
2. Firm policy prohibits this practice.
3. Another staff person has stated that this is common practice in the firm.

Ethical Issue The ethical issue in this situation is not difficult to identify.

- Is it ethical for Bryan to work hours and not record them as hours worked in this situation?

Who Is Affected and How Is Each Affected? There are typically more people affected in situations in which ethical dilemmas occur than might be expected. The following are the key persons involved in this situation:

Who	*How Affected*
Bryan	Being asked to violate firm policy. Hours of work will be affected. Pay will be affected. Performance evaluations may be affected. Attitude about firm may be affected.
Martha	Same as Bryan.
Charles	Success on engagement and in firm may be affected. Hours of work will be affected.
Barton & Barton	Stated firm policy is being violated. May result in underbilling clients in the current and future engagements. May affect firm's ability to realistically budget engagements and bill clients. May affect the firm's ability to motivate and retain employees.
Staff assigned to Reyon Manufacturing in the future	May result in unrealistic time budgets. May result in unfavorable time performance evaluations. May result in pressures to continue practice of not charging for hours worked.
Other staff in firm	Following the practice on this engagement may motivate others to follow the same practice on other engagements.

Bryan's Available Alternatives

- Refuse to work the additional hours.
- Perform in the manner requested.
- Inform Charles that he will not work the additional hours or will charge the additional hours to the engagement.
- Talk to a manager or partner about Charles's request.
- Refuse to work on the engagement.
- Quit working for the firm.

Each of these options includes a potential consequence, including possible termination by the firm.

Consequences of Each Alternative In deciding the consequences of each alternative, it is essential to evaluate both the short- and long-term effects. There is a natural

tendency to emphasize the short term because those consequences will occur quickly, even when the long-term consequences may be more important. For example, consider the potential consequences if Bryan decides to work the additional hours and not report them. In the short term, he will likely get good evaluations for cooperation and perhaps a salary increase. In the longer term, what will be the effect of not reporting the hours this time when other ethical conflicts arise? Consider the following similar ethical dilemmas Bryan might face in his career as he advances:

- A supervisor asks Bryan to work 3 unreported hours daily and 15 unreported hours each weekend.
- A supervisor asks Bryan to initial certain audit procedures as having been performed when they were not.
- Bryan concludes that he cannot be promoted to manager unless he persuades assistants to work hours that they do not record.
- Management informs Bryan, who is now a partner, that either the company gets an unqualified opinion for a $40,000 audit fee or the company will change auditors.
- Management informs Bryan that the audit fee will be increased $25,000 if Bryan can find a plausible way to increase earnings by $1 million.

Appropriate Action Only Bryan can decide the appropriate option to select in the circumstances after considering his ethical values and the likely consequences of each option. At one extreme, Bryan can decide that the only relevant consequence is the potential impact on his career. Most of us believe that Bryan is an unethical person if he follows that course. At the other extreme, Bryan can decide to refuse to work for a firm that permits even one supervisor to violate firm policies. Many people consider such an extreme reaction naive. Most CPA firms have policies such as an anonymous hotline to report unethical behavior and provide employees with mentors and other more formal methods of communication to help staff resolve ethical questions.

SPECIAL NEED FOR ETHICAL CONDUCT IN PROFESSIONS

OBJECTIVE 5-3

Explain the importance of ethical conduct for the accounting profession.

Our society has attached a special meaning to the term *professional*. Professionals are expected to conduct themselves at a higher level than most other members of society. For example, when the press reports that a physician, clergyperson, U.S. senator, or CPA has been indicted for a crime, most people feel more disappointment than when the same thing happens to people who are not labeled as professionals.

The term *professional* means a responsibility for conduct that extends beyond satisfying individual responsibilities and beyond the requirements of our society's laws and regulations. A CPA, as a professional, recognizes a responsibility to the public, to the client, and to fellow practitioners, including honorable behavior, even if that means personal sacrifice.

The reason for an expectation of a high level of professional conduct by any profession is the need for *public confidence* in the quality of service by the profession, regardless of the individual providing it. For the CPA, it is essential that the client and external financial statement users have confidence in the quality of audits and other services. If users of services do not have confidence in physicians, judges, or CPAs, the ability of those professionals to serve clients and the public effectively is diminished.

It is not practical for most customers to evaluate the quality of the performance of professional services because of their *complexity*. A patient cannot be expected to evaluate whether an operation was properly performed. A financial statement user cannot be expected to evaluate audit performance. Most users have neither the competence nor the time for such an evaluation. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and conduct on the part of all practitioners.

Difference Between CPA Firms and Other Professionals

CPA firms have a different relationship with users of financial statements than most other professionals have with their customers. Attorneys, for example, are typically engaged and paid by a client and have primary responsibility to be an advocate for that client. CPA firms are usually engaged by management for private companies and the audit committee for public companies, and are paid by the company issuing the financial statements, but the primary beneficiaries of the audit are financial statement users. Often, the auditor does not know or have contact with the financial statement users but has frequent meetings and ongoing relationships with client personnel.

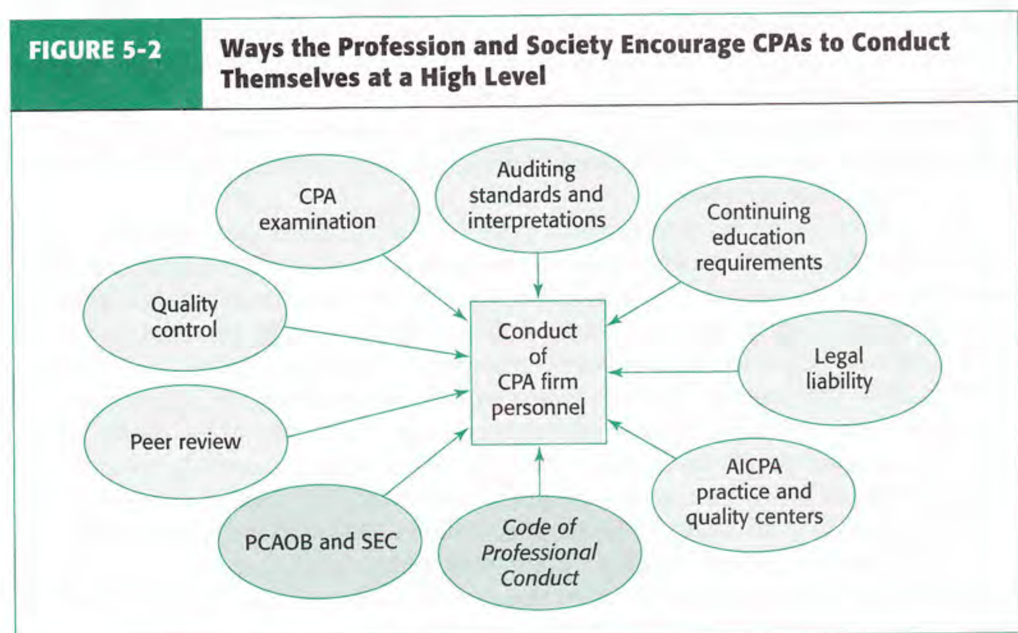
It is essential that users regard CPA firms as competent and unbiased. If users believe that CPA firms do not perform a valuable service (reduce information risk), the value of CPA firms' audit and other attestation reports is reduced and the demand for these services will thereby also be reduced. Therefore, there is considerable incentive for CPA firms to conduct themselves at a high professional level.

Ways CPAs Are Encouraged to Conduct Themselves Professionally

Figure 5-2 summarizes the most important ways in which CPAs can conduct themselves appropriately and perform high-quality audits and related services. We discussed in Chapter 2 auditing standards and their interpretations, the CPA examination, quality control, peer review requirements, PCAOB and SEC, AICPA audit practice and quality centers, and continuing education. The legal liability of CPA firms also exerts considerable influence on the way in which practitioners conduct themselves and audits, and this topic is examined in Chapter 4.

In the United States, the two most influential factors—shown shaded in Figure 5-2—are the AICPA *Code of Professional Conduct* and the PCAOB and SEC. The *Code of Professional Conduct* is meant to provide a standard of conduct for all members of the AICPA. The PCAOB is authorized to establish ethics and independence standards for auditors of public companies, and the SEC also plays a significant role in establishing independence standards for auditors of public companies. At the international level, the International Ethics Standards Board for Accountants (IESBA), an independent standards setting body within the International Federation of Accountants (IFAC), establishes ethical standards and guidance and fosters international debate on ethical issues faced by accountants through its *Code of Ethics for Professional Accountants.* While CPAs in the United States must follow the AICPA *Code*, the AICPA Professional Ethics Executive Committee closely monitors IESBA activities to converge the U.S. guidance, where appropriate, to guidance in the IESBA *Code*. As a member

FIGURE 5-2 **Ways the Profession and Society Encourage CPAs to Conduct Themselves at a High Level**



AICPA TO CLARIFY ETHICS STANDARDS AND PROVIDE CONVERGENCE WITH INTERNATIONAL STANDARDS

Similar to the Clarity Project for auditing standards undertaken by the AICPA Auditing Standards Board that was discussed in Chapter 2, the Professional Ethics Executive Committee (PEEC) of the AICPA is undertaking a project to restructure the ethics standards to make the *Code of Professional Conduct* easier to read and apply, as well as making it more intuitive. The PEEC intends to implement the revised ethics code in 2014. The goal of the project is to clarify rather than to change existing rules, and thus very few significant changes to the current rules are proposed. However, part of the clarification will involve separating the rules applicable to members in the practice of public accounting from rules for those in business, as well as others such as retired members, to make it easier for CPAs to determine the applicable rules.

As a member of the International Federation of Accountants (IFAC), the AICPA agrees to have ethics standards that, at a minimum, meet the ethics standards issued by the International Ethics Standards Board for Accountants (IESBA). The PEEC is continuing the process of converging with the IESBA standards throughout this ethics codification project. One particular aspect of the IESBA standards that will be helpful in the new AICPA ethics standards is the development of a conceptual framework that members can use when particular guidance is unavailable. The AICPA adopted an independence conceptual framework in 2006 and will develop further guidance in the revised ethics code.

Source: Based on AICPA Ethics Codification Briefing Paper, November 23, 2010.

body of IFAC, the AICPA agrees to have ethics standards that are at least as stringent as the IESBA ethics standards. The remainder of this chapter addresses the AICPA *Code* and related PCAOB and SEC requirements.

CODE OF PROFESSIONAL CONDUCT

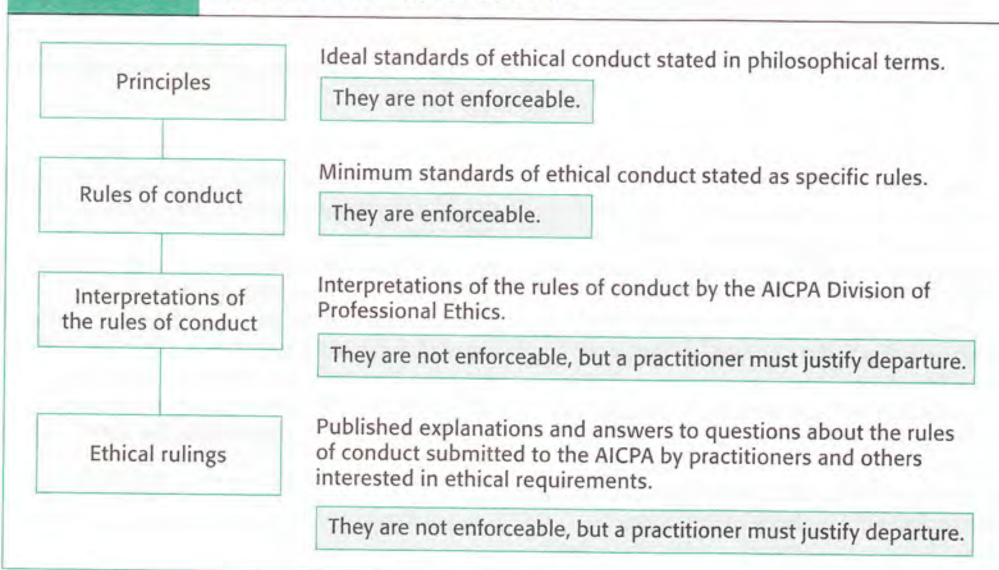
OBJECTIVE 5-4

Describe the purpose and content of the AICPA *Code of Professional Conduct.*

The AICPA *Code of Professional Conduct* provides both general standards of ideal conduct and specific enforceable rules of conduct. There are four parts to the code: principles, rules of conduct, interpretations of the rules of conduct, and ethical rulings. The parts are listed in order of increasing specificity; the principles provide ideal standards of conduct, whereas ethical rulings are highly specific. The four parts are summarized in Figure 5-3 and discussed in the following sections.

A few definitions, taken from the AICPA *Code of Professional Conduct*, must be understood to help interpret the rules.

FIGURE 5-3 **Code of Professional Conduct**



- *Client.* Any person or entity, other than the member's employer, that engages a member or a member's firm to perform professional services.
- *Firm.* A form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants that is engaged in the practice of public accounting. Except for the purposes of applying Rule 101, Independence, the firm includes the individual partners thereof.
- *Institute.* The American Institute of Certified Public Accountants.
- *Member.* A member, associate member, or international associate of the American Institute of Certified Public Accountants.
- *Practice of public accounting.* The practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPA(s); of the professional services of accounting, tax, personal financial planning, litigation support services; and those professional services for which standards are promulgated by bodies designated by Council.

Ethical Principles

1. **Responsibilities** In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
2. **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.
3. **Integrity** To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
4. **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.
5. **Due Care** A member should observe the profession's technical and ethical standards, strive continually to improve competence and quality of services, and discharge professional responsibility to the best of the member's ability.
6. **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.

Principles of Professional Conduct

The section of the AICPA *Code* dealing with principles of professional conduct includes a general discussion of characteristics required of a CPA. The principles section consists of two main parts: six ethical principles and a discussion of those principles. The ethical principles are listed in the box above. Discussions throughout this chapter include ideas taken from the principles section.

The first five of these principles are equally applicable to all members of the AICPA, regardless of whether they practice in a CPA firm, work as accountants in business or government, are involved in some other aspect of business, or are in education.

GUIDANCE FOR MEETING OBJECTIVES OF PRINCIPLES

Specific threats to a CPA's ability to meet the objectives of the six principles may arise when providing professional services to clients and employers. Because it is impossible to address in the Code every potential threat, the AICPA Professional Ethics Executive Committee (PEEC) issued an authoritative *Conceptual Framework for AICPA Independence Standards* as well as a non-authoritative *Guide for Complying with Rules 102–505* to assist all members, including those in business and government, with meeting the objectives of the six ethical principles when facing circumstances not explicitly addressed by the *Code*. Similar to the International Ethics Standards Board (IESBA) *Code of Ethics for Professional Conduct*, the framework and guide contain a risk-based structure that outlines categories of potential threats to compliance with the principles and include suggested safeguards to prevent noncompliance. Although use of the guide is not required, it can assist members in complying with the rules. Therefore, members should refer to the framework when making decisions on ethical matters not explicitly addressed in the *Code*.

Sources: 1. "Guide for Complying with Rules 102–505" (www.aicpa.org); 2. "Conceptual Framework for AICPA Independence Standards."

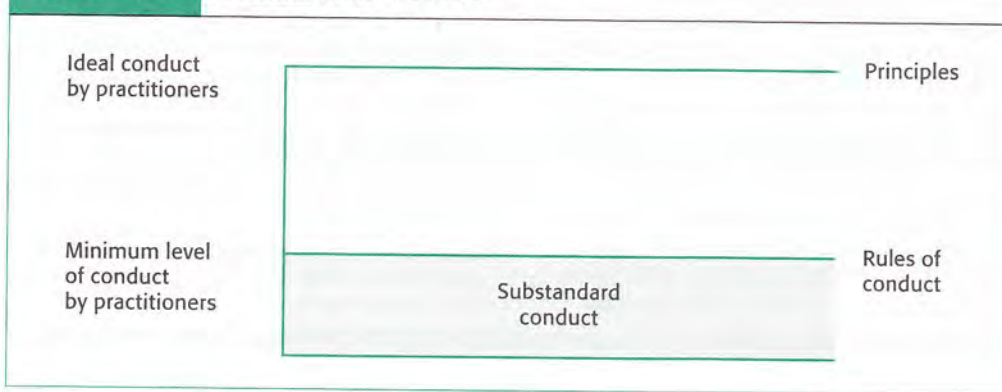


FIGURE 5-4 Standards of Conduct

One exception is the last sentence of objectivity and independence. It applies only to members in public practice, and then only when they are providing attestation services such as audits. The sixth principle, scope and nature of services, applies only to members in public practice. That principle addresses whether a practitioner should provide a certain service, such as providing personnel consulting when an audit client is hiring a chief information officer (CIO) for the client's IT function. Providing such a service can create a loss of independence if the CPA firm recommends a CIO who is hired and performs incompetently.

Rules of Conduct

This part of the *Code* includes the explicit rules that must be followed by every CPA in the practice of public accounting.[1] Those individuals holding the CPA certificate but not practicing public accounting must follow most, but not all requirements. Because the section on rules of conduct is the only enforceable part of the code, it is stated in more precise language than the section on principles. Because of their enforceability, many practitioners refer to the rules as the AICPA *Code of Professional Conduct.*

The difference between the standards of conduct set by the *principles* and those set by the *rules of conduct* is shown in Figure 5-4. When practitioners conduct themselves at the minimum level in Figure 5-4, this does not imply unsatisfactory conduct. The profession has presumably set the standards sufficiently high to make the minimum conduct satisfactory.

At what level do practitioners conduct themselves in practice? As in any profession, the level varies among practitioners. Most practitioners conduct themselves at a high level. Unfortunately, a few conduct themselves below the minimum level set by the profession. The activities designed to encourage CPAs to conduct themselves at a high level described in Figure 5-2 (p. 130) help minimize any substandard practice.

Interpretations of Rules of Conduct

The need for published interpretations of the rules of conduct arises when there are frequent questions from practitioners about a specific rule. The Professional Ethics Executive Committee of the AICPA prepares each interpretation based on a consensus of a committee made up principally of public accounting practitioners. Before interpretations are finalized, they are issued as exposure drafts to the profession and others for comment. Interpretations are not officially enforceable, but a departure from the interpretations is difficult if not impossible for a practitioner to justify in a disciplinary hearing. The most important interpretations are discussed as a part of each section of the rules.

[1]The AICPA *Code of Professional Conduct* is applicable to every CPA who is a member of the AICPA. Each state also has rules of conduct that are required for licensing by the state. Many states follow the AICPA rules, but some have somewhat different requirements.

IESBA CODE OF ETHICS FOR PROFESSIONAL CONDUCT

The International Ethics Standard Board for Accountants (IESBA) *Code of Ethics for Professional Conduct* is also a principles-based framework consisting of three parts. Part A establishes the five fundamental principles related to integrity, objectivity, professional competence and due care, confidentiality, and professional behavior. Part A also provides a conceptual framework that accountants can apply to identify threats to compliance with the fundamental principles, evaluate the significance of identified threats, and apply safeguards, when necessary, to eliminate the threat or reduce the threat to an acceptable level. Parts B and C of the IESBA *Code* describe how the conceptual framework applies in certain situations, including examples of safeguards and descriptions of situations where safeguards are not available to address threats. Part B applies to professional accountants in public practice while Part C applies to professional accountants in business.

Source: Based on International Ethics Standards Board for Accountants, *Code of Ethics for Professional Accountants* (www.ifac.org).

Ethical Rulings

Rulings are explanations by the executive committee of the professional ethics division of *specific factual circumstances*. A large number of ethical rulings are published in the expanded version of the AICPA *Code of Professional Conduct*. The following is an example (Rule 101—Independence; Ruling No. 14):

- *Question*—A member serves as a director or officer of a United Way or similar federated fund-raising organization (the organization). Certain local charities receive funds from the organization. Would independence be considered to be impaired with respect to such charities?
- *Answer*—Independence would be considered to be impaired if any partner or professional employee of the firm served as a director or officer of the organization and the organization exercised managerial control over the local charities.

Applicability of the Rules of Conduct

The rules of conduct in the AICPA *Code of Professional Conduct* apply to all AICPA members for all services provided, whether or not the member is in the practice of public accounting, unless the code specifically states otherwise. Table 5-1 (p. 149) indicates whether the rule applies to all members or only to members in public practice.

Each rule applies to attestation services, and *unless stated otherwise*, it also applies to all services provided by CPA firms such as taxes and management services and to CPAs who are employees who prepare financial statements for their employer organizations. The most notable exception is Rule 101—Independence that requires independence only when the AICPA has established independence requirements through its rule-setting bodies, such as the Auditing Standards Board. The AICPA requires independence only for attestation engagements. For example, a CPA firm can perform management services for a company in which the partner owns stock. Of course, if the CPA firm also performs an audit, that violates the independence requirements for attestation services.

It is a violation of the rules if someone does something on behalf of a member that is a violation if the member does it. An example is a banker who puts in a newsletter that Johnson and Able CPA firm has the best tax department in the state and consistently gets large refunds for its tax clients. That is likely to create false or unjustified expectations and is a violation of Rule 502 on advertising. A member is also responsible for compliance with the rules by employees, partners, and shareholders.

INDEPENDENCE

OBJECTIVE 5-5

Understand Sarbanes–Oxley Act and other SEC and PCAOB independence requirements and additional factors that influence auditor independence.

Independence, because of its importance, is the first rule of conduct. Before we discuss the specific independence requirements, we first discuss external factors that may influence auditor independence.

The value of auditing depends heavily on the public's perception of the independence of auditors. The reason that many diverse users are willing to rely on CPA's reports is their expectation of an unbiased viewpoint. The AICPA *Code of Professional Conduct* and the IESBA *Code of Ethics for Professional Conduct* both define independence as consisting of

two components: independence of mind and independence in appearance. **Independence of mind** reflects the auditor's state of mind that permits the audit to be performed with an unbiased attitude. Independence of mind reflects a long-standing requirement that members be independent in fact. **Independence in appearance** is the result of others' interpretations of this independence. If auditors are independent in fact but users believe them to be advocates for the client, most of the value of the audit function is lost.

The following sections discuss SEC and related PCAOB independence rules, including those required by the Sarbanes–Oxley Act. Organizations and standards other than the AICPA *Code of Professional Conduct* that influence auditor independence are also described.

Sarbanes–Oxley Act and SEC Provisions Addressing Auditor Independence

The SEC adopted rules strengthening auditor independence consistent with the requirements of the Sarbanes–Oxley Act. The SEC rules further restrict the provision of nonaudit services to audit clients, and they also include restrictions on employment of former audit firm employees by the client and provide for audit partner rotation to enhance independence. The PCAOB has also issued additional independence rules related to the provision of certain tax services.

Nonaudit Services The Sarbanes–Oxley Act and SEC rules restrict, but do not completely eliminate, the types of nonaudit services that can be provided to publicly held audit clients. The following nine services are prohibited:

1. Bookkeeping and other accounting services
2. Financial information systems design and implementation
3. Appraisal or valuation services
4. Actuarial services
5. Internal audit outsourcing
6. Management or human resource functions
7. Broker or dealer or investment adviser or investment banker services
8. Legal and expert services unrelated to the audit
9. Any other service that the PCAOB determines by regulation is impermissible

CPA firms are not prohibited from performing these services for private companies and for public companies that are not audit clients. In addition, CPA firms may still provide other services that are not prohibited for public company audit clients. For example, SEC and PCAOB rules allow CPAs to provide tax services for audit clients, except for tax services for company executives who oversee financial reporting, and tax avoidance planning services. Nonaudit services that are not prohibited by the Sarbanes–Oxley Act and the SEC rules must be preapproved by the company's audit committee. In addition, a CPA firm is not independent if an audit partner receives compensation for selling services to the client other than audit, review, and attest services.

Companies are required to disclose in their proxy statement or annual filings with the SEC the total amount of audit and nonaudit fees paid to the CPA firm for the two most recent years. Four categories of fees must be reported: (1) audit fees, (2) audit-related fees, (3) tax fees, and (4) all other fees. Audit-related fees are for services such as comfort letters and reviews of SEC filings that can only be provided by CPA firms. Companies are also required to provide further breakdown of the "other fees" category and to provide qualitative information on the nature of the services provided.

Audit Committees An **audit committee** is a selected number of members of a company's board of directors whose responsibilities include helping auditors remain independent of management. Most audit committees are made up of three to five or sometimes as many as seven directors who are not a part of company management. In response to the Sarbanes–Oxley Act requirement that all members of the audit committee be independent, the national stock exchanges amended their listing rules to reflect the provision. Now, with very limited exceptions, public company audit committees should be comprised solely of independent members, and companies must disclose whether or not the audit committee includes at least one member who is a financial expert.

The Sarbanes–Oxley Act further requires the audit committee of a public company to be responsible for the appointment, compensation, and oversight of the work of the auditor. The audit committee must preapprove all audit and nonaudit services, and is responsible for oversight of the work of the auditor, including resolution of disagreements involving financial reporting between management and the auditor. Auditors are responsible for communicating all significant matters identified during the audit to the audit committee.

For public companies, PCAOB rules require a CPA firm, before its selection as the company's auditor, to describe in writing and document its discussions with the audit committee about all relationships between the firm and the company, including executives in financial reporting positions, to determine whether there is any impairment of the CPA firm's independence. If selected as the auditor, these communications are to be made at least annually.

Collectively, these provisions increase the independence and role of the audit committee and enhance auditor independence by effectively making the audit committee the client for public companies, rather than management.

Conflicts Arising from Employment Relationships The employment of former audit team members with an audit client raises independence concerns. Consistent with the requirements of the Sarbanes–Oxley Act, the SEC added a one-year "cooling off" period before a member of the audit engagement team can work for the client in certain key management positions. This has important implications for an auditor working for a CPA firm who receives an employment offer from a publicly held client for a position as a chief executive officer, controller, chief financial officer, chief accounting officer, or equivalent position. The CPA firm cannot continue to audit that client if the auditor accepts the position and has participated in any capacity in the audit for one year preceding the start of the audit. This has no effect on the CPA firm's ability to continue the audit if the former auditor accepts a position such as assistant controller or accountant without primary accounting responsibilities.

Under SEC rules existing before the Sarbanes–Oxley Act and continuing, a CPA firm is not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee of the firm accepts employment with a client if he or she has a continuing financial interest in the CPA firm or is in a position to influence the CPA firm's operations or financial policies.

Partner Rotation As required by the Sarbanes–Oxley Act, the SEC independence rules require the lead and concurring audit partner to rotate off the audit engagement after five years. (The concurring partner is not involved with the actual performance of the audit and reviews the work at the completion of the audit.) Although not addressed in the Sarbanes–Oxley Act, the SEC requires a five-year "time-out" for the lead and concurring partners after rotation before they can return to that audit client. Additional audit partners with significant involvement on the audit must rotate after seven years and are subject to a two-year time-out period.

Ownership Interests SEC rules on financial relationships take an engagement perspective and prohibit ownership in audit clients by those persons who can influence the audit. The rules prohibit any ownership by covered persons and their immediate family, including (a) members of the audit engagement team, (b) those in a position to influence the audit engagement in the firm chain of command, (c) partners and managers who provide more than 10 hours of nonaudit services to the client, and (d) partners in the office of the partner primarily responsible for the audit engagement. These rules are designed to provide workable rules that still safeguard independence.

Shopping for Accounting Principles

Both management and representatives of management, such as investment bankers, often consult with other accountants on the application of accounting principles. Although consultation with other accountants is appropriate, it can lead to a loss of

WILL PUBLIC CLIENTS BE REQUIRED TO CHANGE AUDITORS ON A REGULAR BASIS?

The PCAOB has issued a concept release on auditor independence and audit firm rotation. The PCAOB wants to have a dialogue about the potential benefits and costs of mandatory audit firm rotation and whether requiring public client firms to change auditors on a regular basis will increase auditor independence as well as professional skepticism. The issue became a hot topic again as many of the companies involved in the recent financial crisis, such as Lehman Brothers and AIG, had engaged the same audit firm for decades.

Current U.S. rules require rotation of the audit engagement *partner* on a regular basis, but many clients have retained the same audit firm for decades, creating a question as to whether the audit firm is really independent of mind. The PCAOB received over 650 comment letters on the concept release, a record number. Many of the commenters are opposed to mandatory audit firm rotation because they argue that audit quality would not improve, and possibly could suffer in the first year or two due to the significant learning curve that takes place when an audit firm begins a relationship with a new client. It is also very likely that audit costs and fees would increase in the first year or two of the new relationship. In addition, commenters argued that there are already sufficient deterrents to impairment of independence, such as legal liability, PCAOB inspections and enforcement actions, and the threat of being sanctioned for violations of the *Professional Code of Conduct*.

A similar proposal for mandatory audit firm rotation has been put forth in the EU by the European Commission (EC). In addition, the EC is considering banning the provision of any nonaudit services to an audit client, as well as other proposals intended to strengthen auditor independence and skepticism.

Sources: 1. PCAOB Release No. 2011-016, "Concept Release on Auditor Independence and Audit Firm Rotation," August 16, 2011 (www. pcaobus.org); 2. European Commission, "Proposal for a Regulation of the European Parliament and of the Council on Specific Requirements Regarding Statutory Audits of Public Interest Entities" (ec.europa.eu); 3. "Musical Chairs," *The Economist*, September 3, 2011 (www.economist.com).

independence in certain circumstances. For example, suppose one CPA firm replaces the existing auditors on the strength of accounting advice offered but later find facts and circumstances that require the CPA firm to change its stance. It may be difficult for the new CPA firm to remain independent in such a situation. Auditing standards set forth requirements that must be followed when a CPA firm is requested to provide a written or oral opinion on the application of accounting principles or the type of audit opinion that would be issued for a specific or hypothetical transaction of an audit client of another CPA firm. The purpose of the requirement is to minimize the likelihood of management following the practice commonly called opinion shopping and the potential threat to independence of the kind described. Primary among the requirements is that the consulted CPA firm should communicate with the entity's existing auditors to ascertain all the available facts relevant to forming a professional judgment on the matters on which the firm has been requested to report.

Engagement and Payment of Audit Fees by Management

Can an auditor be truly independent in fact and appearance if the payment of the audit fees is dependent on the entity's management? There is probably no satisfactory answer to this question, but it does demonstrate the difficulty of assuring that auditors are independent. The alternative to engagement of the CPA firm by the audit committee and payment of audit fees by management is probably the use of either government or quasi-government auditors. All things considered, it is questionable whether the audit function would be performed better or more cheaply by the public sector.

INDEPENDENCE RULE OF CONDUCT AND INTERPRETATIONS

OBJECTIVE 5-6

Apply the AICPA *Code* rules and interpretations on independence and explain their importance.

The previous section discussed the importance of auditor independence. It is not surprising that independence is the first subject addressed in the rules of conduct.

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.

CPA firms are required to be independent for certain services that they provide, but not for others. The last phrase in Rule 101, "as required by standards promulgated by bodies designated by Council," is a convenient way for the AICPA to include or exclude independence requirements for different types of services. For example, the Auditing Standards Board requires that auditors of historical financial statements be independent. Rule 101 therefore applies to audits. Independence is also required for other types of attestations, such as review services and audits of prospective financial statements. However, a CPA firm can do tax returns and provide management services without being independent. Rule 101 does not apply to those types of services.

There are more interpretations for independence than for any of the other rules of conduct. Some of the more significant issues and interpretations involving independence are discussed in the following sections.

Financial Interests

Interpretations of Rule 101 prohibit covered members from owning *any stock or other direct investment* in audit clients because it is potentially damaging to actual audit independence (independence of mind), and it certainly is likely to affect users' perceptions of the auditors' independence (independence in appearance). *Indirect investments*, such as ownership of stock in a client's company by an auditor's grandparent, are also prohibited, but *only if the amount is material* to the auditor. The ownership of stock rule is more complex than it appears at first glance. A more detailed examination of that requirement is included to aid in understanding and to show the complexity of one of the rules. There are three important distinctions in the rules as they relate to independence and stock ownership.

Covered Members Rule 101 applies to covered members in a position to influence an attest engagement. Covered members include the following:

1. Individuals on the attest engagement team
2. An individual in a position to influence the attest engagement, such as individuals who supervise or evaluate the engagement partner
3. A partner or manager who provides nonattest services to the client
4. A partner in the office of the partner responsible for the attest engagement
5. The firm and its employee benefit plans
6. An entity that can be controlled by any of the covered members listed above or by two or more of the covered individuals or entities operating together

For example, a staff member in a national CPA firm could own stock in a client corporation and not violate Rule 101 if the staff member is not involved in the engagement. However, if the staff member is assigned to the engagement or becomes a partner in the office of the partner responsible for the attest engagement, he or she would have to dispose of the stock or the CPA firm would no longer be independent of that client.

These independence rules also generally apply to the covered member's immediate family. The interpretations of Rule 101 define immediate family as a spouse, spousal equivalent, or dependent.

Some CPA firms do not permit any ownership by staff of a client's stock regardless of which office serves the client. These firms have decided to have higher requirements than the minimums set by the rules of conduct.

Direct Versus Indirect Financial Interest The ownership of stock or other equity shares and debt securities by members or their immediate family is called a **direct financial interest**. For example, if either a partner in the office in which an audit is conducted or the partner's spouse has a financial interest in a company, the CPA firm is prohibited by Rule 101 from expressing an opinion on the financial statements of that company.

An **indirect financial interest** exists when there is a close, but not a direct, ownership relationship between the auditor and the client. An example of an indirect ownership interest is the covered member's ownership of a mutual fund that has an investment in a client.

Material or Immaterial *Materiality* affects whether ownership is a violation of Rule 101 only for *indirect* ownership. Materiality must be considered in relation to the member person's wealth and income. For example, if a covered member has a significant amount of his or her personal wealth invested in a mutual fund and that fund has a large ownership position in a client company, a violation of the *Code* is likely to exist.

Related Financial Interest Issues

Several interpretations of Rule 101 deal with specific aspects of financial relationships between CPA firm personnel and clients. These are summarized in this section.

Former Practitioners In most situations, the interpretations permit former partners or shareholders who left the firm due to such things as retirement or the sale of their ownership interest to have relationships with clients of the firm of the type that are normally a violation of Rule 101, without affecting a firm's independence. A violation by the firm would occur if the former partner was held out as an associate of the firm or took part in activities that are likely to cause other parties to believe the person is still active in the firm.

Normal Lending Procedures Generally, loans between a CPA firm or covered members and an audit client are prohibited because it is a financial relationship. There are several exceptions to the rule, however, including automobile loans, loans fully collateralized by cash deposits at the same financial institution, and unpaid credit card balances not exceeding $10,000 in total. It is also permissible to accept a financial institution as a client, even if covered members of the CPA firm have existing home mortgages, other fully collateralized secured loans, and immaterial loans with the institution. No new loans are permitted, however. Both the restrictions and exceptions are reasonable ones, considering the trade-off between independence and the need to permit CPAs to function as businesspeople and individuals.

Financial Interests and Employment of Immediate and Close Family Members The financial interests of immediate family members, defined as a spouse, spousal equivalent, or dependent, are ordinarily treated as if they were the financial interest of the covered member. For example, if the spouse of a professional on the audit engagement team owns any stock in the client, Rule 101 is violated. Independence is also impaired if an immediate family member holds a key position, such as financial officer or chief executive officer, with the client that allows them to influence accounting functions, preparation of financial statements, or the contents of the financial statements.

Ownership interests of close family members, defined as a parent, sibling, or nondependent child, do not normally impair independence unless the ownership interest is material to the close relative. Imagine the potential difficulty in maintaining independence and objectivity if the firm is asked to audit a client where the parent of the audit partner is chief executive officer and has a significant ownership interest in the client. For individuals on the engagement team, independence is impaired if a close relative has a key position with the client or has a financial interest that is material to the close relative or enables the relative to exercise significant influence over the client. Immaterial ownership interests of close family members do not normally impair independence. Independence is also not impaired if the covered member is not aware of the close relative's ownership interest.

Similar rules apply to other individuals in a position to influence the audit engagement or partners in the audit-engagement office. However, in these cases, the ownership interest does not impair independence unless the ownership interest is material to the close relative *and* allows the close relative to exercise significant influence over the audit client.

Joint Closely Held Investments with a Client Assume, for example, that a CPA owns stock in a nonaudit client, Jackson Company. Frank Company, which is an audit client, also owns stock in Jackson Company. This may be a violation of Rule 101. A joint closely held investment is an investment by the member and the client that

enables them to control the entity or property. A covered member's independence is considered to be impaired if the joint closely held investment is material to the covered member.

Director, Officer, Management, or Employee of a Company If a CPA is a member of the board of directors or an officer of a client company, his or her ability to make independent evaluations of the fair presentation of financial statements is affected. Even if holding one of these positions did not actually affect the auditor's independence, the frequent involvement with management and the decisions it makes is likely to affect how statement users perceive the CPA's independence. To eliminate this possibility, interpretations prohibit covered members, partners, and professional staff in the office of the partner responsible for the attest engagement from being a director or officer of an audit client company. Similarly, the auditor cannot be an underwriter, voting trustee, promoter, or trustee of a client's pension fund; or act in any other capacity of management; or be an employee of the company.

Independence can also be impaired when a former partner or member of the audit firm leaves the firm and is employed by the client in a key position, unless certain conditions are met. For example, the audit engagement team may need to modify audit procedures to reduce the risk that the former employee has knowledge of the audit plan, and the firm will need to evaluate whether members of the engagement team can maintain an effective level of professional skepticism when evaluating audit information and other representations provided by the former firm member. Independence can also be impaired when a member of the audit team discusses potential employment or receives an offer of employment from the audit client. In those situations, independence can be preserved if the individual promptly reports the offer to appropriate firm personnel and is removed from the engagement until the offer is accepted or rejected.

Interpretations permit CPAs to do audits and be *honorary* directors or trustees for not-for-profit organizations, such as charitable and religious organizations, as long as the position is purely honorary. To illustrate, it is common for a partner of the CPA firm doing the audit of a city's United Way drive to also be an honorary director, along with many other civic leaders. The CPA cannot vote or participate in any management functions.

Litigation Between CPA Firm and Client

When there is a lawsuit or intent to start a lawsuit between a CPA firm and its client, the ability of the CPA firm and client to remain objective is questionable. The interpretations regard such litigation as a violation of Rule 101 for the current audit. For example, if management sues a CPA firm claiming a deficiency in the previous audit, the CPA firm is not considered independent for the current year's audit. Similarly, if the CPA firm sues management for fraudulent financial reporting or deceit, independence is lost. The CPA firm and client company or management may be defendants in a suit brought by a third party, such as in a securities class action. This litigation in itself does not affect independence. However, independence may be affected if cross-claims between the auditor and client are filed that have a significant risk of a material loss to the CPA firm or client.

Litigation by the client related to tax or other nonaudit services, or litigation against both the client and the CPA firm by another party, does not usually impair independence. The key consideration in all such suits is the likely effect on the ability of client, management, and CPA firm personnel to remain objective and comment freely.

Bookkeeping and Other Services

If a CPA records transactions in the journals for the client, posts monthly totals to the general ledger, makes adjusting entries, and subsequently does an audit, there is some question as to whether the CPA can be independent in the audit role. The interpretations *permit a CPA firm to do both bookkeeping and auditing for a private company audit client.* The AICPA conclusion is presumably based on a comparison of the effect on independence of having both bookkeeping and auditing services performed by

the same CPA firm with the additional cost of having a different CPA firm do the audit. There are three important requirements that the auditor must satisfy before it is acceptable to do bookkeeping and auditing for the client:

1. The client must accept full responsibility for the financial statements. The client must be sufficiently knowledgeable about the enterprise's activities and financial condition and the applicable accounting principles so that the client can reasonably accept such responsibility, including the fairness of valuation and presentation and the adequacy of disclosure. When necessary, the CPA must discuss accounting matters with the client to be sure that the client has the required degree of understanding.
2. The CPA must not assume the role of employee or of management conducting the operations of an enterprise. For example, the CPA cannot consummate transactions, have custody of assets, or exercise authority on behalf of the client. The client must prepare the source documents on all transactions in sufficient detail to identify clearly the nature and amount of such transactions and maintain accounting control over data processed by the CPA, such as control totals and document counts.
3. The CPA, in making an audit of financial statements prepared from books and records that the CPA has maintained completely or in part, must conform to auditing standards. The fact that the CPA has processed or maintained certain records does not eliminate the need to make sufficient audit tests.

The first two requirements are often difficult to satisfy for a smaller company with an owner who may have little knowledge of or interest in accounting or processing transactions.

The AICPA independence rules require members to adhere to more restrictive independence rules of other regulatory bodies, such as the SEC. As a result, it is not permissible for an audit firm to provide bookkeeping services to a public company audit client under both SEC rules and the AICPA rules on independence.

Consulting and Other Nonaudit Services CPA firms offer many other services to attest clients that may potentially impair independence. Such activities are permissible as long as the member does not perform management functions or make management decisions. For example, a CPA firm may assist in the installation of a client's information system as long as the client makes necessary management decisions about the design of the system. Subject to some restrictions, CPA firms may also provide internal auditing and other extended auditing services to their clients as long as management maintains responsibility for the direction and oversight of the internal audit function.

The CPA firm must assess the client's willingness and ability to perform all management functions related to the engagement and must document the understanding with the client. The understanding should include a description of the services, the engagement objectives, any limitations on the engagement, the member's responsibilities, and the client's agreement to accept its responsibilities.

As indicated in the discussion of bookkeeping services, the more restrictive SEC independence rules concerning provision of nonaudit services apply to AICPA members when providing services to public company audit clients. As a result, providing nonaudit services that are prohibited by the SEC to a public company audit client would be a violation of AICPA rules as well as PCAOB and SEC rules. These prohibited nonaudit services were listed on page 135.

Unpaid Fees

Under Rule 101 and its rulings and interpretations, independence is considered impaired if billed or unbilled fees remain unpaid for professional services provided more than 1 year before the date of the report. Such unpaid fees are considered a loan from the auditor to the client and are therefore a violation of Rule 101. Unpaid fees from a client in bankruptcy do not violate Rule 101.

Network of Firms

Audit firms frequently join larger groups or associations of other firms to enhance their capabilities to provide professional services. When they share certain characteristics, such as a common brand name, common control, common business strategy, common quality control procedures, or they share in profits, costs, or professional resources, the network firm is required to be independent of audit and review clients of other network firms.

Independence Conceptual Framework

While the guidance contained in Rule 101 and related interpretations address many specific circumstances that may impair independence, CPAs are likely to face other circumstances that may threaten independence. To assist CPAs in evaluating independence issues, the Professional Ethics Executive Committee developed an independence conceptual framework consistent with a similar framework in the IESBA *Code* that provides a risk-based approach to analyzing independence matters. This risk-based approach involves a three-step process for assessing whether independence is impaired:

1. *Identify and evaluate circumstances that might threaten independence.* For example, a CPA firm's reliance on revenue from a single audit client may be significant, posing a potential threat to the firm's independence from that client.
2. *Determine whether safeguards are already in place or can be implemented that eliminate or sufficiently mitigate the threat.* For example, to address the threat associated with the excessive reliance on revenues from a single audit client, the CPA firm has established policies to closely monitor the firm's reliance on a single client's revenue and those policies include specific actions that prevent excessive reliance.
3. *Conclude that independence is impaired if no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level.* In making this judgment, the CPA considers whether the circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the CPA's independence.

The independence framework outlines seven broad categories of threats to independence, explores common issues associated with these kinds of threats, and describes examples of the types of safeguards that can be used to mitigate or eliminate threats to independence.

OTHER RULES OF CONDUCT

Although independence is critical to public confidence in CPAs, it is also important that auditors adhere to the other rules of conduct listed in Table 5-1 (p. 149). We begin by discussing the rules for integrity and objectivity.

Integrity and Objectivity

OBJECTIVE 5-7

Understand the requirements of other rules under the AICPA *Code*.

Integrity means impartiality in performing all services. Rule 102 on integrity and objectivity is presented below:

> **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.

To illustrate the meaning of integrity and objectivity, assume the auditor believes that accounts receivable may not be collectible but accepts management's opinion without an independent evaluation of collectibility. The auditor has subordinated his or her judgment and thereby lacks objectivity. Now assume a CPA is preparing the tax return for a client and, as a client advocate, encourages the client to take a deduction on the returns that the CPA believes is valid, but for which there is some but not complete support. This is not a violation of either objectivity or integrity, because it is acceptable for the CPA to be a client advocate in tax and management

services. If the CPA encourages the client to take a deduction for which there is no support but has little chance of discovery by the IRS, a violation has occurred. That is a misrepresentation of the facts; therefore, the CPA's integrity has been impaired.

Audit staff members should not subordinate their judgment to supervisors on the audit. Staff auditors are responsible for their own judgments documented in the audit files and should not change those conclusions at the request of supervisors on the engagement unless the staff auditor agrees with the supervisor's conclusion. Firm procedures should allow assistants to document situations where they disagree with a conclusion involving a significant matter.

Freedom from conflicts of interest means the absence of relationships that might interfere with objectivity or integrity. For example, it is inappropriate for an auditor who is also an attorney to represent a client in legal matters. The attorney is an advocate for the client, whereas the auditor must be impartial.

An interpretation of Rule 102 states that apparent conflicts of interest may not be a violation of the rules of conduct if the information is disclosed to the member's client or employer. For example, if a partner of a CPA firm recommends that a client have the security of its Web site evaluated by a technology consulting firm that is owned by the partner's spouse, a conflict of interest may appear to exist. No violation of Rule 102 occurs if the partner informs the client's management of the relationship and management proceeded with the evaluation with that knowledge. The interpretation makes it clear that the independence requirements under Rule 101 cannot be eliminated by these disclosures. Rule 102 also applies to CPAs who are not in public practice. For example, a CPA who, as an employee of an entity, makes false or misleading entries or representations in financial statements is in violation of Rule 102.

Technical Standards

The next three standards of the *Code* relate to the auditor's adherence with the requirements of technical standards. The following are the requirements of the technical 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.

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 Council.

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 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.

The primary purpose of the requirements of Rules 201 to 203 is to provide support for the ASB, PCAOB, FASB, IASB, and other technical standard-setting bodies. In 2008 the AICPA designated the IASB as the body to establish professional standards with respect to international financial accounting and reporting principles under Rule 202 of the *Code*.

Confidentiality

It is essential that practitioners not disclose confidential information obtained in any type of engagement without the consent of the client. The specific requirements of Rule 301 related to **confidential client information** are shown in the box in the middle of this page.

Need for Confidentiality During audits and most other types of engagements, practitioners obtain considerable confidential information, including officers' salaries, product pricing and advertising plans, and product cost data. If auditors divulge this information to outsiders or to client employees who have been denied access to the information, their relationship with management can be seriously strained and, in extreme cases, the client can be harmed. The confidentiality requirement applies to all services provided by CPA firms, including tax and management services.

Ordinarily, the CPA's audit files can be made available to someone else only with the express permission of the client. This is the case even if a CPA sells the practice to another CPA firm or is willing to permit a successor auditor to examine the audit documentation prepared for a former client.

> **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 and 203, (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.

Exceptions to Confidentiality As stated in the second paragraph of Rule 301, there are four exceptions to the confidentiality requirements. All four exceptions concern responsibilities that are more important than maintaining confidential relations with the client.

1. *Obligations related to technical standards.* Suppose that 3 months after an unqualified audit report was issued, the auditor discovers that the financial statements were materially misstated. When the chief executive officer is confronted, he responds that even though he agrees that the financial statements are misstated, confidentiality prevents the CPA from informing anyone. Rule 301 makes it clear that the auditor's responsibility to discharge professional standards is greater than that for confidentiality. In such a case, a revised, correct audit report must be issued. Note, however, that the conflict seldom occurs.
2. *Subpoena or summons and compliance with laws and regulations.* Legally, information is called **privileged information** if legal proceedings cannot require a person to provide the information, even if there is a subpoena. Information communicated by a client to an attorney or by a patient to a physician is

privileged. *Information obtained by a CPA from a client generally is not privileged.* Exception (2) of Rule 301 is therefore needed to put CPA firms in compliance with the law.

3. *Peer review.* When a CPA or CPA firm conducts a peer review of the quality controls of another CPA firm, it is normal practice to examine several sets of audit files. If the peer review is authorized by the AICPA, state CPA society, or state Board of Accountancy, client permission to examine the audit documentation is not needed. Requiring permission from each client may restrict access of the peer reviewers and would be a time burden on all concerned. Naturally, the peer reviewers must keep the information obtained confidential and cannot use the information for other purposes. Note that access to files for PCAOB inspections is also allowed to comply with the requirements of the Sarbanes–Oxley Act.
4. *Response to ethics division.* If a practitioner is charged with inadequate technical performance by the AICPA Ethics Division trial board under any of Rules 201 to 203, board members are likely to want to examine audit documentation. Exception (4) in Rule 301 prevents a CPA firm from denying the inquirers access to audit documentation by saying that it is confidential information. Similarly, a CPA firm that observes substandard audit documentation of another CPA firm cannot use confidentiality as the reason for not initiating a complaint of substandard performance against the firm.

Contingent Fees

To help CPAs maintain objectivity in conducting audits or other attestation services, basing fees on the outcome of engagements is prohibited. The requirements of Rule 302 related to contingent fees are shown below.

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 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.

To illustrate the need for a rule on contingent fees, suppose a CPA firm was permitted to charge a fee of $50,000 if an unqualified opinion was provided but only $25,000 if the opinion was qualified. Such an agreement may tempt a practitioner to issue the wrong opinion and is a violation of Rule 302. It is also a violation of Rule 302 for members to prepare an original or amended tax return or a claim for tax refunds for a contingent fee.

CPA firms are permitted to charge contingent fees *for nonattestation services, unless the CPA firm is also performing attestation services* for the same client. For example, it is *not* a violation for a CPA to charge fees as an expert witness determined by the amount awarded to the plaintiff or to base consulting fees on a percentage of a bond issue *if the CPA firm does not also do an audit or other attestation for the same client.*

Prohibiting contingent fees for attestation services and tax return preparation is important because of the importance of independence and objectivity. Because CPAs compete when providing other services with other professions who do not have contingent fee restrictions, it would be unfair to prohibit CPAs from providing these services on the same basis. When these nonattestation services are provided for a client receiving attestation services, the need for independence and objectivity prevails and the auditor is not allowed to provide the services on a contingent fee basis.

Discreditable Acts

Because of the special need for CPAs to conduct themselves in a professional manner, the *Code* has a specific rule prohibiting acts discreditable to the profession. Although a discreditable act is not well defined in the rules or interpretations, some of the requirements are discussed below.

> **Rule 501 – Acts Discreditable** A member shall not commit an act discreditable to the profession.

Do excessive drinking, rowdy behavior, or other acts that many people consider unprofessional constitute a discreditable act? Probably not. Determining what constitutes professional behavior continues to be the responsibility of each professional.

For guidance as to what constitutes a discreditable act, the AICPA bylaws provide clearer guidelines than the AICPA *Code of Professional Conduct*. The bylaws state that membership in the AICPA can be terminated without a hearing for judgment of conviction for any of the following four crimes: (1) a crime punishable by imprisonment for more than 1 year; (2) the willful failure to file any income tax return that the CPA, as an individual taxpayer, is required by law to file; (3) the filing of a false or fraudulent income tax return on the CPA's or client's behalf; or (4) the willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client. Observe that three of these deal with income tax matters of the member or a client.

Interpretations of Rule 501 identify several acts that are considered to be discreditable. For example, it is discreditable to retain a client's records after a demand is made for them or whenever a member is found to have violated any federal, state, or local antidiscrimination laws. The solicitation or disclosure of the Uniform CPA examination questions and answers without permission of the AICPA is also not permitted.

Rule 501 applies to all CPAs, even those not in public practice. For example, a member is considered to have committed an act discreditable if by his or her negligence others are made or permitted or directed to make materially false and misleading entries in the financial statements and records of an entity, the member fails to correct financial statements that are materially false and misleading, or the member signs or permits or directs another to sign a document containing materially false and misleading information. Also, if a member prepares financial statements or related information for reporting to governmental bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to requirements of accounting standards.

Other interpretations of Rule 501 describe additional acts considered to be discreditable. For example, auditors conducting audits of governmental entities must comply with standards for government audits. Similarly, when a member accepts an engagement that involves reporting to a regulatory agency such as the SEC, the member must follow the additional requirements of the regulatory agency.

Advertising and Solicitation

To encourage CPAs to conduct themselves professionally, the rules also prohibit advertising or solicitation that is false, misleading, or deceptive.

> **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, overreaching, or harassing conduct is prohibited.

Solicitation consists of the various means that CPA firms use to engage new clients other than accepting new clients who approach the firm. Examples include taking prospective clients to lunch to explain the CPA's services, offering seminars on current tax law changes to potential clients, and advertising on an Internet site. The last example is advertising, which is only one form of solicitation.

Many CPA firms have developed sophisticated advertising for national journals read by businesspeople and for local newspapers. It is common for CPA firms to identify potential clients being serviced by other CPA firms and make formal and informal presentations to convince management to change CPA firms. Price bidding for audits and other services is common and often highly competitive. As a result of these changes, some companies now change auditors more often than previously to reduce audit cost.

Has the quality of audits become endangered by these changes? Although there have been several recent high-profile cases involving apparent audit failures, the existing legal exposure of CPAs, peer review requirements, and PCAOB inspections, and the potential for interference by the SEC and government has kept audit quality high.

Commissions and Referral Fees

Commissions are compensation paid for recommending or referring a third party's product or service to a client or recommending or referring a client's product or service to a third party. Restrictions on commissions are similar to the rules on contingent fees. CPAs are prohibited from receiving commissions for a client who is receiving attestation services from the CPA firm. Commissions are permissible for other clients, but they must be disclosed. Referral fees for recommending or referring the services of another CPA are not considered commissions and are not restricted. However, any referral fees for CPA services must also be disclosed.

> **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.

The rule for commissions and referral fees means that a CPA firm does not violate AICPA rules of conduct if it sells such things as real estate, securities, and entire firms

on a commission basis if the transaction does not involve a client who is receiving attestation services from the same CPA firm. This rule enables CPA firms to profit by providing many services to nonattestation services clients that were previously prohibited.

The reason for the AICPA continuing to prohibit commissions for any attestation service client is the need to ensure that the CPA firm is independent. This requirement and the reasons for it are the same as those discussed under contingent fees.

The Board of Accountancy in the state in which the firm is licensed may have more restrictive rules than the AICPA. The CPA firm must follow the more restrictive requirements if different rules exist.

Form of Organization and Name

The organizational structure of CPA firms was first discussed in Chapter 2. The rules of conduct restrict the permissible forms of organization and prohibit a member from practicing under a firm name that is misleading.

Rule 505 permits practitioners to organize in any of six forms, as long as they are permitted by state law: proprietorship, general partnership, general corporation, professional corporation (PC), limited liability company (LLC), or limited liability partnership (LLP). Each of these forms of organization was discussed in Chapter 2 (pp. 48–49).

> **Rule 505 – Form of Organization and Name** A member may practice public accounting only in a form of organization permitted by state 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.

Ownership of CPA firms by non-CPAs is allowed under the following conditions:

- CPAs must own a majority of the firm's financial interests and voting rights.
- A CPA must have ultimate responsibility for all financial statement attest, compilation, and other services provided by the firm that are governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services.
- Owners must at all times own their equity in their own right.
- The following rules apply to all non-CPA owners:
  1. They must actively provide services to the firm's clients as their principal occupation.
  2. They cannot hold themselves out as CPAs but may use any title permitted by state law such as principal, owner, officer, member, or shareholder.
  3. They cannot assume ultimate responsibility for any financial statement attest or compilation engagement.
  4. They are not eligible for AICPA membership but must abide by the AICPA *Code of Professional Conduct.*

A recent development has been the acquisition of CPA firms by corporate entities. In such instances, the CPA firm may form a subsidiary to provide attest services to clients. These alternative practice structures are permissible, but an AICPA Council resolution makes it clear that to protect the public interest, CPAs have the same responsibility for the conduct of their attest work as they have in traditional practice structures.

A CPA firm may use any name as long as it is not misleading. Most firms use the name of one or more of the owners. It is not unusual for a firm name to include the names of five or more owners. A CPA firm can use a trade name, although this is unusual in practice. Names such as Marshall Audit Co. or Chicago Tax Specialists are permissible if they are not misleading.

A summary of the rules of conduct is included in Table 5-1 on page 149.

TABLE 5-1 Summary of Rules of Conduct

Rules of Conduct		Applicability		Summary of Rules
Number	**Topic**	**All Members**	**Members in Public Practice**	
101	Independence		X	A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.
102	Integrity and objectivity	X		In performing 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.
201	General standards	X		For all services, a member shall comply with the following professional standards and interpretations thereof by bodies designated by Council: (1) undertake only those professional services that the member can reasonably expect to complete with professional competence, (2) exercise due professional care, (3) adequately plan and supervise all engagements, and (4) obtain sufficient relevant data to afford a reasonable basis for all conclusions or recommendations.
202	Compliance with standards	X		A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.
203	Accounting principles	X		A member shall follow the professional audit reporting standards promulgated by bodies designated by Council in issuing reports about entities' compliance with generally accepted accounting principles.
301	Confidential client information		X	A member in public practice shall not disclose any confidential client information without the specific consent of the client, except for the four specific situations included in Rule 301.
302	Contingent fees		X	A member in public practice shall not perform for a contingent fee any professional service if the member also performs for the client an audit, review, or certain compilations of financial statements, or an examination of prospective financial statements. A member in public practice should also not prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client.
501	Acts discreditable	X		A member shall not commit an act discreditable to the profession.
502	Advertising and other forms of solicitation		X	A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited.
503	Commissions and referral fees		X	A member in public practice shall not receive or pay a commission or referral fee for any client if the member also performs for the client an audit, review, or certain compilations of financial statements, or an examination of prospective financial statements. For nonprohibited commissions or referral fees, a member must disclose the existence of such fees to the client.
505	Form of organization and name		X	A member may practice public accounting only in a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council and shall not practice public accounting under a firm name that is misleading.

ENFORCEMENT

OBJECTIVE 5-8

Describe the enforcement mechanisms for CPA conduct.

Failure to follow the rules of conduct can result in *expulsion* from the AICPA. This by itself does not prevent a CPA from practicing public accounting, but it is an important social sanction. In addition to the rules of conduct, the AICPA bylaws provide for automatic suspension or expulsion from the AICPA for conviction of a crime punishable by imprisonment for more than 1 year and for various tax-related crimes.

Action by AICPA Professional Ethics Division

The AICPA Professional Ethics Division is responsible for investigating violations of the *Code* and deciding disciplinary action. The division's investigations result from information obtained primarily from complaints of practitioners or other individuals, state societies of CPAs, or governmental agencies. A member can be automatically sanctioned without an investigation if the member has been disciplined by governmental agencies or other organizations that have been granted the authority to regulate accountants, such as the SEC and PCAOB.

There are two primary levels of disciplinary action. For less serious, and probably unintentional violations, the division limits the discipline to a requirement of remedial or corrective action. An example is the unintentional failure to make sure that a small audit client included all disclosures in its financial statements, which violates Rule 203 of the rules of conduct. The division is likely to require the member to attend a specified number of hours of continuing education courses to improve technical competence. The second level of disciplinary action is action before the Joint Trial Board. This board has authority to *suspend or expel members from the AICPA* for various violations of professional ethics. Typically, action by the board is reported in the Disciplinary Actions sections of the AICPA Web site, including the name and location of the person suspended or expelled and reasons for the action.

Action by a State Board of Accountancy

Even more important than expulsion from the AICPA are the rules of conduct, similar to those of the AICPA, that have been enacted by the Board of Accountancy of each of the 50 states. Because each state grants the individual practitioner a license to practice as a CPA, a significant breach of a state Board of Accountancy's code of conduct can result in the *loss of the CPA certificate and the license to practice.* Although it rarely happens, the loss removes the practitioner from public accounting. Most states adopt the AICPA rules of conduct, but several have more restrictive codes. For example, some states have retained restrictions on advertising and other forms of solicitation. In recent years, an increasing number of states have adopted codes of conduct more restrictive than those of the AICPA.

PCAOB Enforcement Actions

In addition to enforcement actions by the AICPA and state boards of accountancy, auditors of public companies are subject to PCAOB sanctions. The PCAOB has authority to investigate and discipline registered public accounting firms and persons associated with those firms for noncompliance with the Sarbanes–Oxley Act of 2002, as well as the rules of the PCAOB and the Securities and Exchange Commission governing the audits of public companies. When violations are found, the PCAOB can impose appropriate sanctions, including suspension or revocation of a firm's registration, suspension or barring of an individual from associating with a registered public accounting firm, and monetary penalties. The PCAOB may also require improvements in the firm's quality control, additional training, or other remedial measures.

SUMMARY

The demand for audit and other assurance services provided by CPA firms depends on public confidence in the profession. This chapter discussed the role of ethics in society and the unique ethical responsibilities of CPAs.

The professional activities of CPAs are governed by the AICPA *Code of Professional Conduct*, and auditors of public companies are also subject to oversight by the PCAOB and SEC. Foremost of all ethical responsibilities of CPAs is the need for independence. The rules of conduct and interpretations provide guidance on permissible financial and other interests to help CPAs maintain independence. Other rules of conduct are also designed to maintain public confidence in the profession. The ethical responsibilities of CPAs are enforced by the AICPA for members and by state boards of accountancy for licensed CPAs.

ESSENTIAL TERMS

Audit committee—selected members of a client's board of directors whose responsibilities include helping auditors to remain independent of management

Confidential client information—client information that may not be disclosed without the specific consent of the client except under authoritative professional or legal investigation

Direct financial interest—the ownership of stock or other equity shares by members or their immediate family

Ethical dilemma—a situation in which a decision must be made about the appropriate behavior

Ethics—a set of moral principles or values

Independence in appearance—the auditor's ability to maintain an unbiased viewpoint *in the eyes of others*

Independence of mind—the auditor's state of mind that enables an unbiased viewpoint in the performance of professional services; also described as "independence in fact"

Indirect financial interest—a close, but not direct, ownership relationship between the auditor and the client; an example is the ownership of stock by a member's grandparent

Privileged information—client information that the professional cannot be legally required to provide; information that an accountant obtains from a client is confidential but not privileged

REVIEW QUESTIONS

5-1 (Objective 5-1) What are the six core ethical values described by the Josephson Institute? What are some other sources of ethical values?

5-2 (Objective 5-2) List a six-step approach that is intended to be a relatively simple approach to resolving ethical dilemmas.

5-3 (Objective 5-3) Why is there a special need for ethical behavior by professionals? Why do the ethical requirements of the CPA profession differ from those of other professions?

5-4 (Objective 5-4) List the four parts of the *Code of Professional Conduct*, and state the purpose of each.

5-5 (Objective 5-5) Why is an auditor's independence so essential?

5-6 (Objective 5-4) What organization is responsible for developing ethics standards at the international level? What are the fundamental principles of the international ethics standards?

5-7 (Objective 5-5) Distinguish between independence of mind and independence in appearance. State three activities that may not affect independence of mind but are likely to affect independence in appearance.

5-8 (Objective 5-5) What consulting or nonaudit services are prohibited for auditors of public companies? What other restrictions and requirements apply to auditors when providing nonaudit services to public companies?

5-9 (Objective 5-6) Explain how the rules concerning stock ownership apply to partners and professional staff. Give an example of when stock ownership would be prohibited for each.

5-10 (Objective 5-5) Many people believe that a CPA cannot be truly independent when payment of fees is dependent on the management of the client. Explain two approaches that could reduce this appearance of lack of independence.

5-11 (Objective 5-7) After accepting an engagement, a CPA discovers that the client's industry is more technical than he realized and that he is not competent in certain areas of the operation. What are the CPA's options?

5-12 (Objective 5-7) Assume that an auditor makes an agreement with a client that the audit fee will be contingent upon the number of days required to complete the engagement. Is this a violation of the *Code of Professional Conduct*? What is the essence of the rule of professional ethics dealing with contingent fees, and what are the reasons for the rule?

5-13 (Objective 5-7) Explain in brief the auditor's audit files and the peer review process.

5-14 (Objective 5-7) Identify and explain factors that should keep the quality of audits high even though advertising and competitive bidding are allowed.

5-15 (Objective 5-7) Identify two examples of acts or behavior by CPAs that would be considered discreditable to the profession under Rule 501.

5-16 (Objective 5-7) What is the purpose of the AICPA *Code of Professional Conduct* restriction on commissions as stated in Rule 503?

5-17 (Objective 5-7) State the allowable forms of organization a CPA firm may assume.

MULTIPLE CHOICE QUESTIONS FROM CPA EXAMINATIONS

5-18 (Objective 5-6) The following questions concern independence and the *Code of Professional Conduct* or auditing standards. Choose the best response.

a. What is the meaning of the auditing standard that requires the auditor be independent?
   (1) The auditor must be without bias with respect to the client under audit.
   (2) The auditor must adopt a critical attitude during the audit.
   (3) The auditor's sole obligation is to third parties.
   (4) The auditor may have a direct ownership interest in the client's business if it is not material.

b. The Conceptual Framework for AICPA Independence Standards
   (1) adopts a risk-based approach to analysis of independence matters.
   (2) defines independence of mind as avoiding circumstances in which reasonable persons would conclude that integrity or objectivity has been compromised.
   (3) describes threats to independence as circumstances that impair independence.
   (4) states that safeguards must eliminate threats to independence to be considered effective.

c. An auditor strives to achieve independence in appearance to
   (1) comply with the auditing standards of fieldwork.
   (2) become independent in fact.
   (3) maintain public confidence in the profession.
   (4) maintain an unbiased mental attitude.

5-19 (Objective 5-7) The following questions concern possible violations of the AICPA *Code of Professional Conduct*. Choose the best response.

a. In which one of the following situations would a CPA be in violation of the AICPA *Code of Professional Conduct* in determining the audit fee?
   (1) A fee based on whether the CPA's report on the client's financial statements results in the approval of a bank loan.
   (2) A fee based on the outcome of a bankruptcy proceeding.
   (3) A fee based on the nature of the service rendered and the CPA's expertise instead of the actual time spent on the engagement.
   (4) A fee based on the fee charged by the prior auditor.

b. The AICPA *Code of Professional Conduct* states that a CPA shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client. In which one of the following situations would disclosure by a CPA be in violation of the code?
   (1) Disclosing confidential information to another accountant interested in purchasing the CPA's practice.
   (2) Disclosing confidential information in compliance with a subpoena issued by a court.
   (3) Disclosing confidential information in order to properly discharge the CPA's responsibilities in accordance with the profession's standards.
   (4) Disclosing confidential information during an AICPA authorized peer review.

c. A CPA's retention of client records as a means of enforcing payment of an overdue audit fee is an action that is
   (1) not addressed by the AICPA *Code of Professional Conduct.*
   (2) acceptable if sanctioned by the state laws.
   (3) prohibited under the AICPA rules of conduct.
   (4) a violation of generally accepted auditing standards.

DISCUSSION QUESTIONS AND PROBLEMS

5-20 (Objectives 5-5, 5-6) The following situations involve the provision of nonaudit services. Indicate whether providing the service is a violation of AICPA rules or SEC rules including Sarbanes–Oxley requirements on independence. Explain your answer as necessary.

a. Providing bookkeeping services to a public company. The services were preapproved by the audit committee of the company.
b. Providing advice to a private company client on accounting for a merger with another private company.
c. Providing internal audit services to a public company that is not an audit client.
d. Implementing a financial information system designed by management for a private company.
e. Recommending a tax shelter to a client that is publicly held. The services were preapproved by the audit committee.
f. Providing internal audit services to a public company audit client with the preapproval of the audit committee.

5-21 (Objectives 5-6, 5-7) Each of the following situations involves a possible violation of the AICPA *Code of Professional Conduct*. For each situation, state the applicable section of the rules of conduct and whether it is a violation.

a. Emrich, CPA, provides tax services, management advisory services, and bookkeeping services and also conducts audits for the same nonpublic client. Because the firm is small, the same person often provides all the services.
b. Franz Marteens is a CPA, but not a partner, with 3 years of professional experience with Roberts and Batchelor, CPAs. He owns 25 shares of stock in an audit client of the firm, but he does not take part in the audit of the client, and the amount of stock is not material in relation to his total wealth.
c. A nonaudit client requests assistance of M. Wilkenson, CPA, in the installation of a local area network. Wilkenson had no experience in this type of work and no knowledge of the client's computer system, so he obtained assistance from a computer consultant. The consultant is not in the practice of public accounting, but Wilkenson is confident of his professional skills. Because of the highly technical nature of the work, Wilkenson is not able to review the consultant's work.
d. In preparing the personal tax returns for a client, Sarah Milsaps, CPA, observed that the deductions for contributions and interest were unusually large. When she asked the client for backup information to support the deductions, she was told, "Ask me

no questions, and I will tell you no lies." Milsaps completed the return on the basis of the information acquired from the client.

e. Roberta Hernandez, CPA, serves as controller of a U.S.-based company that has a significant portion of its operations in several South American countries. Certain government provisions in selected countries require the company to file financial statements based on international standards. Roberta oversees the issuance of the company's financial statements and asserts that the statements are based on international financial accounting standards; however, the standards she uses are not those issued by the International Accounting Standards Board.

f. Steve Custer, CPA, set up a casualty and fire insurance agency to complement his auditing and tax services. He does not use his own name on anything pertaining to the insurance agency and has a highly competent manager, Jack Long, who runs it. Custer often requests Long to review the adequacy of a client's insurance with management if it seems underinsured. He believes that he provides a valuable service to clients by informing them when they are underinsured.

g. Seven small Seattle CPA firms have become involved in an information project by taking part in an interfirm working paper review program. Under the program, each firm designates two partners to review the audit files, including the tax returns and the financial statements of another CPA firm taking part in the program. At the end of each review, the auditors who prepared the working papers and the reviewers have a conference to discuss the strengths and weaknesses of the audit. They do not obtain authorization from the audit client before the review takes place.

h. Archer Ressner, CPA, stayed longer than he should have at the annual Christmas party of Ressner and Associates, CPAs. On his way home he drove through a red light and was stopped by a police officer, who observed that he was intoxicated. In a jury trial, Ressner was found guilty of driving under the influence of alcohol. Because this was not his first offense, he was sentenced to 30 days in jail and his driver's license was revoked for 1 year.

5-22 (Objectives 5-6, 5-7) Each of the following situations involves possible violations of the AICPA *Code of Professional Conduct*. For each situation, state whether it is a violation of the *Code*. In those cases in which it is a violation, explain the nature of the violation and the rationale for the existing rule.

a. The audit firm of Miller and Yancy, CPAs, has joined an association of other CPA firms across the country to enhance the types of professional services the firm can provide. Miller and Yancy share resources with other firms in the association, including audit methodologies, audit manuals, and common IT systems for billing and time reporting. One of the partners in Miller and Yancy has a direct financial interest in the audit client of another firm in the association.

b. Bruce Sullivan, CPA, is the audit partner on the engagement of Xylium Corporation, which is a public company. In structuring the agreement with the audit committee for the audit of Xylium's financial statements, Sullivan included a clause that limits the liability of Sullivan's firm so that shareholders of Xylium are prohibited from suing Sullivan and the firm for performance issues related to the audit.

c. Connor Bradley is the partner in charge of the audit of Southern Pinnacle Bank. Bradley is in the process of purchasing a beach condo and has obtained mortgage financing from Southern Pinnacle.

d. Jennifer Crowe's audit client has a material investment in Polex, Inc. Jennifer's non-dependent parents also own shares in Polex, and Polex is not an attest client of Jennifer's firm. The amount of her parent's ownership in Polex is not significant to Jennifer's net worth.

e. Joe Stokely is a former partner in Bass and Sims, CPAs. Recently, Joe left the firm to become the chief operating officer of Lacy Foods, Inc., which is an audit client of Bass and Sims. In his new role, Joe has no responsibilities for financial reporting. Bass and Sims made significant changes to the audit plan for the upcoming audit.

f. Odonnel Incorporated has struggled financially and has been unable to pay the audit fee to its auditor, Seale and Seale, CPAs, for the 2011 and 2012 audits. Seale and Seale is currently planning the 2013 audit.

g. Jessica Alma has been serving as the senior auditor on the audit of Carolina BioHealth, Inc. Because of her outstanding work, the head of internal audit at Carolina BioHealth extended her an offer of employment to join the internal audit department as an audit manager. When the discussions with Carolina BioHealth began, Jessica informed her office's managing partner and was removed from the audit engagement.

h. Morris and Williams, a regional CPA firm, is providing information systems consulting to one of their publicly traded audit clients. They are assisting in the implementation of a new financial reporting system selected by management.

i. Audrey Glover is a financial analyst in the financial reporting department of Technologies International, a privately held corporation. Audrey was asked to prepare several journal entries for Technologies International related to transactions that have not yet occurred. The entries are reflected in financial statements that the company recently provided to the bank in connection with a loan outstanding due to the bank.

j. Austin and Houston, CPAs, is performing consulting services to help management of McAlister Global Services streamline its production operations. Austin and Houston structured the fee for this engagement to be a fixed percentage of costs savings that result once the new processes are implemented. Austin and Houston perform no other services for McAlister Global.

5-23 (Objective 5-6) Marie Janes encounters the following situations in doing the audit of a large auto dealership. Janes is not a partner.

1. The sales manager tells her that there is a sale (at a substantial discount) on new cars that is limited to long-established customers of the dealership. Because her firm has been doing the audit for several years, the sales manager has decided that Janes should also be eligible for the discount.
2. The auto dealership has an executive lunchroom that is available free to employees above a certain level. The controller informs Janes that she can also eat there any time.
3. Janes is invited to and attends the company's annual Christmas party. When presents are handed out, she is surprised to find her name included. The present has a value of approximately $200.

Required

Use the three-step process in the AICPA independence conceptual framework to assess whether Janes' independence has been impaired.

a. Describe how each of the situations might threaten Janes' independence from the auto dealership.

b. Identify a safeguard that Janes' firm could impose that would eliminate or mitigate the threat of each situation to Janes' independence.

c. Assuming no safeguards are in place and Janes accepts the offer or gift in each situation, discuss whether she has violated the rules of conduct.

d. Discuss what Janes should do in each situation.

5-24 (Objective 5-5) The U.S. national stock exchanges require listed companies to have an independent audit committee.

Required

a. Describe an audit committee.

b. What does it mean for the audit committee members to be "independent"?

c. What are the typical functions performed by an audit committee?

d. Explain how an audit committee can help an auditor be more independent.

e. Describe the nature of the audit firm's communications with the audit committee regarding independence issues.

f. Some critics of audit committees believe that they bias companies in favor of larger and perhaps more expensive CPA firms. These critics contend that a primary concern of audit committee members is to reduce their exposure to legal liability. The committees will therefore recommend larger, more prestigious CPA firms, even

if the cost is somewhat higher, to minimize the potential criticism of selecting an unqualified firm. Evaluate these comments.

5-25 (Objectives 5-5, 5-6) The following relate to auditors' independence:

Required

a. Why is independence so essential for auditors?

b. Compare the importance of independence of CPAs with that of other professionals, such as attorneys.

c. Explain the difference between independence in appearance and of mind.

d. Assume that a partner of a CPA firm owns two shares of stock of a large audit client on which he serves as the engagement partner. The ownership is an insignificant part of his total wealth.

(1) Has he violated the *Code of Professional Conduct*?

(2) Explain whether the ownership is likely to affect the partner's independence of mind.

(3) Explain the reason for the strict requirements about stock ownership in the rules of conduct.

e. Discuss how each of the following could affect independence of mind and independence in appearance, and evaluate the social consequence of prohibiting auditors from doing each one:

(1) Owning stock in a client company

(2) Having bookkeeping services for an audit client performed by the same person who does the audit

(3) Having a spouse who is the chief financial officer of a client company

(4) Having the annual audit performed by the same CPA firm for 10 years in a row

(5) Having management select the CPA firm

(6) Recommending adjusting entries to the client's financial statements and preparing financial statements, including footnotes, for the client

(7) Providing valuation services on complex financial instruments for an audit client performed by individuals in a department that is separate from the audit department

f. Which of (1) through (7) are prohibited by the AICPA *Code of Professional Conduct*? Which are prohibited by the Sarbanes–Oxley Act or the SEC?

5-26 (Objective 5-4, 5-8) The following questions relate to the AICPA *Code of Professional Conduct*:

a. What are the four parts of the AICPA *Code of Professional Conduct*? What parts are enforceable?

b. Explain the principles portion of the *Code of Professional Conduct*. How do the principles relate to the rules of conduct?

c. What enforcement actions may occur if an auditor fails to follow the rules of conduct?

d. Go to the AICPA Web site (www.aicpa.org) and search for "Annual Disciplinary Report" within the "Professional Ethics" section. Find the most recent annual disciplinary report. How many cases involved expulsion or suspension, admonishment, or corrective action? What are the differences in these types of enforcement actions?

CASES

5-27 (Objectives 5-6, 5-7) The following are situations that may violate the *Code of Professional Conduct*. Assume, in each case, that the CPA is a partner, unless stated otherwise.

1. Jasmine, CPA, has set up a small financial services company that specializes in 401Ks and health plans for small businesses. However, Jasmine takes her CPA work with her when she is at the financial services company and has two other CPAs helping her with the financial company.
2. Elmyra, CPA, advertises her practice online, citing several prominent clients she has worked with. She has provided links to their Web sites and included quotes from her happy clients.

3. Upon reviewing a new client's financial statements, Rukan, CPA, approaches the company's president. He noticed that several of the company's checks have been canceled and then rewritten at a later date, but there are two cashed checks for the same amount of money. The company's bookkeeper quit two months prior to the audit.
4. Samir, CPA, is hired to do the audit of Al-Sharif Transportation Co. Samir owns a substantial limited partnership interest in a construction company. Zubair Al-Sharif is a 100% owner in Al-Sharif Transportation Co. Al-Sharif also owns a substantial limited partnership in the same construction company as Samir.
5. After the auditor of a construction company suddenly quit, Basil, CPA, was hired to do the accounting for the company. The audits are due within two weeks, and there are several discrepancies between bank statements and the general ledger. He spoke to his supervisor, who told him to reconcile the two books as quickly as possible.
6. Jamal, CPA, works for Gilgamesh Practices. As part of his job, he is in charge of the audit, tax return, bookkeeping, and management services work for the Uthman Decorating Company. Makin Uthman relies on Jamal's advice before making any business decisions that could significantly affect the taxes or financial statements of his company. Jamal also attends all meetings of the company's board of directors. Because he doesn't know too much about the industry, Jamal attends some professional development courses in interior decorating. Recently, it was announced that Uthman's vice president will be retiring soon, and Uthman has hinted that he would like Jamal to join his company with a higher pay than he is currently receiving at Gilgamesh.

Required

Which of the following situations indicates violations of the *Code of Professional Conduct?* Which code does the situation violate, and what is the nature of the violation(s)?

5-28 (Objectives 5-2, 5-7) Barbara Whitley had great expectations about her future as she sat in her graduation ceremony in May 2012. She was about to receive her Master of Accountancy degree, and next week she would begin her career on the audit staff of Green, Thresher & Co., CPAs.

Things looked a little different to Barbara in February 2013. She was working on the audit of Delancey Fabrics, a textile manufacturer with a calendar year-end. The pressure was enormous. Everyone on the audit team was putting in 70-hour weeks, and it still looked as if the audit wouldn't be done on time. Barbara was doing work in the property area, vouching additions for the year. The audit program indicated that a sample of all items over $20,000 should be selected, plus a judgmental sample of smaller items. When Barbara went to take the sample, Jack Bean, the senior, had left the client's office and couldn't answer her questions about the appropriate size of the judgmental sample. Barbara forged ahead with her own judgment and selected 50 smaller items. Her basis for doing this was that there were about 250 such items, so 50 was a reasonably good proportion of such additions.

Barbara audited the additions with the following results: The items over $20,000 contained no misstatements; however, the 50 small items contained a large number of misstatements. In fact, when Barbara projected them to all such additions, the amount seemed quite significant.

A couple of days later, Jack Bean returned to the client's office. Barbara brought her work to Jack in order to apprise him of the problems she found and got the following response:

> "Gosh, Barbara, why did you do this? You were only supposed to look at the items over $20,000 plus 5 or 10 little ones. You've wasted a whole day on that work, and we can't afford to spend any more time on it. I want you to throw away the schedules where you tested the last 40 small items and forget you ever did them."

When Barbara asked about the possible audit adjustment regarding the small items, none of which arose from the first 10 items, Jack responded, "Don't worry, it's not material anyway. You just forget it; it's my concern, not yours."

Required

a. In what way is this an ethical dilemma for Barbara?

b. Use the six-step approach discussed in the book to resolve the ethical dilemma.

5-29 (Objectives 5-1, 5-2, 5-3) People believed that the handover of Hong Kong in 1997 would lead to an appreciation in value of the British Queen's Head coins. This gave rise to a shortage of coins in the market as people started to keep the coins as an investment. The release of the Octopus card in 1997 helped by relieving the demand for coins. The Octopus card, a contactless rechargeable stored value smart card, is widely used as one of the electronic payment methods in Hong Kong. The Octopus card system is operated by the Octopus Holdings Limited, a joint-venture business owned by five major transport operators in Hong Kong. Originally, the Octopus system was used to provide a simple way to pay fares on public transport in Hong Kong. Eventually, the Octopus card was generally accepted by thousands of merchants in the city.

Instead of charging the normal fare, the public transport operators charge less for journeys made using an Octopus card. This facilitates the popular use of the Octopus system. In addition, the Octopus reward program was launched to allow holders of the Octopus card to earn rewards at participating service providers or merchants. Bonus points or reward dollars are offered by the participating merchants and are stored on the Octopus card. Once the bonus points or reward dollars are accumulated up to HK$1, they can be redeemed by the card holder, either entirely or partially.

Monetary value can be added to the Octopus card by using the add value machines or paying cash at the customer service offices at the Hong Kong Railway stations. In addition, authorized service providers including supermarkets, convenience stores, and fast food shops offer an add value service. Card holders can also add value to their cards by using the Octopus Automatic Add Value Service offered by banks participating in this program. Once the balance of the Octopus card reaches a minimum, value is added automatically through credit cards issued by the participating banks. Banks also offer reward points to card holders every time the Octopus card is reloaded by the add value service. Credit card holders can enjoy an interest-free repayment period as the repayment of value added on the Octopus card is accumulated with other credit card payments. A maximum value of HK$1,000 can be stored on an Octopus card.

Before 2007, customers could also use the self-service add value machines to transfer money from their bank accounts directly to the Octopus card. However, the company received complaints on wrongly deducted amounts from the card holders' bank accounts when the add value machines were used. After an investigation in 2007, it was found that HK$3.7 million was incorrectly deducted from the customers' accounts without adding value to their Octopus cards. In order to eliminate any chance of errors in the communication system, self-service add value machines were abandoned in 2007. Therefore, customers relied more on the add value service provided by supermarkets and convenience stores.

Peter Mak is the sole practitioner of a CPA firm in Hong Kong and primarily provides accounting, auditing and tax services. In April 2008, Peter was approached by John Caine to provide tax services. John is an information systems engineer working in a local IT consulting firm in Hong Kong. Because John is a U.S. citizen, in addition to filing the tax return to the Inland Revenue department in Hong Kong, he also needs to submit a tax return to the U.S. Internal Revenue Service (IRS). John asked for Peter's advice to minimize his tax payments to the IRS. Peter knows that John frequently goes to his clients' offices by public transportation to provide on-site services. Public transportation service providers such as the Hong Kong Railway and mini-buses do not offer receipts. Because business related transportation expenses are tax deductible from U.S. tax, Peter advises John to use the Octopus card to pay for his personal expenses and keep the receipts of adding value for the Octopus card as proof of transportation expenses for claiming deduction on the U.S. tax return. Therefore, John uses the Octopus card to pay for food, drinks, and even housewares available from the supermarkets. He saves all receipts for adding value transactions on his Octopus card and claims them as traveling expenses incurred to render his services to his clients.

a. Did Peter's tax advice to John violate any ethical standards? Be specific in your answer. **Required**

b. If during the course of an audit, you discover that your client includes both the receipts of adding value for the Octopus card as well as those for the actual purchases paid by Octopus card as proof of expenses in the company's financial statement, what should you do?

5-30 (Objective 5-2) Ann Donnelly is a senior audit manager in an East Coast office of a public accounting firm. Her prospects for promotion to partner are excellent if she continues to perform at the same high-quality level as in the past. Ann was recently married, and she and her husband bought a large home in a prestigious neighborhood.

Ann just returned from a vacation and was immediately called into an audit partner's office for a discussion related to one of her publicly traded audit clients. This audit engagement, which had been completed with an audit report issued several months prior, had been selected for a PCAOB inspection and the partner is concerned. PCAOB inspections can be stressful for the primary engagement partner and often result in the identification of audit deficiencies by the PCAOB, which are then discussed with the audit firm. The partner is concerned he will look bad and may even face penalties from the firm if there are serious deficiencies identified.

Under PCAOB auditing standards, all working paper documentation for an audit of a publicly traded client should be completed within 45 days of the audit report release date. Any working papers added to the file after that date should be dated accordingly, signed by the preparer, with a note as to the purpose of the added working paper. The audit engagement team is not allowed to modify or delete original documentation included in the working papers.

In the current meeting between Ann and the partner, the partner on the audit engagement feels they need to provide further support for one of the judgmental audit areas on the audit engagement in order to avoid scrutiny from the PCAOB, and that they also need to go through the working papers and ensure that all work was appropriately signed off by the manager and partner. The partner suggests to Ann that she include an additional memo to support their conclusion on the judgmental audit area in question and that she date this memo as if she completed it at the time she and the staff originally did the work, and that she ensure all required signatures are in the working papers. Ann reminds the partner this is in violation of the PCAOB auditing standards; however, the partner assures Ann that no one will know and they can avoid possible penalties that would result if they do not ensure that their audit engagement will pass inspection. "After all," the engagement partner reminds Ann, "you will soon be considered for promotion to partner and you would not want a negative inspection outcome on a prior engagement to stand in your way of making partner."

Use the six-step approach discussed in the book to resolve the ethical dilemma. **Required**

RESEARCH PROBLEM 5-1: IESBA CODE OF ETHICS

The International Ethics Standards Board for Accountants (IESBA) *Handbook of the Code of Ethics for Professional Accountants* is available for free download from the IFAC Web site (www.ifac.org). Similarly, the AICPA *Code of Professional Conduct* is searchable at the AICPA Web site (www.aicpa.org).

a. Locate both the IESBA *Code* and the AICPA *Code* on the respective Web sites. **Required**

b. Compare the six Principles in the AICPA *Code* with the five Fundamental Principles in the IESBA *Code*. Evaluate where there are similarities and differences in concepts across the principles.

c. One of the Principles in the AICPA *Code* is "public interest." Describe how the IESBA *Code* addresses the concept of "public interest."

d. Compare the organizational structure of the AICPA *Code* with the IESBA *Code*.

e. Identify where in the IESBA *Code* issues related to independence are addressed.