Professional Ethics: AICPA’s Comprehensive Course
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By Catherine R. Allen, CPA
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CPE standards place responsibility on both the individual participant and the program sponsor to maintain a record of attendance at a CPE program. CPAs who participate in only part of a CPE program should only claim CPE credit for the portion that they attended or completed.

CPE participants must document their claims of CPE credit. Examples of acceptable evidence of completion include:

- for group and independent study programs, a certificate or other verification supplied by the CPE program sponsor.
- for self-study programs, a certificate supplied by the CPE program sponsor after satisfactory completion of an examination.

Participants in group study and other live presentations will receive a completion certificate from the program sponsor. CPE program sponsors are required to keep documentation on programs for five years, including records of participation.

All self-study participants must complete the exam within one year of date of course purchase in order to receive a certificate indicating satisfactory completion of the CPE program.

- When purchased as a self-study course in text format, the exam is located in the *Examination* section at the end of the course manual.
The course code number for both the self study exam and the self study evaluation can be found in the Examination’s introductory material.

The self study examination answer sheet and evaluation form are included with your course materials. Participants may complete them online or use the paper forms. If using the paper forms, you should mail the original answer sheet and course evaluation form in the pre-addressed envelope. Photocopies or faxes of the original forms are not acceptable. The paper grading process averages five to seven business days from date of receipt. During peak reporting periods (June, September, and December), the processing time may be 10 to 15 business days.

Alternatively, self-study participants may choose to complete the exam and course evaluation online at https://cperegrading.aicpa.org. Participants must provide the unique serial number printed on the Answer Sheet.

Participants must achieve a minimum passing grade of at least 70 percent to qualify for CPE credit.

Upon achieving a passing grade, participants will receive a certificate displaying the number of CPE credits earned based on a 50-minute hour, in compliance with CPE standards.

- If you do not achieve a passing grade and you mailed in the exam, you will not receive any notification.
- If you do not achieve a passing grade and you completed the exam online, the website will notify you of your score.

Self study online participants may print the completion certificate after successful completion of the exam. Participants who do not pass the exam within three attempts must mail in the answer key.

Program Evaluations
The information accumulated from participant evaluation forms is an important element in our continual efforts to provide high quality continuing education for the profession. Participants in group study and other live presentations should return their evaluation forms prior to departing their program sessions. Self-study participants should either mail the completed evaluation form along with the examination answer sheet in the envelope provided, or complete the course evaluation online. Your comments are very important to us.

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Overview

Introduction

This course will teach you about the basic ethical requirements applicable to CPAs, including a methodology for analyzing ethical matters.

Course Objectives

After completing this course, you will be able to:

- Explain the governance of the accounting profession.
- Identify the principles that underlie the AICPA Code of Professional Conduct (the Codification).
- Describe the structure and content of the Codification.
- Explain the Conceptual Framework approach.
- Apply the frameworks to specific fact patterns.
- Apply AICPA rule interpretations on integrity, objectivity, confidentiality, and advertising.
- Explain acts discreditable to the profession.
- Explain the obligations to exercise due professional care, comply with professional standards, and be competent in performing professional services.
- Analyze ethical matters using an ethical decision-making model to determine an appropriate course of action.
- Identify the consequences of violating ethical standards.
- Assess the importance of independence, when independence is required, and why you must be independent both in fact and in appearance.
- Identify the financial, family, and employment relationships that impair independence.
- Analyze the non-attest services and business relationships that create threats to independence.
- Evaluate fee issues and their effect on independence and objectivity.
• Assess other matters that may affect independence, such as indemnification clauses and litigation.

• Apply the additional independence provisions applicable to attest clients subject to the SEC, the PCAOB, the U.S. Government Accountability Office (GAO), the U.S. Department of Labor (DOL), and banking and insurance industry requirements.

• Apply the ethics rules relating to tax practice, including the AICPA Statements on Standards for Tax Services, IRS Circular No. 230, and IRS preparer penalty provisions.

Because this is an introductory course, the content is general, but there is additional information available to you throughout this manual, which should provide a comprehensive foundation for further research and inquiry.

A Brief Story

Imagine you are the controller of Apex Corporation, a troubled company, whose one hope is a possible acquisition by Fire Corporation of America (FCA). Here is the background.

Apex is a telecommunications company and is in serious trouble with less than six months of cash left and liabilities mounting. FCA is completing the final stages of its due diligence to acquire 100 percent of the stock of Apex and infuse $30 million in cash to keep the operations going. Surprisingly enough, FCA is very bullish on the prospects for Apex and seems ready to move ahead with the transaction and save Apex from certain bankruptcy.

There is only one problem: FCA’s consultants, Implus Partners, prepared and submitted pro forma financial projections to Apex…and you believe them to be overstated! You know that you should speak up and educate FCA; however, you were not directly involved in communicating information to FCA.

This was handled by the CFO of Apex. In fact, you are not entirely sure that the projection is misstated by a material amount, although you suspect this probably is the case. You also remember clearly the Apex CEO’s announcement to the staff that should the acquisition go through, FCA planned to keep everyone at Apex on the staff.

“We must make the best possible impression on FCA,” she said. “Be optimistic, friendly, and supportive to FCA over the next seven days. This is our last chance to avoid bankruptcy and save our jobs.”

What do you do?

On the one hand, you want to be fair to FCA, but you also want to be fair to your employer and your colleagues, not to mention the company stockholders and lenders, who will surely suffer if the acquisition does not go through and the company is forced into bankruptcy.
Such is the nature of ethical matters, where often we do not have all the facts and must probe to uncover the “right” or best way to respond to a dilemma. Ethical dilemmas involve competing values—for example, fairness, loyalty, or keeping a confidence—which force us to make a choice.

Some values may be addressed in the profession’s codes of conduct, while others may not.

Complicating the dilemma, sometimes there may be more than one “right” answer. As a professional, you cannot shy away from these gray areas, but instead must learn to work actively through them to determine the best possible answer given a particular set of facts and circumstances.

In this course, we will introduce you to an ethics decision-making model, which is a series of evaluative questions to help you analyze and determine the best possible solution to an ethical dilemma. Then we will apply the model to the short case study we just reviewed.

However, before we get into the ethics decision-making model, we will discuss some key points about recognizing and handling an ethical matter.

**Recognizing Ethical Matters and Making Good Decisions**

To address an ethical matter and make good judgments, you must first be able to recognize issues when they arise. This means being familiar with the profession’s body of rules and regulations from the AICPA and your local state accountancy board, which issues your license to practice, among others. This also means staying attuned to potential ethical “warning signs.”

You should understand the relevant rules, which may change over time. You can accomplish this by paying attention to rule-making initiatives and making ethics part of your continuing education plans. Many state accountancy boards require you to earn a certain number of educational hours in ethics each year or renewal period.

To be effective, you also need to know how to analyze a matter. You will practice working through a few matters in this course. Sometimes, especially when a matter is complex, extremely important, or highly sensitive, you may wish to allow others to help you evaluate it from different perspectives, keeping mindful of your obligations to maintain confidentiality.

It is a good practice to consider possible people with whom you can consult before you encounter a situation. This should be someone whose judgment you trust and respect—a colleague, friend, or relative who is fair and open-minded. You can contact the AICPA Ethics Hotline at 1.888.777.7077, Option 6, and then Option 1, or your state CPA society or board of accountancy for assistance. In some instances, where there are potential legal issues involved, consider consulting with an attorney before making a decision.

And always, you must consider the sensitivity of the information to ensure that you do not inappropriately divulge information.
Ethical Decision-Making Model

Now let us look at a series of questions that can help you evaluate the brief story you heard at the beginning of this chapter.

**Step 1: Recognize the Ethical Issue**

First, we need to recognize the ethical issue *in this situation*. As controller, you are torn between helping your employer and ensuring that the company seeking to acquire your employer, FCA, has complete and accurate information. This is an ethical dilemma because you are experiencing a conflict in your values, that is, loyalty to your employer and fellow employees versus full and fair disclosure to FCA.

**Step 2: Gather the Critical Facts**

Next, you should *gather the critical facts* of the matter. Here, it is clear that you do not have all of the facts—*this can be very dangerous*. While you may at times have to make decisions without the benefit of *all* the facts, you should not be making decisions without key pieces of information.

In this case, whether the information is *material* to the Apex financial projection is a critical piece of data. You should determine this before proceeding. It is critical because if the financial projections are overstated by a *miniscule* amount, this will likely have little or no bearing on FCA’s decision to buy Apex. In such a case, the ethical issue would probably vanish.

**Step 3: Identify the Stakeholders**

Let us assume you take further action and determine that the projection is overstated by a *material* amount.

Next, you need to identify the stakeholders—these are the people or organizations that will be affected either positively (benefited) or negatively (harmed) by your decision and actions.

For example, this would include Apex and its owners and employees and FCA and its owners and employees. Owners include shareholders of both companies; you may also consider companies that have significant loans to Apex and FCA and both companies’ primary customers and vendors. Another stakeholder is the consulting firm hired by FCA to prepare the financial projection. Generally, you should consider as many stakeholders as possible to get a comprehensive picture of who would be affected by your decision.
**Step 4: Consider Your Alternatives**

Once you have identified the stakeholders, you should consider your alternatives—the various approaches you could take to address this matter and resolve the ethical conflict. The following are just a few options:

1. Arrange a meeting with FCA to discuss your concerns.
2. Arrange a meeting with the Apex CFO to discuss your concerns.
3. Send an anonymous letter to FCA’s consulting firm describing your concerns.
4. Take no action.

**Step 5: Consider the Effect on Stakeholders**

Now that you have identified the stakeholders and considered your alternatives, you need to consider how each of these approaches is likely to affect each stakeholder. Obviously, you must use your judgment to predict likely outcomes and this is far from an exact science. However, performing this analysis and applying your best judgment allows you to assess the potential ramifications of each option.

For example, Option 1 involves bypassing your superior at Apex, which will very likely jeopardize or damage your employment situation. By avoiding discussion with the CFO of Apex, you do not allow her the chance to respond to your concerns. Because you were not directly involved in providing data to FCA, it is possible that she has additional information that will allay your concerns. Your actions will likely cast a negative light on Apex.

On the other hand, if the information is incorrect, as you suspect, you may help FCA to avoid a costly error—their shareholders, creditors, and other stakeholders will likely benefit from your disclosure. It may also prevent future litigation against Apex principals for providing misleading information to FCA.

However, without the acquisition, Apex will likely file for bankruptcy protection and you and your colleagues will be out of work.

Option 2 allows you to air your concerns within Apex before deciding whether to go to anyone else. This gives your superior the opportunity to respond to your concerns. It is also possible that she can provide you additional key information that will allay your concerns. Assuming this outcome, no further action by you will be necessary. On the other hand, if your meeting with the CFO is unsatisfactory and you still believe FCA will be relying on inaccurate financial information, you will have delayed your disclosure to FCA and will need to consider further actions.
Option 3 is similar to Option 1 because it involves reporting your concerns to a party outside of your organization. However, the information is provided anonymously, so the consultants will not know who is providing the information. Most likely, they will approach Apex management to obtain more information. This approach can also affect the transaction because it will raise concerns about a lack of integrity and cohesiveness at Apex.

Finally, we have Option 4, which will maintain the status quo—FCA may purchase Apex based on what they believe to be true and reliable information. If the information is in fact misleading, it is possible that FCA’s purchase of Apex will cause its owners and employees to suffer financial loss, which will include the newly acquired Apex Corporation. This option can also result in litigation between the parties and between FCA and its consultants. Another possibility is that FCA or its consulting firm may bring ethics charges against you and the CFO of Apex Corporation with the AICPA, the state accountancy board, and/or the state CPA society.

**Step 6: Consider Your Comfort Level**

Although this analysis was far from exhaustive, we have identified the issues and stakeholders, gathered information, and evaluated possible approaches and how they would likely affect each stakeholder. Before you make a decision, you should ask yourself some questions:

- How comfortable are you with each option?
- If you had to discuss your decision in public, would you be concerned about how it reflects on your ethics?
- Regarding Options 1 and 3, would you feel embarrassed that you did not have the nerve to raise these concerns within Apex before going outside the organization?
- Are you very uncomfortable with Option 4—doing nothing?
- Do you feel you could explain taking Option 2? Does this feel like a correct decision—at least at this time?

Remember: Option 2 may be only a partial solution to the problem. Depending on your meeting with the CFO, you may need to take additional action.

**Step 7: Consider Rules, Regulations, and Laws**

Are these options consistent with applicable professional ethics rules, regulations, and laws?

Obviously, this is an important question which you must be prepared to address. You may determine that the greatest benefit and least amount of harm would likely result if you take a particular course of action, but if that course of action is inconsistent with the profession’s rules of conduct, you may not ignore those rules.
You must weigh your ethical requirements against all of your proposed alternative actions. For example, would the professional ethics rules allow you to divulge information to outside parties in these circumstances?

If you are uncertain of the professional, regulatory, or legal implications of your actions, you should seek appropriate counsel. You must weigh the applicable rules, regulations, and laws against all of your proposed alternative actions.

**Step 8: Make a Decision**

Once you have considered all of these things, you may be ready to make your decision. Perhaps you have discussed the matter with a trusted colleague and considered the matter from various perspectives. However, if you still feel that you cannot make your decision, you should seek further counsel from a colleague, or, if warranted, an attorney. But just remember—in the end, the decision is yours to make. Although you will not always have the luxury of time, whenever feasible, you should take the time you need to fully consider all of the issues. Hasty decisions may be regretted later.

So, you make your decision—Option 2—and you will meet with the CFO, explain your concerns to her, and see where that conversation leads. This decision was rather an obvious one. In these situations, you should exhaust all of your options and gain as much information as possible before you consider disclosing information to parties outside of your organization.

Of course, if that meeting does not resolve the issue, you have some more thinking to do!

**Step 9: Document Your Efforts**

Once you have made a decision, and while it is fresh in your mind, you should consider documenting your understanding of the facts, the names of any people with whom you consulted, their professional affiliations (if relevant), and your decision.

**Step 10: Evaluate the Outcome**

Once time has passed, it may be constructive to re-evaluate the decision you made and consider whether, given the outcome of events, you would have done anything differently.
The Accounting Profession

The accounting profession has various sectors with numerous bodies that set standards and disciplinary rules for the profession.

The various sectors of the accounting profession have CPAs who work in many different types of roles.

- Many professionals are in public practice, working for public accounting firms. These professionals provide a variety of services to clients and ultimately the public, from audits of financial statements to tax compliance to an array of consulting services.

- Other professionals are members in business, working or volunteering for organizations, whether commercial or non-for-profit, or they may be employed in the governmental sector and work for state, federal, or local agencies or for governmental entities, such as states, counties, or municipalities. These members are responsible for accounting, finance, and other areas of business, such as internal audit. Other members in business serve in teaching roles in vocational programs, high schools, colleges, and universities.
There are a number of professional and regulatory bodies that set standards and disciplinary rules for the accounting profession. The main ones are as follows.

**State CPA Licensing Boards**

State CPA licensing boards are charged with issuing CPA licenses and overseeing the ethical conduct of CPAs in 55 jurisdictions in the U.S. It is critically important for CPAs to know their state board’s requirements. If you are licensed by more than one state board, you should familiarize yourself with the requirements of each state board.

State board rules can vary significantly from one state to another. Some, like the Texas State Board of Public Accountancy, incorporate the rules of other bodies, such as the AICPA and the SEC “by reference.” This means that the board adopts the rules of these other bodies. Other boards have adopted versions of the AICPA rules, and still others have adopted their own rules. Boards generally post their rules and statutes to their web sites.

**AICPA**

The AICPA is the national professional organization for all CPAs. Its mission is to provide members with the resources and information that enable them to offer valuable services in the highest professional manner to benefit the public, employers, and clients.

In fulfilling its mission, the AICPA works with state CPA societies and boards, giving priority to those areas where public reliance on CPA skills is most significant.

The AICPA Professional Ethics Executive Committee (PEEC) promulgates and enforces ethics and independence rules that apply to all members. We will discuss these rules extensively in this course.

**SEC**

There are a number of regulators that oversee the profession. The SEC establishes and enforces accounting and auditing policy, including auditor independence. Its mission is to improve the professional performance of public company auditors to ensure that financial statements are presented fairly and have credibility. We will discuss the SEC independence rules in Chapter 3 of this course.

**PCAOB**

The Sarbanes-Oxley Act of 2002 directed the PCAOB to establish auditing and related attestation, quality control, ethics, and independence standards for public company auditors. The SEC oversees the PCAOB’s activities. In Chapter 3, we will address the independence rules that apply to public company auditors, which include the PCAOB rules.
**GAO**

The GAO issues ethics and independence rules that apply to engagements performed under generally accepted government auditing standards (GAGAS). These governmental standards are commonly referred to as the “Yellow Book.” We will discuss these rules in Chapter 4 of this course.

**DOL**

Auditors of employee benefit plans that file reports with the DOL should be aware of the DOL interpretive bulletin on independence. These rules will be addressed in Chapter 4 of this course.

**IRS**

The IRS is a government agency under the U.S. Department of the Treasury. The Internal Revenue Code (IRC) authorizes the Secretary of the Treasury to promulgate rules and regulations necessary to enforce the U.S. tax laws. Treasury Department Circular No. 230 governs federal tax practice before the IRS by CPAs, enrolled agents, attorneys, and actuaries and the IRS Office of Professional Responsibility (OPR) that enforces these regulations. Preparer penalty and confidentiality provisions appear in the IRC. We will discuss the ethics requirements for CPAs in tax practice in Chapter 5 of this course.

**International Federation of Accountants (IFAC)**

The IFAC develops standards for auditing, education, ethics, and public sector financial reporting in the accounting profession globally. It also promotes good ethical practices by encouraging professional accounting organizations throughout the world to adopt high ethical standards and helps foster meaningful debate on ethical issues that accountants face. The IFAC’s International Ethics Standards Board for Accountants (IESBA) develops ethical standards and guidance for use by professional accountants. The IESBA ethical standards appear in the Code of Ethics for Professional Accountants (the IESBA Code), which serves as the foundation for codes of ethics developed and enforced by IESBA member bodies, such as the AICPA in the U.S.

**Others**

In addition, there are banking and insurance regulators, such as the Federal Deposit Insurance Corporation (FDIC) and state insurance regulators, and, finally, state CPA societies, which have codes that their members agree to abide by.
The Codification

As a member of the accounting profession, you should be aware of all the ethical requirements that apply to you. The specific rules that you need to follow will depend on which area in the profession you serve, for example, public practice or business (and in some cases, both). Also, if you are in public practice, the types of clients you perform services for will affect which rules you need to apply. The AICPA PEEC recently adopted a completely restructured AICPA Codification so that one part of the Code applies to members in public practice, another to members in business, and a third to members falling into neither category (for example, retired, or between jobs). This course will provide a thorough description of the Codification’s structure, approach and content. With the exception of the Code’s new conceptual frameworks (discussed later), the Codification becomes effective December 15, 2014.

In some cases, you may be subject to rules of different bodies. For example, auditors of public companies need to comply with the independence rules of the AICPA, the SEC, and the PCAOB. If more than one rule applies to a situation, you should apply the most restrictive requirement. This course focuses on your obligations under the AICPA Code.

In general, a code of professional conduct describes the basic tenets of ethical conduct in a profession, whether accounting, medicine, or engineering. Let’s take a look at some of the characteristics of a typical code of professional conduct.

A code of professional conduct requires you to assume responsibilities above and beyond those required by law. For example, no laws exist that limit the fee a lawyer may charge his or her client, but a member of the Association of Personal Injury Lawyers should not make “excessive or unnecessary monetary charges to the client.” Professions that serve the public interest adopt a code of conduct to help maintain public confidence in the profession as a whole.

For example, we do not usually think of chemists as serving the public interest, but the Royal Society of Chemistry highlights service to the public as a primary duty of the professional chemist. Members of a profession are commonly called upon to act honorably, even at the sacrifice of personal advantage. For example, hockey coaches who are members of the American Hockey Coaches Association are admonished never to place the value of a win over instilling higher ideals and character traits in their players.

The AICPA’s Codification also reflects many of the ideas contained in these other professional codes that you just read about. Exhibit 0-1 contains the preamble to the Code.
Exhibit 0-1
Preamble

.01 Membership in the American Institute of Certified Public Accountants is voluntary. By accepting membership, a member assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

.02 The Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

Professional Responsibilities and the Public Interest

The preamble to the AICPA Codification clearly states that “Membership in the AICPA is voluntary, and a member assumes an obligation of self-discipline that may be in addition to the requirements of laws and regulations. These principles express the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.”

Ethics may be defined as the rules or standards governing the conduct of the members of a profession, and more generally, as the study of the general nature of morals and of specific moral choices. When something is “ethical,” it is in accordance with the accepted principles that govern the conduct of a group, especially that of a profession (The American Heritage Dictionary, third edition).

The first two principles in the AICPA Code, Responsibilities and the Public Interest, say, in part, that “Members of the AICPA have responsibilities to all those who use their professional services.” It also notes that “a distinguishing mark of a profession is acceptance of its responsibility to the public.” The public interest is defined as “the collective well-being of the community of people and institutions the profession serves.”

AICPA principles also indicate, in part, that “Members should exercise sensitive professional and moral judgments in all their activities. They should also act in a manner that serves the public interest and honors the public trust that is bestowed upon them as a member of the accounting profession.”

AICPA Code Principles

The following Appendix A contains the AICPA Code of Professional Conduct, Principles of Professional Conduct.
Appendix

AICPA Code of Professional Conduct
Principles of Professional Conduct

0.300.010 Preamble

.01 Membership in the American Institute of Certified Public Accountants is voluntary. By accepting membership, a member assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

.02 These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

0.300.020 Responsibilities

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

.02 As professionals, members perform an essential role in society. Consistent with that role, members of the American Institute of Certified Public Accountants have responsibilities to all those who use their professional services. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public’s confidence, and carry out the profession’s special responsibilities for self-governance. The collective efforts of all members are required to maintain and enhance the traditions of the profession.

0.300.030 The Public Interest

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

.02 A distinguishing mark of a profession is acceptance of its responsibility to the public. The accounting profession’s public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of members to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on members. The public interest is defined as the collective well-being of the community of people and institutions that the profession serves.
In discharging their professional responsibilities, *members* may encounter conflicting pressures from each of those groups. In resolving those conflicts, *members* should act with integrity, guided by the precept that when *members* fulfill their responsibility to the public, *clients’* and employers’ interests are best served.

Those who rely on *members* expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

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

**0.300.040 Integrity**

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

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

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

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

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

**0.300.050 Objectivity and Independence**

**.01** *Objectivity and independence principle.* A *member* should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A *member* in public practice should be independent in fact and appearance when providing auditing and other attestation services.
Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.

Members often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. Members in public practice render attest, tax, and management advisory services. Other members prepare financial statements in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, members should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

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

Although members not in public practice cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services. Members employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as members in public practice and must be scrupulous in their application of generally accepted accounting principles and candid in all their dealings with members in public practice.

Due Care

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

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

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

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

.05 Members should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.

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

0.300.070 Scope and Nature of Services

.01 Scope and nature of services principle. 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.

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

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

.04 In order to accomplish this, members should

   a. Practice in firms that have in place internal quality control procedures in place to ensure that services are competently delivered and adequately supervised.

   b. Determine, in their individual judgments, whether the scope and nature of other services provided to an audit client would create a conflict of interest in the performance of the audit function for that client.

   c. Assess, in their individual judgments, whether an activity is consistent with their role as professionals.
Chapter 1

Professional Ethics

Introduction

The AICPA Code of Professional Conduct (the Code, or the Codification) contains the rules that guide all AICPA members in the performance of their professional responsibilities. In this chapter, we will discuss in greater detail many of these rules.

Learning Objectives

After completing this chapter, you will be able to:

- Describe the structure and content of the AICPA Ethics Codification including the underlying principles.
- Describe the conceptual framework approach embedded in the Codification.
- Apply AICPA rule interpretations on integrity, objectivity, confidentiality, and advertising, including where applicable, the conceptual framework.
- Explain acts discreditable to the profession.
- Explain the obligations to exercise due professional care, comply with professional standards, and be competent in performing professional services.
The New AICPA Ethics Codification

In 2014, the AICPA’s Professional Ethics Executive Committee (PEEC) released the restructured and recodified AICPA Code of Professional Conduct. One purpose of the codification project was to present the Code in a more logical and intuitive manner.

The new Code fully embodies the conceptual framework approach, which provides a methodology for assessing facts and circumstances not contemplated under the rules. (Previously, only independence rules incorporated this approach, which will be discussed in detail in this chapter.)

As a result, the Code now appears as follows:

- Preface – Applies to all members of the AICPA (provides an overview, the principles, structure and application of the code, and definitions)
- Part 1 – Rules/interpretations applicable to members in public practice, including a new conceptual framework applicable to rules other than independence, an independence conceptual framework, and guidance on ethical conflict resolution
- Part 2 – Rules/interpretations applicable to members in business, including a new conceptual framework applicable to all rules and guidance on ethical conflict resolution
- Part 3 – Rules/interpretation applicable to all other members (for example, retired or between jobs)

The PEEC made very few substantive changes, with most of the Code’s substance left unchanged. For example, it is still prohibited under the independence rules for the firm to hold stock in an audit client. The numbering scheme and several titles are different than before. The Code includes a glossary of terms, refers to relevant nonauthoritative guidance, when applicable, and provides a mapping document for those who want to link between the old and new Codes.

The revised Code is effective December 15, 2014, and will be available online. Members have until December 15, 2015, to implement the new conceptual frameworks in parts 1 and 2 of the Code.
Structure of the Codification

As noted, the Code has three parts that apply to a member depending on the type of work (if any) the member performs. The preface to the three parts of the Code describes the principles that underlie the Code. These principles, which have been part of the Code for decades, are described in the following section.
Principles

Imagine a classic building such as the Parthenon. Anchored to the foundation are several large pillars. In turn, these pillars support the roof of the structure.

The AICPA’s Code is structured in a similar manner. The *Principles of Professional Conduct* are the pillars of the Code. The Principles set forth the broad ethical standards and guidance for the profession. Upon these pillars rest the rules and detailed interpretations and rulings.

The Principles

In this chapter, we will focus on the detailed rules of conduct. However, it is important for you to understand the principles from which these rules are derived.

- Responsibilities – In carrying out your professional responsibilities, you should exercise sensitive professional and moral judgment.

- The Public Interest – You should act in a way that will serve the public interest, honor the public trust, and demonstrate your commitment to professionalism.

- Integrity – To maintain and broaden public confidence, you should perform all professional responsibilities with the highest sense of integrity.
• Objectivity and Independence – You should maintain objectivity and be free of conflicts of interest in discharging your professional duties. If you work for a public accounting firm that provides audit and other attestation services, you should be independent in fact and appearance.

• Due Care – You should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of your ability.

• Scope and Nature of Services – As a member in public practice, you should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be performed.

Review Questions: The CPA’s Creed

Our profession does not require you to take an oath, but in this exercise, you will create one based on the Principles of Professional Conduct you just learned. Complete the oath by circling the appropriate word or phrase to fill in each blank.

As a professional CPA, I willingly accept my responsibility…

1. To serve
   a. My clients.
   b. My best interest.
   c. The public interest.

2. To maintain and broaden public confidence by performing all my responsibilities with
   a. Integrity.
   b. Speed.
   c. Accuracy.

3. To maintain my objectivity and be free of conflicts of interest, and to discharge all my responsibilities with due
   b. Care.
   c. Diligence.

Note: That is why our professional creed reads as follows: As a professional CPA, I willingly accept my responsibility: (1) To serve the public interest. (2) To maintain and broaden public confidence by performing all my responsibilities with integrity. (3) To maintain my objectivity and be free of conflicts of interest, and to discharge all my responsibilities with due care.
Rules of Conduct

The Code includes various rules that apply to members. Some rules apply to all members—for example, Acts Discreditable, while others only apply to certain members. (For example, the Independence rule only applies to members in public practice.) The rules in the Codification are as follows:

Part 1: Members in Public Practice

- 1.100 – Integrity and Objectivity
- 1.200 – Independence
- 1.300 – General Standards
- 1.310 – Compliance with Standards
- 1.320 – Accounting Principles
- 1.400 – Acts Discreditable
- 1.500 – Fees and Other Types of Remuneration
- 1.600 – Advertising and Other Forms of Solicitation
- 1.700 – Confidential Information
- 1.800 – Form of Organization and Name

Part 2: Members in Business

- 2.100 – Integrity and Objectivity
- 2.300 – General Standards
- 2.310 – Compliance with Standards
- 2.320 – Accounting Principles
- 2.400 – Acts Discreditable

Part 3: Other Members

- 3.400 – Acts Discreditable
Interpretations

Most of the text in the Code provides interpretations of each of the rules of conduct. These interpretations provide guidelines to the member on the meaning of each rule; however they are more than informational. Members are required to apply these interpretations unless they can justify noncompliance. See the following excerpt:

Exhibit 1-1
Interpretations and Other Guidance

*Interpretations* of the rules of conduct are adopted after exposure to the membership, state societies, state boards, and other interested parties. The *interpretations* of the rules of conduct, “Definitions” [0.400], “Application of the Code” [0.200.020], and “Citations” [0.200.030], provide guidelines about the scope and application of the rules but are not intended to limit such scope or application. A *member* who departs from the *interpretations* shall have the burden of justifying such departure in any disciplinary hearing. *Interpretations* that existed before the adoption of the code on January 12, 1988, will remain in effect until further action is deemed necessary by the appropriate senior committee.

Integrity and Objectivity

Now let us take a look at some of the specific rules and interpretations in the Code. The first of the ethics rules relates to integrity and objectivity, which provides that a member shall maintain objectivity and integrity, be free of conflicts of interest, and not knowingly misrepresent facts or subordinate his or her judgment to others.
Professional Conduct: Integrity

Integrity

The AICPA Code states, “Integrity is an element of character fundamental to professional recognition.” As controller for Apex (the company discussed in the Overview chapter), would you feel that you maintained your integrity by doing nothing about the misleading financial projection?

The Code goes on to say that, “Integrity requires a member to be, among other things, honest and candid,” and that integrity is measured in terms of what is right and just. To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.

As stated earlier, when a CPA becomes a member of the AICPA, he or she agrees to abide by the Code. AICPA members are subject to disciplinary proceedings if they are found to have engaged in acts deemed to violate the AICPA rules of conduct or the bylaws.

Listed in Exhibit 1-2 are the interpretations that relate to a member’s obligation to maintain his or her integrity in performing professional services. Specifically, a member cannot knowingly misrepresent information or subordinate his or her judgment to others.

There are also specific obligations that members in business have to their employers’ external auditors. The Code defines members in business as members employed or engaged on a contractual or volunteer basis in an executive, staff, governance, advisory, or administrative capacity in such areas as industry, the public sector, education, the not-for-profit sector, or regulatory or professional bodies.
Exhibit 1-2
Integrity and Objectivity Rule and an Interpretation of the Rule

The rule:

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

One interpretation of this rule states:

Knowing Misrepresentations in the Preparation of Financial Statements or Records

.01 Threats to compliance with the “Integrity and Objectivity Rule” [1.100.001] would not be at an acceptable level and could not be reduced to an acceptable level by the application of safeguards and the member would be considered to have knowingly misrepresented facts in violation of the “Integrity and Objectivity Rule,” if the member

a. makes, or permits or directs another to make, materially false and misleading entries in an entity’s financial statements or records;

b. fails to correct an entity’s financial statements or records that are materially false and misleading when the member has the authority to record the entries; or

c. signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .02 of ET section 102]
Helping Hands Case Study

Background

In this case study, you are the newly hired controller of Helping Hands, a charitable organization. Like the Apex case study, Helping Hands is having severe financial difficulties.

When your employer is struggling, in crisis mode, or in desperate straits, the temptation to manipulate accounting information may become overwhelming as the organization fights to survive. When this is the case, it may be easier for some people to justify actions they would otherwise never consider. Here is the background for the case study.

Sara Cabibi stared out her office window. Her employer, Helping Hands, was in trouble. The charity does such good work, she thought, helping disabled people find employment with things like résumé preparation, interview techniques, wardrobe, transportation, and job skills improvement. However, as the charity’s controller, she wondered how the entity could survive much longer. For her entire tenure, the charity struggled but always managed to tread water. However, the extended recession took such a toll on fundraising that she doubted they could make it this time. The payroll was due and she had delayed paying the utilities for as long as she could. To round out her problems, Helping Hands’ largest donor, Gerald Alles, had not been provided the quarterly financial statements they were required to provide him to continue receiving funds. In fact, Gerald had not been provided any statements since the audit conducted at the charity’s prior year-end, eight months before.

“There’s someone here to see you.” Alice Hunt, the Wednesday morning volunteer receptionist, walked into Sara’s office, her round face beaming with her usual good humor. “Gerald Alles would like an update.”

Sara stood, came around her desk, and held out her hand. “Gerald,” she said. “So good to see you. Please, sit down.”

Gerald shook Sara’s hand, looking at her sternly. “I don’t mean to be rude, Sara. I’ve known you a long time, but my accountant needs the financial information I was promised. After all, it’s been months. If I could just show him that the organization is doing well; I can give you this quarter’s check.”

“Let me apologize.” Sara gestured toward her paper-strewn desk. “In fact, I’m working on the statements now. It’s just been so hectic.”
“Is there a problem?”

“Problem?” Sara stuttered slightly. “What do you mean?”

Gerald relaxed slightly. “I apologize if I seemed harsh, but I’ve been very frustrated by not being able to get an answer about Helping Hands’ finances. My accountant says I can’t donate any more to your organization until I get those financials.”

“I understand. You’ll have them next week,” Sara promised.

“I’d better.” Gerald said, getting tense. “There are lots of other places that could use my donations.”

Later that day in Sara’s Office…

“I realize we have a problem,” Don McElroy, Helping Hands’ Executive Director, said. “But at least we have enough cash to get through another week, until Gerald makes his next contribution.”

“Just barely, Don,” Sara said.

“I know, I know. We’ll give Gerald the financial statements for the past two quarters, and then we’re caught up with our obligations.” Don looked hard at her and said, “Look, I know our fundraising efforts have slowed down these past few years and we’re looking at a cash crunch.”

“No doubt,” said Sara. “In fact, if Gerald hadn’t made his second quarter contribution despite not having financial statements, we would have already run out of money.”

“Okay,” he agreed. “The financials don’t look so hot. It’s a great, big circle. We need Gerald’s contribution to stay in operation, but we need solid financials to get his contribution. So all we have to do is make the financial statements look good for the short term.”

Pausing, Don added, “Listen. I’ve thought this through and I think I have a quick fix to our problem. One of our biggest payables (besides payroll) is to C.A. Transport. Charles, the president, is a golfing buddy of mine, even though we haven’t paid him in months. He told me he would be willing to give us an official letter immediately waiving our debt to his company, not permanently, but just until we get through this cash crunch.”

Seeing Sara frown, he added, “Listen. It’ll keep us afloat. And we’re not doing anything illegal. Charles is fully authorized to do this, you know, as a goodwill gesture to a worthy cause. Who knows? Maybe in the end, he will cancel our debt. You never know! So, what do you think?”
The Response

How should Sara respond to Don’s suggestion?

a. Make the financials look good temporarily so Gerald will make his donation, which achieves the “greater good.”

b. Explain to Don that there are several reasons why it would be unethical to make the financial statements look good, even temporarily.
Suggested Solution

a. Incorrect. Dressing up the financials would provide a misleading picture of the charity’s financial situation. Sara would not retain her integrity if she agreed to do this, even if she would not be doing anything “illegal.”

b. Correct. To adjust the books simply to make them appear healthy to donors would be dishonest and show a lack of integrity. There may not be any illegal acts involved, but this does not mean the action is ethical.

Let’s observe as Sara explains this to Don.

Sara: “Not a good solution, for several reasons. In the first place, I don’t perform magic accounting tricks. To manipulate financial statements is a clear violation of my professional obligations. Second, this is no small thing. This would be material to the financial statements. We’d be ‘tricking’ Gerald into making his donation. If Gerald knew the true state of our finances, not to mention the fact that we are temporarily ‘fudging’ the numbers, it would undoubtedly affect his decision on whether to continue donating to Helping Hands.”

Alone in her office, Sara swiveled her chair to look out the window. She was well aware that if Gerald stopped donating to Helping Hands, the charity might go under. Considering all the handicapped people who depended on Helping Hands, she felt a sense of guilt and helplessness in risking the loss of those donations.

*Given all the facts, what would you do?*
Helping Hands Case Study: Applying the Decision-Making Model

Let’s look at certain steps in our ethical decision-making model, and apply them to this situation. Read each step and write in your response to each in the text box on the far right.

<table>
<thead>
<tr>
<th>Step</th>
<th>Analysis</th>
<th>Your Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Consider your comfort level.</td>
<td>Consider your level of comfort in making a particular decision. For example, if your decision became public knowledge, would you have any reservations about it?</td>
<td></td>
</tr>
<tr>
<td>2. Consider rules, regulations, and laws.</td>
<td>Are these approaches consistent with the profession’s Codes of Conduct, and regulatory and legal requirements?</td>
<td></td>
</tr>
<tr>
<td>3. Make a decision.</td>
<td>What is your decision?</td>
<td></td>
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</tbody>
</table>

When you are finished, turn the page to read the suggested responses.
Helping Hands Case Study:
Applying the Decision-Making Model: Suggested Solutions

Here are the suggested responses. Remember, in complex ethical matters, more than one correct response to a situation may exist.

<table>
<thead>
<tr>
<th>Step</th>
<th>Analysis</th>
<th>Author’s Response</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Consider your comfort level.</td>
<td>Consider your level of comfort in making a particular decision. For example, if your decision became public knowledge, would you have any reservations about it?</td>
<td>Don suggests making the financial statements appear a certain way to the organization’s donor. It would be temporary, however, Sara would be relying on a document she knows to be false in removing the liability and related expenses from their financial statements. She would be acting in bad faith by providing the donor misleading financial information. For these reasons, Sara would not feel comfortable following Don’s suggestions.</td>
</tr>
<tr>
<td>2. Consider rules, regulations, and laws.</td>
<td>Are these approaches consistent with the profession’s Codes of Conduct, and regulatory and legal requirements?</td>
<td>No, the entries suggested in this case study would not be consistent with the AICPA’s requirements that members maintain their integrity when performing professional services because they would be based on information that Sara knows to be false. <em>(Note: It does not matter that Don is holding out hope for a waiver of the liability; until CA Transport’s president truly agrees to permanently waive the liability, it should remain on their books.)</em></td>
</tr>
</tbody>
</table>
3. Make a decision. What is your decision? Sara should not misstate the financial statements as Don suggests. She should not subordinate her judgment to him and create false and misleading entries in the financial statements under any circumstances. To do so would not only represent a breach of her professional ethics, but it might also subject her to possible disciplinary action by the AICPA and her local state accountancy board and CPA society; this could threaten her ability to practice as a CPA.

Sometimes, people may be tempted to adjust the financial statements to achieve some “greater good” (as in the previous case study), or to save jobs if a company is on the brink of bankruptcy. However, the AICPA Code clearly states that you should not subordinate your judgment to another person; this rule applies even when that person is in a position of authority over you.

**Whistle-Blowing**

The issue of “whistle-blowing,” that is, alerting proper parties of unethical conduct in an organization, has gained a lot of attention over the years. Generally speaking, you should proceed cautiously whenever you are contemplating making such disclosures. First and foremost, you should consider all of the relevant professional and legal requirements. Likely, you will want to obtain legal and other counsel in making your decision.

Some questions you will want to consider carefully before taking any actions are as follows:

- Should I disclose this information?
- To whom?
- In what manner?
Members should consider provisions in the Code on client and employer confidentiality. For example, a member should maintain the confidentiality of his or her employer or firm’s (employer) confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship; for example, discussions with the employer’s vendors, customers, or lenders. Confidential employer information is any proprietary information pertaining to the employer or any organization for whom the member may work in a volunteer capacity that is not known to be available to the public and is obtained as a result of the relationships.

**Revenue Recognition Case Study**

Let’s consider another case study; this one involves a young accountant who believes his employer may be booking income prematurely. Here is the background for the case study.

Jeffrey Cavanaugh, newly hired by the accounting department of Amazing Online Buys (AOB), an Internet retailer, looks across the room. Trying to fight a sinking feeling, he rubs his eyes and wonders if he is overreacting or just tired. After all, he’s heard such good things about this company; a family owned business that grew rapidly and was now a public company.

Still, the way the company was booking revenue just did not make sense; in fact, it seemed as if revenue was being recognized prematurely.

Being new to the company, he doesn’t want to “rock the boat;” yet, as the company’s senior accountant, he would be directly responsible for recording these transactions. He could not risk being involved in fraudulent financial reporting.

He decides to visit Carl Adams, the CFO/Controller, to ask him about it.

*Carl (cheerfully)*: “Always glad to answer questions, Jeffrey. You’ve picked a difficult topic to start with. Revenue recognition can be very tricky.”

*Jeff*: “I appreciate that. My question is very simple. When do we recognize sales? Looking at some recently booked sales, it appears as though this occurs when the product is shipped, not when the customer receives the goods. But that doesn’t seem right to me, because title does not change until the consumer receives it. And, based on my research, that’s not how it should be booked. Am I missing something?”

*Carl*: “No, you aren’t, but let me explain. At the beginning of our company’s history, I guess it was in 1990, we looked at that whole issue, the difference between booking the sale on the ship date or when the customer received the merchandise. And it was small enough that we decided it was just simpler to book it on the ship date.”
Jeff (trying hard to be polite): “Maybe that was the case way back then, but aren’t the numbers pretty significant now?”

Carl (hesitates, then chuckles): “Let’s face it. We don’t know exactly when people receive their products. Plus, as far as I can tell in the industry, everybody records at ship date, bigger companies than ours. So we’ve continued to record at the ship date.”

Jeff: “I have to tell you, this makes me very uncomfortable. (pausing) I know you’ve been with the company since the beginning and you have a lot more experience than I do, but the company just went public, and if the SEC determines you’re wrong, there’s a lot at stake here. It makes me a bit nervous; frankly, I don’t need any problems.”

Carl (defensive): “You’re exactly right. None of us needs any problems. (In a more calming tone) Listen, Jeff, after 28 years in this profession, I will tell you, accounting is not an exact science. Not by a long shot. A lot of judgment is involved.”

Given all these facts, what would you do? The following review question will help you sort through these facts.

**Review Question**

4. Which of the following is *not* a critical fact in this case study?

   a. AOB might be booking revenue prematurely, which results in misleading financial statements.
   b. AOB might be booking expenses late, which results in misleading financial statements.
   c. Carl Adams is a long-time employee of AOB with many years of experience.
   d. Revenue recognition can be complex under GAAP.
Conceptual Framework

One of the key changes in the newly adopted Code is the broadened application of the conceptual framework to all ethics rules in the Code. (The previous code included a conceptual framework for independence rules only.) Two new frameworks—one for members in public practice and another for members in industry—appear in their entirety in Appendixes A and B. Highlights of the conceptual framework approach follow.

The code’s interpretations are set forth to provide guidelines and requirements for complying with the rules in many—but not all—situations a member may encounter. The conceptual framework employs a “threats and safeguards” approach to analyzing threats to compliance with the ethics rules that members must employ when evaluating a matter that the Code does not specifically address. The following describes the process. (Key terms are in *italics* and defined after the list.)

1. Identify threat(s) to compliance with one or more rules and evaluate (in the aggregate, if applicable).

2. Evaluate whether the threat is significant (that is, at an acceptable level).
   - If threat not significant – Stop, no further consideration is needed.
   - If threat is significant – Proceed to (3).

3. Identify and apply safeguards.
   - If safeguard(s) would eliminate the threat or reduce the threat to an acceptable level, proceed with professional services/engagement.
   - If safeguard(s) is not available or is insufficient (that is, it does not reduce threat(s) to an acceptable level), decline or discontinue professional service or resign from the engagement.
**Key Terms**

**threats.** Relationships or circumstances that could compromise a member’s compliance with the rules. These include adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence. See Appendix A for the detailed definitions of each threat.

**acceptable level.** A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member’s compliance with the rules is not compromised.

**safeguard.** May partially or completely eliminate a threat or diminish the influence of a threat. To be effective, safeguards should eliminate the threat or reduce it to an acceptable level. See Appendix A for a full description/list of safeguards.
Conflicts of Interest

While most of us are familiar with the phrase “conflicts of interest,” what does it mean to the accounting professional? An interpretation in the Code provides guidance.

Exhibit 1-3

Conflicts of Interest: Interpretations—AICPA Code of Professional Conduct (partial)

*In performing a professional service for a client, a conflict of interest may occur if a member or the member’s firm has a relationship with another person, entity, product, or service that, in the member’s professional judgment, the client or other appropriate parties may view as impairing the member’s objectivity. In such situations, adverse interest or self-interest threats may exist to the member’s compliance with the “Integrity and Objectivity Rule”...*

As you can see, applying this interpretation requires judgment. To illustrate the application of this rule, let’s consider an example and apply the conceptual framework described earlier to some facts. Assume you perform tax services for a married couple who decide to divorce. Does this situation create a potential conflict of interest? Some would say yes, because your professional relationship may be stronger with one spouse than the other, and the two spouses may have opposing interests as the divorce proceeds. According to the rule, several scenarios, including this one, may create adverse interest or self-interest threats to your compliance with the integrity and objectivity rule:

adverse interest threat. Threat that member will not act with objectivity because the member’s interests are opposed to the client’s interests.

self-interest threat. Threat that member could benefit, financially or otherwise, from an interest in, or relationship with the client, or persons associated with the client.

Gifts and Entertainment

Assume you are a senior financial analyst working for a large brokerage firm. Since you also have an IT background, you are responsible for making recommendations regarding any new software your department needs to do its research.

One of the firm’s vendors invites you to lunch to discuss some new software programs they would like your firm to consider purchasing for your department. The vendor takes you to a nice, upscale restaurant in town and you discuss business over your meal. Does this situation threaten your ability to be objective?
The interpretation considers three possible threats: self-interest, familiarity, and undue influence threats:

**self-interest.** Threat that member could benefit, financially or otherwise, from an interest in, or relationship with the client, or people associated with the client.

**familiarity.** Threat that due to a long or close relationship with the client, a member will become too sympathetic to the client’s interests or too accepting of the client’s work product.

**undue influence.** Threat that member will subordinate his or her judgment to an individual associated with the client or any relevant third party due to that individual’s reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member.

Generally, having a meal with a vendor to discuss business would not create a significant threat to your objectivity and integrity. Although you would want to consider some other relevant factors, such as how frequently you are treated to meals by this vendor, whether the same vendor also provides you other gifts or entertainment, and so on. If your only activity with this vendor is an occasional outing to discuss business, you would likely conclude that threats are at an acceptable level.

But what if this vendor also sends you an expensive watch as a gift? Does that threaten your objectivity? In this case, you would likely conclude differently; the expensive gift creates a significant threat because it is not reasonable in the circumstances as the interpretation describes.

You should also consider your employer’s internal policies for accepting gifts from suppliers. There may even be regulatory restrictions involved in accepting gifts and entertainment from your company’s suppliers or other business associates; for example, government employees have very strict guidelines to follow in this area.
Conflicts of Interest Case Study

Bob is a CPA who works as a senior accountant in a small but diversified financial services company. Bob works for the parent company (bank) in a division that makes business loans. His mother has been offered a seat on the board of directors of a subsidiary company that is an investment advisor. Does this scenario cause a significant threat to Bob’s integrity and objectivity?

Review Question

5. What is the best response?

a. No. The bank and investment advisory firm are separate and distinct businesses.
b. Yes. Directorships of relatives always result in conflicts of interests.
c. Maybe. But more facts should be considered first to make a decision.

As you just learned, to determine whether a conflict exists, Bob should consider a few more things. First, would this situation cause third parties to question his ethics given his mother’s position on the board? Bob should also ask himself, answering honestly, whether he feels he can be completely unbiased in providing services to his employer under these circumstances. Let’s observe what he is thinking.

Bob: My company and the subsidiary company are in separate and distinct businesses; each company has its own independent board and management structure. My mother’s service on the subsidiary’s board would have no bearing on my work, position, status, or compensation. For these reasons, I firmly believe that any threats to my objectivity that may result from this situation are at an acceptable level—that is, I feel I can continue to perform my duties as an employee objectively if my mother accepts the position. We’ll make sure to disclose the matter fully to both boards and managements to make sure they are comfortable with the situation, too.

Working through this analysis, Bob is comfortable with the situation. If instead, he concluded that threats were not at an acceptable level, Bob would have to consider safeguards to reduce the threats to an acceptable level. Either his mother should not take a seat on the board or he would have to change positions or organizations, create some other buffer, or take another type of action to mitigate these threats.

Although Bob is comfortable with the situation, it is not enough to stop there. The rules also require that he discuss the matter with the appropriate parties and that it is in Bob’s plans. Generally, these are the people who are affected by the work Bob does, and therefore, have an interest in his continued objectivity. If such persons raise concerns, he should address them. If they cannot be resolved, he must take actions as discussed previously to sufficiently reduce these
threats. If these persons believe that the situation is acceptable and provide their consent, the rule’s requirements are satisfied.

**Mergers and Acquisitions**

A conflict of interest may arise when a CPA firm provides services to clients who are involved in a merger or acquisition. What happens when two of your clients agree to merge or one of your clients acquires another? For example, Company A wants to acquire Company B and both of them are your clients, and both of them want you to perform services related to the transaction.

The Code does not explicitly prohibit a CPA firm from representing both companies in this situation, provided that you disclose the relationship to both companies, and that each of them agrees to let you represent the other company.

However, as a matter of policy, many CPA firms do not permit themselves to represent both sides in a merger or acquisition. If you find yourself in this position, you should be sure to determine whether your firm has an established policy covering the situation.

If your firm does not have a policy, you should carefully consider the risks to the firm of representing both companies in a merger or acquisition.

**Responding to a Conflict of Interest**

Notwithstanding the example we just discussed, whenever a potential conflict exists, you should consider the following course of action, as explained in Illustration 1-1.
Are Threats At An Acceptable Level?

First, consider whether the situation creates threats to your compliance with the rule. Be realistic and honest with yourself; for example, can you truly be objective in performing services for a plaintiff when the defendant is one of your clients? Do not underestimate the influence a relationship may have on your thinking and your services. If threats are insignificant, your evaluation is complete. If threats are significant, consider whether applying safeguards would eliminate or sufficiently reduce the threats to an acceptable level.
Have You Disclosed The Matter To The Appropriate People?

If the answer to Question 1 is no, then you may not perform the services. If the answer to Question 1 is yes, then you should disclose the matter to all of the relevant parties. (You are required to maintain the confidentiality of your client’s information when making disclosure under this rule.)

Do The Relevant Parties Agree With Your Assessment?

If the relevant parties agree to let you perform the engagement, you may do so. If they do not agree, you must decline the engagement.

Note: This rule applies to all professional services you provide; however, if your engagement requires independence, you must comply with the independence requirements. That is, independence impairments under the Code cannot be eliminated by disclosure and consent.

Review Question

6. Which of the following factors must be in place for you to perform services in light of a potential conflict of interest?

a. The affected parties have agreed to bring the matter to the board of directors.
b. The affected parties have agreed not to sue you or your firm.
c. You have determined that threats to your objectivity are reduced to an acceptable level.
d. You have determined that some third parties might not question your objectivity.
Professional Conduct: Competence and Due Care

Next, we will discuss the profession’s standards of competence and due care. An AICPA member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of his or her services, and discharge professional responsibility to the best of his or her ability.

Evaluating your own skills, knowledge, and efforts can be very subjective since there is no precise definition of competence or due care in the Code. The following is a summary of the Code’s guidelines on the subject:

- Each CPA should assess professional competence by evaluating whether his or her education, experience, and judgment are adequate for the responsibilities assumed.
- Diligence imposes the responsibility to render services promptly and carefully, to be thorough, and to observe applicable technical and ethical standards.
- Due care requires a CPA to adequately plan and supervise professional activities.

The principles of competence and due care are intertwined. Exhibit 1-4 offers an interpretation on competence providing some context for self-evaluation.

<table>
<thead>
<tr>
<th>Exhibit 1-4</th>
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<tr>
<td>Competence: Interpretations—AICPA Code of Professional Conduct</td>
</tr>
</tbody>
</table>

1.300.010 Competence

.01 Competence, in this context, means that the member or member’s staff possess the appropriate technical qualifications to perform professional services and that the member, as required, supervises and evaluates the quality of work performed. Competence encompasses knowledge of the profession’s standards, the techniques and technical subject matter involved, and the ability to exercise sound judgment in applying such knowledge in the performance of professional services.

.02 A member’s agreement to perform professional services implies that the member has the necessary competence to complete those services according to professional standards and to apply the member’s knowledge and skill with reasonable care and diligence. However, the member does not assume a responsibility for infallibility of knowledge or judgment.
Exhibit 1-4 (continued)

.03 The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. A normal part of providing professional services involves performing additional research or consulting with others to gain sufficient competence.

.04 If a member is unable to gain sufficient competence, the member should suggest, in fairness to the client and public, the engagement of a competent person to perform the needed professional service, either independently or as an associate. [Prior reference: paragraph .02 of ET section 201]

Due Care

As described in the Code’s principles, the quest for excellence is the essence of due care. The standard of due care requires members to

- discharge professional responsibilities with competence and diligence;
- perform professional services to the best of one’s abilities; and
- serve the best interests of those for whom services are performed, consistent with the profession’s responsibility to the public.

Professional ethical standards also refer to “due professional care.” What does this mean? By exercising due care, you take whatever steps are necessary to provide the client with a level of service that is consistent with the level of care that a “prudent professional” would exercise, that is, consistent with the profession’s standards.

The Code requires its members to exercise due care when performing professional services. Due care requires a member to be diligent in performing professional services; diligence requires service delivery that is prompt, thorough, and consistent with the applicable technical and ethical standards.

For example, performing an audit of a company’s financial statements requires adherence to technical auditing standards that specify, in varying degrees of detail, the profession’s standard of care for audit services. Although you will also apply your professional judgment, as an element of competence, these standards generally dictate how to perform the audit.

Technical standards help to define due care for audit, attestation, accounting and review, consulting, tax, and personal financial planning services performed for clients. It is important to remember that the standards of due care and competence apply not only to members in public practice but to all members who provide professional services, including persons who work in private industry, government, and academia.
Ben Archer could not believe his ears. After only one year as the Controller of Cindy Dee’s Restaurants, he was being offered the position of chief financial officer. Ben was a CPA who spent four years in public accounting before joining Cindy Dee’s. His five-year plan was to be a CFO, either in this company or another one; suddenly it fell into his lap following the current CFO’s announcement that she would be moving to another state next month. That would not allow much of a transition period, and Ben was a little concerned about that.

The other thing he thought about was the company’s decision to become a public company; these plans were only recently put in motion and there was a lot more to do. He wondered if he would be able to manage the whole process since he had no real background in SEC rules and regulations.

He had attended a class when the company announced its plans; but was that enough? As CFO, he would be the key player in preparing financial information for the filing, and discussing matters with the attorneys, auditors, and underwriters. He would be responsible for supervising other professionals, including the person who would fill his position.

Despite his concerns, he kept coming back to how great this would be for his career. And, the promotion would provide a sizeable increase in salary and status. Obviously, he had made a very favorable impression on the management of Cindy Dee’s, and they told him that he was the only person in the company they thought could handle the job. Ben attributed this to his excellent people and presentation skills and the solid relationships he had with certain company executives. In fact, the company had not even interviewed anyone from outside the company. They would only do so if Ben declined the offer.

He knew it would be nearly impossible to take the position and gain the competence he needed to be effective; after all, he would be plunging straight into preparations for the offering; there would be no time! He really wanted this position, though, and said to himself, “Management wouldn’t offer me an executive position if they didn’t think I was capable, would they?”

**Case Study Question**

1. What would you do if you were Ben?

   a. Take the promotion which is a wonderful opportunity and a huge boost to your career and finances?
   b. Decline the offer and work toward gaining the skills you will need down the road to make a good CFO?
Case Study Suggested Solution

1. 
   a. Incorrect. Overall, this approach would likely put the stakeholders at a disadvantage. Realistically, Ben would not be able to gain sufficient competence or experience in a reasonable period of time to perform his new duties effectively.
   
   b. Correct. Overall, this approach would likely benefit the stakeholders because of Ben’s current understanding of the company’s operations. Although it may take several months, he would eventually attain all the skills and knowledge needed to perform the job. By accepting the CFO position, he would likely cause Cindy Lee’s management, employees, and other stakeholders to suffer because of his inexperience. Specifically, he would not have sufficient time and opportunity to gain the requisite competence during a critical period in the company’s development, that is, the Initial Public Offering (IPO).

Accounting Principles

CPAs should not indicate that a company’s financial data, for example, financial statements, are presented in conformity with generally accepted accounting principles (GAAP) if such data contain any departure from an accounting principle. An exception exists for data that justifiably departs from GAAP because not doing so would make the information misleading. This rule applies to letters and other communications that members in industry send to their employer’s auditors or to others, such as regulators and creditors. It also applies to members in public practice when they issue an opinion on a company’s financial statements.

Members may prepare or report on financial statements under frameworks besides U.S. GAAP, such as the GAAP of another country or other frameworks, for example a framework prescribed by law or contract. The member should ensure that the basis of accounting (such as income tax based financial statements) is clearly specified so that readers do not wrongly assume that the statements were prepared in accordance with U.S. GAAP.
Exhibit 1-5 lists the rules that relate to a member’s obligations concerning accounting principles.

Exhibit 1-5
Accounting Principles: Interpretations—AICPA Code of Professional Conduct

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.
Confidential Client Information

A CPA in public practice is privy to a great deal of confidential information about his or her clients. For that reason, the Code requires that you do not disclose any confidential information unless the client specifically allows you to do so. As a general rule, it is best to treat all of the information about your client as confidential.

Most clients would want to share little if any of the type of information they regularly provide you with other persons or entities. Can you imagine your client willingly providing his coworkers with a copy of his W-2?

So, what is confidential client information? The Code includes a definition:

Confidential client information is any information obtained from the client not available to the public. Information available to the public includes, but is not limited to, information

- in a book, periodical, newspaper, or similar publication;
- in a client document released by the client to the public or that has otherwise become a matter of public knowledge;
- on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information;
- released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum;
- maintained by, or filed with, regulatory or governmental bodies available to the public; or
- obtained from other public sources.

Unless the particular client information is available to the public, that information should be considered confidential client information.

Note: Federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in the Code.
The following are three clients and their perspectives on the sharing of information.

*Barbara Fox*, retailer of high-end children’s clothing:

“Our clothes are expensive, but our cost isn’t that much more than a discount retailer. That means our profit margins are huge. I would never want our customers to know how much we mark up our clothes. They might stop buying.”

*Andrew Lyons*, founder of computer component parts company:

“In my business, the product life cycle is about nine months. It’s all about innovation, research, and development. I would love to know where my competitors are investing in R&D, and I’m sure they think the same. If one of us knew what the other guys were doing, it’d be a huge competitive advantage. R&D activities are our biggest company secret.”

*Allison Deere*, investment advisor to high-income individuals:

“Are you kidding? I’d never share my tax return with anyone. It’s nobody’s business how much money I make. And what about other personal information? Would you volunteer your Social Security Number to just anyone?”
Confidential Client Information: Disclosures

There are only a few exceptions to the client confidentiality rule as described in Table 1-1.

<table>
<thead>
<tr>
<th>Table 1-1</th>
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<tbody>
<tr>
<td>You May Disclose Confidential Client Information Without Client Permission</td>
<td>Only In Certain Circumstances</td>
</tr>
<tr>
<td>Comply with standards</td>
<td>To comply with the requirements of other professional standards, for example, audit, review, or tax standards (Your requirement to comply with these other standards always takes precedence over your responsibilities to maintain client confidentiality.)</td>
</tr>
<tr>
<td>Comply with laws</td>
<td>In response to a validly issued and enforceable subpoena or summons or in order to comply with a law or regulation</td>
</tr>
<tr>
<td>Ethics investigation</td>
<td>To initiate a complaint with or respond to inquiries made in connection with an investigation or disciplinary proceeding</td>
</tr>
<tr>
<td>Firm sale or merger</td>
<td>In conjunction with a prospective sale, purchase, or merger of your practice (The member must take appropriate precautions, that is, forge an agreement with the prospective purchaser not to disclose any information obtained during the course of the review.)</td>
</tr>
<tr>
<td>Third-party service provider</td>
<td>Member has a contractual agreement with the third party to protect the client’s data and is reasonably assured that the third party has appropriate controls in place to prevent unauthorized release of the data to others</td>
</tr>
</tbody>
</table>

Coach Your Staff

Maintaining client confidentiality is usually not intuitive, but instead is a learned behavior. Staff members who are new to the profession may not be aware of this responsibility. They have probably never held a job before in which customers trusted them with privileged information. Part of being a professional is being discreet when discussing client matters, especially in public places.
Stories From the Field

These two young people learned a lesson about client confidentiality the hard way.

Doug Shaw

- Background: Doug sold computer equipment before getting his degree in accounting.

- What he said: “One of my first jobs was the audit of an electronics retailer. A few days after observing inventory, I was telling another staff person my experience. We were in the client’s lobby, and I said something like, ‘You wouldn’t believe all the old junk they have in their warehouse. Some of this stuff is two years old. Who’d buy it?’ ”

- Who found out: “Sitting in the lobby was the company’s banker, who was waiting to see the company president. The banker told the president, who called the partner, who called me. She pulled me off the job that afternoon and reassigned me. From there, my career had nowhere to go but up.”

Theresa Santangelo

- Background: Theresa worked in a coffeehouse/bookshop to put herself through college.

- What she said: “In my old job, we had a lot of regular customers who used to sit around the coffeehouse for hours and talk. The rule at the table was that if you weren’t there, we talked about you. Then I joined the accounting firm. One night on an out-of-town assignment I went to dinner with an old friend from college and told her stories about how awful and incompetent the client was. Coffeehouse gossip.”

- Who found out: “In the booth right next to us was the treasurer and her family. I was talking about her staff! She came over to my table and introduced herself, and I turned bright red. She asked if we could talk privately. She was nice, but also very firm in telling me that I should never, ever, discuss client matters in a public place. I’m just glad she didn’t tell my manager.”
Disclosure or Use of Confidential Information

A regional manufacturing association asks a firm to provide certain financial information about the firm’s manufacturing clients. Once compiled and analyzed, the association will distribute the information to its members. None of the supplied information will be specifically identified as belonging to any particular client. Would this violate the Code?

The member would violate the code if the clients’ information is considered to be confidential client information, unless the member first obtains the clients’ specific consent, preferably in writing, about the nature of the information that may be disclosed, the persons to whom it may be disclosed, and its intended use.

However, if information is already available to the public, it is not confidential information and the rule does not apply.

The member should consider whether federal, state, or local statutes, rules, or regulations concerning confidentiality of client information are more restrictive than the AICPA Code.

Another Scenario

Imagine you are a member in public practice. An auditing professor wants to perform academic research and asks you to provide confidential client information that has been stripped of any identifying reference to your client. Before providing any information, you should obtain your client’s permission, preferably in writing, to disclose and use the information. You should also consider entering into a formal agreement with the professor to help ensure that he or she only uses and/or discloses your client’s information in accordance with what the client agreed to. The same standard applies to you if you want to use or disclose the client’s confidential information; for example, if you wanted to develop a benchmarking study to distribute to clients and prospects.

Confidential Client Information: XYZ Company

You are auditing the financial statements of XYZ, Company. During your audit, you determine that the client’s financial statements should disclose concentrations in revenue from a particular product and in the available sources of raw materials (as required by accounting standards). You explain this to Ms. Alphonso, president of XYZ, who responds as follows: “That’s confidential information. I don’t want our competitors to know that most of our profits come from one product. And I sure don’t want our supplier to know he’s our sole source. Can you imagine what sort of leverage he’d have over me? You can’t disclose that.”
Case Study Question

2. What is your best course of action in this situation?
   a. Don’t require the disclosure. You are bound by the Code to not disclose confidential client information without the specific consent of the client.
   b. Require the client make the disclosure or qualify your auditor’s report. Your obligation to follow audit and accounting standards supersedes your obligation to keep client information confidential.
Case Study Suggested Solution

2.
   a. Incorrect. Information is not considered confidential if it is required to be disclosed in the financial statements.
   b. Correct. Your obligation to follow the audit and accounting rules always takes precedence over retaining client confidentiality.
Acts Discreditable to the Profession

The rule on “acts discreditable to the profession” is rather broad and subject to some degree of interpretation. While some of the more obvious discreditable acts might include, among other things, misappropriation of client funds, insider trading, or other acts of lawlessness, several specific situations constituting discreditable acts have been interpreted in the rule itself.

Examples of Acts Discreditable to the Profession

<table>
<thead>
<tr>
<th>Description</th>
<th>Act Discreditable to the Profession</th>
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</thead>
<tbody>
<tr>
<td>Discrimination and harassment</td>
<td>Being found guilty of violating any antidiscrimination laws</td>
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<tr>
<td>Government regulations</td>
<td>Failure to follow standards and/or procedures or other requirements in governmental or regulatory audits or attest services</td>
</tr>
<tr>
<td>Preparation of financial statements</td>
<td>Through negligence, making or permitting others to make materially false or misleading entries in the financial statements or accounting records</td>
</tr>
<tr>
<td></td>
<td>Failure to correct an entity’s financial statements that are materially false and misleading when the member has the authority to record an entry</td>
</tr>
<tr>
<td></td>
<td>Signing, or permitting or directing another to sign, a document containing materially false and misleading information</td>
</tr>
<tr>
<td>Removing client files</td>
<td>Upon leaving a public accounting firm, an employee removes the firm’s client files (or copies of files) or proprietary information without the firm’s permission except where permitted by contractual arrangement</td>
</tr>
<tr>
<td>Timely filing of tax returns</td>
<td>Failure to timely file personal tax returns or those of the firm, or failure to remit payroll or other taxes in a timely manner</td>
</tr>
<tr>
<td>Indemnification/Limitation of liability</td>
<td>Entering into (or directing another to enter into) an indemnification or other liability-limiting agreement with an attest client which does not comply with applicable provisions of regulatory bodies, for example, SEC, banking and insurance regulators</td>
</tr>
<tr>
<td>Description</td>
<td>Act Discreditable to the Profession</td>
</tr>
<tr>
<td>---------------------------------------------------------------------------</td>
<td>----------------------------------</td>
</tr>
<tr>
<td>Disclosure of employer’s confidential information (including volunteer positions)</td>
<td>Member should maintain the confidentiality of his or her employer or firm (employer) confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship, for example, discussions with the employer’s vendors, customers, or lenders. (Confidential employer information is any proprietary information pertaining to the employer or any organization for which the member may work in a volunteer capacity that is not known to be available to the public and is obtained as a result of the relationships.)</td>
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</table>
Case Study: A Messy Situation

Suppose that you are preparing a tax return for a new individual client. The return is much more complicated than you originally planned because the client failed to inform you of several significant transactions.

You tell the client that the cost of finishing the return will be $2,000 greater than the original estimate. The client refuses to pay this, and the engagement is terminated. The client owes you $5,000 for the work you have already performed, which he also refuses to pay. He demands that you return his original accounting records.

Case Study Question

3. Suppose that a statute exists in your state that allows you to place a lien on client records in the event of unpaid fees. Given these facts, are you obligated to return the client’s records?
   a. No, not until he pays the $5,000.
   b. Yes, these records should be provided upon request.

It Gets a Little Messier

As part of your work, you prepared several schedules relating to the client’s investment trading activity. He now says he needs these schedules so that he can complete his tax return himself.

Case Study Question

4. Are you required to provide him with the schedules you prepared?
   a. No, these are not considered client provided records.
   b. Yes, schedules that you prepare are considered client provided records.

Another Saga

As part of another engagement, you have agreed to complete tax returns for a limited partnership for which the client representative (the individual you dealt with on client matters) was the general partner. After the engagement was completed, you returned all the appropriate client records to the general partner, including those related to the partnership.
Case Study Question

5. You now are receiving requests from all the limited partners asking that they receive copies of the partnership records. They claim that the general partner refused to furnish these records and referred all inquiries to you. Assume that you retained copies of the records in question. Are you required to furnish these to all limited partners who ask?

   a. No, since they are not the client representative.
   b. Yes, you must furnish client records to anyone with a legitimate need for them.
Suggested Solutions to Case Study Questions

3.  
   a. Incorrect. Remember that the Code requires actions above and beyond the law. The laws of your state do not change the profession’s ethical standard, which is to return client provided records in all circumstances.  
   b. Correct. The Code requires you to return client provided records under all circumstances.

4.  
   a. Correct. Your workpapers, including analyses and schedules prepared by the client at your request, are your property, not client provided records.  
   b. Incorrect. Schedules that you prepare are not considered client records. Given these circumstances, you would only be required to return client provided records.

5.  
   a. Correct. The Code generally requires you to return client records once. After you have delivered them to the general partner (client’s representative), you need not comply with subsequent requests to again provide this information. However, if as a result of a natural disaster or an act of war, the client (general partner, in this instance) loses records that you had previously provided to him or her, you should honor a subsequent request to provide the records.  
   b. Incorrect. The Code does not require you to go to these lengths once you have provided the information to the client’s representative (general partner, in this instance). The only subsequent request you are expected to honor is one in which as a result of a natural disaster or an act of war, the client (general partner, in this instance) loses records that you had previously provided to him or her.
CPAs in Public Practice

Certain ethics rules relate only to CPAs in public practice. A few follow.

Ethics Rulings on Outsourcing

The Code requires you to take certain actions when you outsource the performance of your services to “third-party service providers.” The standards apply to all independent contractors that your firm uses.

Prior to sharing confidential client information with the contractor, you are required to inform the client, preferably in writing, that you may be using a service provider when providing professional services to that client.

When you use a service provider to render professional services to clients, you are responsible for overseeing the service provider’s work and ensuring that all applicable professional standards are met.

You are required to enter into a contractual agreement with the contractor to maintain the confidentiality of the client’s information, including those who provide only administrative support services. You should also ensure that the service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information.

Advertising and Solicitations

Members in public practice may not advertise their services in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited.

Form of Organization and Firm Name

You may practice public accounting only in a form of organization permitted by law or regulation that also conforms to the resolutions of the AICPA Council. Your firm name cannot be misleading. Names of past owners may be included in the firm name, even when the firm merges with another firm. You may designate your firm as a member of the AICPA only if all CPA owners are members of the Institute.
CPAs in Public Practice: Case Study

It is not unusual for a member to own all or part of a separate business that performs accounting, consulting, or other professional services. Does the Code apply to a separate business? This issue is addressed in the Code and is fairly clear.

If the member, either individually or with members of his or her firm, controls the separate business, as defined by GAAP, then the separate business (including all of its owners and employees) is subject to the Code. If the member does not control the separate business, then only the member (as an individual) must comply with the Code.

Now let’s take a look at a brief case study.

Review Question

7. Alf & Company, CPAs, decides to subcontract a portion of its tax return preparation work to Dee Howard Tax Preparation Services, an unaffiliated income tax service provider. What does Alf & Company need to do to outsource tax work to the service provider?

   I. Ensure that the service provider is current in its income tax obligations.
   II. Ensure that the service provider has appropriate controls in place to protect the confidentiality of client data.
   III. Disclose to the client that services may be performed by a third-party service provider.
   IV. Have a contractual agreement with the service provider to protect the confidentiality of client information.

   a. Items I, II, and III are required.
   b. Items II, III, and IV are required.
   c. Items III and IV are required.
   d. All of the items are required.

“What if my compliance with one rule in the Code causes me to violate another rule in the Code?”

With the introduction of the new Code, the PEEC has adopted a new interpretation on ethical conflicts, as follows in Exhibit 1-6:
Exhibit 1-6

Ethical Conflicts

.01 An ethical conflict arises when a *member* encounters one or both of the following:

a. Obstacles to following an appropriate course of action due to internal or external pressures

b. Conflicts in applying relevant professional standards or legal standards

For example, a *member* suspects a fraud may have occurred, but reporting the suspected fraud would violate the *member’s* responsibility to maintain *client* confidentiality.

.02 Once an ethical conflict is encountered, a *member* may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the *member* should consider factors such as the following:

a. Relevant facts and circumstances, including applicable rules, laws, or regulations

b. Ethical issues involved

c. Established internal procedures

.03 The *member* should also be prepared to justify any departures that the *member* believes were appropriate in applying the relevant rules and law. If the *member* was unable to resolve the conflict in a way that permitted compliance with the applicable rules and law, the *member* may have to address the consequences of any violations.

.04 Before pursuing a course of action, the *member* should consider consulting with appropriate persons within the *firm* or the organization that employs the *member*.

.05 If a *member* decides not to consult with appropriate persons within the *firm* or the organization that employs the *member* and the conflict remains unresolved after pursuing the selected course of action, the *member* should consider either consulting with other individuals for help in reaching a resolution or obtaining advice from an appropriate professional body or legal counsel. The *member* also should consider documenting the substance of the issue, the parties with whom the issue was discussed, details of any discussions held, and any decisions made concerning the issue.

.06 If the ethical conflict remains unresolved, the *member* will in all likelihood be in violation of one or more rules if he or she remains associated with the matter creating the conflict. Accordingly, the *member* should consider his or her continuing relationship with the engagement team, specific assignment, *client*, *firm*, or employer.

Effective December 15, 2014.
Consequences of Ethical Infractions

As auditors and accountants, CPAs play a key role in safeguarding the integrity of financial reporting. They also provide tax compliance and other advisory services that are valuable to the public. They serve the business community in many important ways.

For these reasons, CPAs are subject to numerous ethical requirements and must be able to

- identify ethical issues,
- critically assess them, and
- use professional judgment to arrive at a reasonable decision.

None of this is easy. There are many hard choices to make, but it is extremely important to develop these skills. The stakes are very high. A single significant error in judgment could lead to investigation by the AICPA, the state accountancy board, or the SEC, to name just a few of the bodies charged with overseeing the profession.

The results can be significant. For example, you could

- lose your license to practice as a CPA,
- be expelled from membership in the AICPA or a state CPA society, and
- incur significant fines and steep legal liabilities.

The following is an example of a fictional matter that could possibly appear in The CPA Letter which results in multiple violations of AICPA rules, termination of membership by the AICPA, and publication of the matter on the AICPA website.
Fictional Disclosure in “The CPA Letter”
Ethics Infractions by a CPA in Business and Industry

John A. Doe of Anywhere, USA

Information came to the attention of the Ethics Charging Authority (ECA) (comprised of the AICPA’s Professional Ethics Executive Committee) alleging a potential disciplinary matter with respect to John A. Doe’s performance of professional services as Controller and later, Chief Financial Officer of a public company (the Company) for the fiscal years ended 2013 and 2014.

After an investigation, John A. Doe was charged with violating the AICPA Code of Professional Conduct, as follows:

**Integrity and Objectivity Rule** – Knowing misrepresentations in the preparation of financial statements or records

As Controller, Mr. Doe was responsible for the internal financial reporting of the Company for the fiscal years ended December 31, 2013 and 2014 knowing that those financial statements and records were materially misstated.

**Integrity and Objectivity Rule** – Obligation of a member to his or her employer’s external accountant

Mr. Doe knowingly misrepresented facts to Company’s external accountants in regards to the Company’s financial statements for the fiscal years ended December 31, 2013 and 2014 by representing that the financial statements were in accordance with generally accepted accounting principles, when he knew they were not. Mr. Doe was not candid, knowingly misrepresented facts, and failed to disclose facts to the external accountants.

**Integrity and Objectivity Rule** – Subordination of judgment by a member

Mr. Doe subordinated his judgment to his superior by relying on his superior’s representations for recording revenue in the financial statements for the fiscal years ended December 31, 2013 and 2014 instead of utilizing appropriate judgment.

**Accounting Principles Rule**

Mr. Doe stated affirmatively that the financial statements were in conformity with generally accepted accounting principles, when they did not comply with the requirements of revenue recognition when the right of return exists (FASB ASC 605-15-05).
Acts Discreditable Rule

Mr. Doe was negligent in his role as Controller of the Company for not having performed sufficient procedures to determine whether the financial statements were free from material misstatements in the allowance for doubtful accounts area for the fiscal years ended December 31, 2013 and 2014.

Agreement

In consideration of the ECA forgoing further investigation of Mr. Doe’s conduct as described above, and in consideration of the ECA forgoing any further proceedings in this matter, Mr. Doe agrees as follows:

To waive his rights to a hearing under AICPA bylaws section 7.4.

To neither admit nor deny the above-specified charges.

To his expulsion from membership in the AICPA, effective…

That the ECA shall publish his name, the charges, and terms of this settlement agreement in an abbreviated format in the printed version of a membership periodical of the AICPA with a more detailed description of the disciplinary action in the online version of this periodical on the AICPA’s website.

You may have noticed that the Acts Discreditable rule was cited in The CPA Letter. While the rule is interpreted to include several examples of behavior that would be considered an act that discredits the profession, the PEEC also applies this rule in disciplinary matters on a case-by-case basis. To discredit the profession means

- to harm the reputation of, as to make someone or something appear untrustworthy or wrong; or
- the loss of someone’s or something’s good name or reputation, or a person or thing that causes its loss, for example, conduct that is considered to taint the profession as a whole.

In the Works

Excluding Independence, which is addressed in Chapter 2 of this course, and the proposed revisions already mentioned in this chapter, the PEEC is proposing or has adopted the following additional changes to the Code (see Exhibit 1-7):
Exhibit 1-7

Those charged with governance—new definition. When an interpretation requires communicating with those charged with governance, the member should determine, considering the nature and importance of the particular circumstances and matter to be communicated, the appropriate person(s) within the entity’s governance structure with whom to communicate. If the member communicates with a subgroup of those charged with governance (for example, an audit committee or an individual), the member should determine whether communication with all of those charged with governance is also necessary, so that they are adequately informed.

Charged with governance is defined as

The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).

Effective – April 30, 2014

Conflicts of interest. In November 2013, the PEEC exposed for comment a revised interpretation on conflicts of interest for members in public practice and a new interpretation for members in business. (The existing interpretation applies to both members in public practice and business.) The proposed interpretations, which come under the Integrity and Objectivity rule, provide tailored guidance to members in public practice and members’ business concerning the typical issues that arise in their respective practice areas.

The proposed interpretations would require the member to take reasonable steps to identify circumstances that might create a conflict. When identified, the member would be required to apply the conceptual framework by analyzing threats to compliance with the rule and applying safeguards, as needed. Even when threats to compliance are reduced to an acceptable level, the member would be required to disclose the conflict of interest to the client or employer and any other appropriate parties, and such persons must agree that the member may perform the professional services. The member is encouraged to document those conversations.

The proposal reflects consideration of new ethics standards on conflicts of interest for professional accountants issued by the International Ethics Standards Board for Accountants’ (IESBA) in its Code of Ethics for Professional Accountants (IESBA Code) in March 2013.
Questions to Consider and Lessons Learned

The purpose of this chapter was to provide you with a general understanding of the ethics rules and interpretations in the new Ethics Codification and various methodologies for evaluating ethical matters, including potential conflicts between two or more rules.

Questions to Consider

- Have I familiarized myself with the structure and content of the new Ethics Codification, which becomes effective December 15, 2014?
- Do I know how to apply the conceptual framework to ethical matters?
- Do I refer to the new Code content on resolving ethical matters when a conflict between the rules arises?
- Do I know what the requirements of the AICPA and my state accountancy board are for client records requests?

Lessons Learned

- Know your ethical obligations to clients and the public.
- When evaluating ethical issues, take the time to understand the facts, the applicable rules and regulations, the available options, legal implications, and the effect of your actions on various stakeholders.
- You should document matters when application of the conceptual framework requires you to apply safeguards to mitigate threats to your compliance with rule(s) in the Code.
- Keep your understanding of ethics rules current; the ramifications of violating the rules, even inadvertently, can be significant.
Exhibit 1-8

2.000.020 Ethical Conflicts

.01 An ethical conflict arises when a member encounters one or both of the following:

a. Obstacles to following an appropriate course of action due to internal or external pressures

b. Conflicts in applying relevant professional and legal standards

For example, a member suspects a fraud may have occurred, but reporting the suspected fraud would violate the member’s responsibility to maintain the confidentiality of his or her employer’s confidential information.

.02 Once an ethical conflict is encountered, a member may be required to take steps to best achieve compliance with the rules and law. In weighing alternative courses of action, the member should consider factors such as the following:

a. Relevant facts and circumstances, including applicable rules, laws, or regulations

b. Ethical issues involved

c. Established internal procedures

.03 The member should also be prepared to justify any departures that the member believes were appropriate in applying the relevant rules and law. If the member was unable to resolve the conflict in a way that permitted compliance with the applicable rules and law, the member may have to address the consequences of any violations.

.04 Before pursuing a course of action, the member should consider consulting with appropriate persons within the organization that employs the member.

.05 If a member decides not to consult with appropriate persons within the organization that employs the member, and the conflict remains unresolved after pursuing the selected course of action, the member should consider either consulting with other individuals for help in reaching a resolution or obtaining advice from an appropriate professional body or legal counsel. The member also should consider documenting the substance of the issue, the parties with whom the issue was discussed, details of any discussions held, and any decisions made concerning the issue.

.06 If the ethical conflict remains unresolved, the member will in all likelihood be in violation of one or more rules if he or she remains associated with the matter creating the conflict. Accordingly, the member should consider his or her continuing relationship with the specific assignment or employer. [No prior reference: new content]

Effective Date

.07 Effective December 15, 2014.
Solutions to Review Questions

1.  
   a. Incorrect. It is true that you provide services to your clients, but this is not your primary responsibility.  
   b. Incorrect. The CPA’s personal interests rank last in this list.  
   c. Correct. Your primary responsibility is to serve the public interest.  

2.  
   a. Correct. Integrity is one of the cornerstones of our profession.  
   b. Incorrect. Speed alone will not maintain the public confidence.  
   c. Incorrect. Accuracy is important, but too narrow a concept; some things do not lend themselves to quantitative measures.  

3.  
   a. Incorrect. Due process implies that we circulate tentative conclusions and solicit feedback before making a final conclusion.  
   b. Correct. Due care implies a certain level of quality and competence in the performance of services.  
   c. Incorrect. Due diligence requires a thorough gathering of information prior to making a decision.  

4.  
   a. Incorrect. Booking revenue before it should be recorded under GAAP is a critical fact in this case.  
   b. Correct. This is not a critical fact; in fact, there is no mention of expenses at all in the case study.  
   c. Incorrect. Carl Adams’s background and experience are critical facts in this case.  
   d. Incorrect. The complexity of the accounting rules is a critical fact in this case.  

5.  
   a. Incorrect. We cannot presume that threats are at an acceptable level because the businesses are separate and distinct.  
   b. Incorrect. We cannot presume that threats are at an acceptable level because directorships of relatives may not always result in conflicts of interest.  
   c. Correct. We need more information to determine whether this situation creates a significant threat to Bob’s ability to be objective.
6.  
a. Incorrect. This may be a step that is taken once you disclose a matter to the appropriate parties, but it would not be required.
b. Incorrect. While this might be a nice assurance to have, it would not be required.
c. Correct. To proceed with evaluating your potential conflict of interest, you must conclude that you can provide the services objectively (that is, threats to your objectivity are insignificant or have been reduced to an acceptable level).
d. Incorrect. This would not be a required factor, although you may believe that only some third parties might question your objectivity.

7.  
a. Incorrect. Although the firm is not required to monitor the timeliness of the service provider’s tax obligations, it is required to take certain steps to protect client confidentiality and to inform the client that a third-party service provider may be used.
b. Correct. The firm needs to take certain steps to protect client confidentiality and to inform the client that a third-party service provider may be used.
c. Incorrect. The firm must take another action to outsource client services.
d. Incorrect. While, among other things, the firm has to ensure that the service provider performs services in compliance with professional standards, it is not required to monitor the timeliness of its tax obligations.
Appendix A

Conceptual Framework for Members in Public Practice
Appendix A

1.000.010  Conceptual Framework for Members in Public Practice

Introduction

.01  Members may encounter various relationships or circumstances that create threats to the member’s compliance with the rules. The rules and interpretations seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to the member’s compliance with the rules that is not at an acceptable level. When making that evaluation, the member should apply the conceptual framework approach as outlined in this interpretation.

.02  The code specifies that in some circumstances no safeguards can reduce a threat to an acceptable level. For example, the code specifies that a member may not subordinate the member’s professional judgment to others without violating the “Integrity and Objectivity Rule” [1.100.001]. A member may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in the code.

.03  The “Conceptual Framework for Independence” interpretation [1.210.010] of the “Independence Rule” [1.200.001] provides authoritative guidance that members should use when making decisions on independence matters that are not explicitly addressed by the “Independence Rule” and its interpretations.

Definitions Used in Applying the Conceptual Framework

.04  Acceptable level. A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member’s compliance with the rules is not compromised.

.05  Safeguards. Actions or other measures that may eliminate a threat or reduce a threat to an acceptable level.

.06  Threats. Relationships or circumstances that could compromise a member’s compliance with the rules.
Conceptual Framework Approach

.07 Under the conceptual framework approach, members should identify threats to compliance with the rules and evaluate the significance of those threats. Members should evaluate identified threats both individually and in the aggregate because threats can have a cumulative effect on a member’s compliance with the rules. Members should perform three main steps in applying the conceptual framework approach:

a. **Identify threats.** The relationships or circumstances that a member encounters in various engagements and work assignments will often create different threats to complying with the rules. When a member encounters a relationship or circumstance that is not specifically addressed by a rule or an interpretation, under this approach, the member should determine whether the relationship or circumstance creates one or more threats, such as those identified in paragraphs .10–.16 that follow. The existence of a threat does not mean that the member is in violation of the rules; however, the member should evaluate the significance of the threat.

b. **Evaluate the significance of a threat.** In evaluating the significance of an identified threat, the member should determine whether a threat is at an acceptable level. A threat is at an acceptable level when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat would not compromise the member’s compliance with the rules. Members should consider both qualitative and quantitative factors when evaluating the significance of a threat, including the extent to which existing safeguards already reduce the threat to an acceptable level. If the member evaluates the threat and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat does not compromise a member’s compliance with the rules, the threat is at an acceptable level, and the member is not required to evaluate the threat any further under this conceptual framework approach.

c. **Identify and apply safeguards.** If, in evaluating the significance of an identified threat, the member concludes that the threat is not at an acceptable level, the member should apply safeguards to eliminate the threat or reduce it to an acceptable level. The member should apply judgment in determining the nature of the safeguards to be applied because the effectiveness of safeguards will vary, depending on the circumstances. When identifying appropriate safeguards to apply, one safeguard may eliminate or reduce multiple threats. In some cases, the member should apply multiple safeguards to eliminate or reduce one threat to an acceptable level. In other cases, an identified threat may be so significant that no safeguards will eliminate the threat or reduce it to an acceptable level, or the member will be unable to implement effective safeguards. Under such circumstances, providing the specific professional services would compromise the member’s compliance with the rules, and the member should determine whether to decline or discontinue the professional services or resign from the engagement.
Threats

.08 Many threats fall into one or more of the following seven broad categories: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence.

.09 Examples of threats associated with a specific relationship or circumstance are identified in the interpretations of the code. Paragraphs .10–.16 of this section define and provide examples, which are not all inclusive, of each of these threat categories.

.10 Adverse interest threat. The threat that a member will not act with objectivity because the member’s interests are opposed to the client’s interests. Examples of adverse interest threats include the following:

a. The client has expressed an intention to commence litigation against the member.

b. A client or officer, director, or significant shareholder of the client participates in litigation against the firm.

c. A subrogee asserts a claim against the firm for recovery of insurance payments made to the client.

d. A class action lawsuit is filed against the client and its officers and directors and the firm and its professional accountants.

.11 Advocacy threat. The threat that a member will promote a client’s interests or position to the point that his or her objectivity or independence is compromised. Examples of advocacy threats include the following:

a. A member provides forensic accounting services to a client in litigation or a dispute with third parties.

b. A firm acts as an investment adviser for an officer, a director, or a 10 percent shareholder of a client.

c. A firm underwrites or promotes a client’s shares.

d. A firm acts as a registered agent for a client.

e. A member endorses a client’s services or products.

.12 Familiarity threat. The threat that, due to a long or close relationship with a client, a member will become too sympathetic to the client’s interests or too accepting of the client’s work or product. Examples of familiarity threats include the following:

a. A member’s immediate family or close relative is employed by the client.

b. A member’s close friend is employed by the client.
c. A former partner or professional employee joins the **client** in a **key position** and has knowledge of the **firm’s** policies and practices for the **professional services** engagement.

d. Senior personnel have a long association with a **client**.

e. A **member** has a significant close business relationship with an officer, a director, or a 10 percent shareholder of a **client**.

**Management participation threat.** The **threat** that a **member** will take on the role of **client** management or otherwise assume management responsibilities, such may occur during an engagement to provide nonattest services.

**Self-interest threat.** The **threat** that a **member** could benefit, financially or otherwise, from an interest in, or relationship with, a **client** or persons associated with the **client**. Examples of self-interest **threats** include the following:

a. The **member** has a **financial interest** in a **client**, and the outcome of a **professional services** engagement may affect the fair value of that **financial interest**.

b. The **member’s** spouse enters into employment negotiations with the **client**.

c. A firm enters into a contingent fee arrangement for a tax refund claim that is not a predetermined fee.

d. Excessive reliance exists on revenue from a single **client**.

**Self-review threat.** The **threat** that a **member** will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the **member** or an individual in the **member’s firm** and that the **member** will rely on that service in forming a judgment as part of another service. Examples of self-review **threats** include the following:

a. The **member** relies on the work product of the **member’s firm**.

b. The **member** performs bookkeeping services for a **client**.

c. A **partner** in the **member’s office** was associated with the **client** as an employee, an officer, a director, or a contractor.

**Undue influence threat.** The **threat** that a **member** will subordinate his or her judgment to an individual associated with a **client** or any relevant third party due to that individual’s reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the **member**. Examples of undue influence **threats** include the following:

a. The **firm** is threatened with dismissal from a **client** engagement.

b. The **client** indicates that it will not award additional engagements to the **firm** if the **firm** continues to disagree with the **client** on an accounting or tax matter.
c. An individual associated with a client or any relevant third party threatens to withdraw or terminate a professional service unless the member reaches certain judgments or conclusions.

Safeguards

.17 Safeguards may partially or completely eliminate a threat or diminish the potential influence of a threat. The nature and extent of the safeguards applied will depend on many factors. To be effective, safeguards should eliminate the threat or reduce it to an acceptable level.

.18 Safeguards that may eliminate a threat or reduce it to an acceptable level fall into three broad categories:

a. Safeguards created by the profession, legislation, or regulation.

b. Safeguards implemented by the client. It is not possible to rely solely on safeguards implemented by the client to eliminate or reduce significant threats to an acceptable level.

c. Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements.

.19 The effectiveness of a safeguard depends on many factors, including those listed here:

a. The facts and circumstances specific to a particular situation

b. The proper identification of threats

c. Whether the safeguard is suitably designed to meet its objectives

d. The party(ies) who will be subject to the safeguard

e. How the safeguard is applied

f. The consistency with which the safeguard is applied

g. Who applies the safeguard

h. How the safeguard interacts with a safeguard from another category

i. Whether the client is a public interest entity

.20 Examples of safeguards within each category are presented in the following paragraphs. Because these are only examples and are not intended to be all inclusive, it is possible that threats may be sufficiently mitigated through the application of other safeguards not specifically identified herein.
The following are examples of *safeguards* created by the profession, legislation, or regulation:

- Education and training requirements on *independence* and ethics rules
- Continuing education requirements on *independence* and ethics
- Professional standards and the threat of discipline
- External review of a *firm’s* quality control system
- Legislation establishing prohibitions and requirements for a *firm* or a *firm’s* professional employees
- Competency and experience requirements for professional licensure
- Professional resources, such as hotlines, for consultation on ethical issues

Examples of *safeguards* implemented by the *client* that would operate in combination with other *safeguards* are as follows:

- The *client* has personnel with suitable skill, knowledge, or experience who make managerial decisions about the delivery of *professional services* and makes use of third-party resources for consultation as needed.
- The tone at the top emphasizes the *client’s* commitment to fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies.
- Policies and procedures are in place to achieve fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies.
- Policies and procedures are in place to address ethical conduct.
- A governance structure, such as an active audit committee, is in place to ensure appropriate decision making, oversight, and communications regarding a *firm’s* services.
- Policies are in place that bar the entity from hiring a *firm* to provide services that do not serve the public interest or that would cause the *firm’s independence* or objectivity to be considered *impaired*.

The following are examples of *safeguards* implemented by the *firm*:

- *Firm* leadership that stresses the importance of complying with the rules and the expectation that engagement teams will act in the public interest.
- Policies and procedures that are designed to implement and monitor engagement quality control.
c. Documented policies regarding the identification of threats to compliance with the rules, the evaluation of the significance of those threats, and the identification and application of safeguards that can eliminate identified threats or reduce them to an acceptable level.

d. Internal policies and procedures that are designed to monitor compliance with the firm’s policies and procedures.

e. Policies and procedures that are designed to identify interests or relationships between the firm or its partners and professional staff and the firm’s clients.

f. The use of different partners, partner equivalents, and engagement teams from different offices or that report to different supervisors.

g. Training on, and timely communication of, a firm’s policies and procedures and any changes to them for all partners and professional staff.

h. Policies and procedures that are designed to monitor the firm’s, partner’s, or partner equivalent’s reliance on revenue from a single client and that, if necessary, trigger action to address excessive reliance.

i. Designation of someone from senior management as the person responsible for overseeing the adequate functioning of the firm’s quality control system.

j. A means for informing partners and professional staff of attest clients and related entities from which they must be independent.

k. A disciplinary mechanism that is designed to promote compliance with policies and procedures.

l. Policies and procedures that are designed to empower staff to communicate to senior members of the firm any engagement issues that concern them without fear of retribution.

m. Policies and procedures relating to independence and ethics communications with audit committees or others charged with client governance.

n. Discussion of independence and ethics issues with the audit committee or others responsible for the client’s governance.

o. Disclosures to the audit committee or others responsible for the client’s governance regarding the nature of the services that are or will be provided and the extent of the fees charged or to be charged.

p. The involvement of another professional accountant who (a) reviews the work that is done for a client or (b) otherwise advises the engagement team. This individual could be someone from outside the firm or someone from within the firm who is not otherwise associated with the engagement.
g. Consultation on engagement issues with an interested third party, such as a committee of independent directors, a professional regulatory body, or another professional accountant.

r. Rotation of senior personnel who are part of the engagement team.

s. Policies and procedures that are designed to ensure that members of the engagement team do not make or assume responsibility for management decisions for the client.

t. The involvement of another firm to perform part of the engagement.

u. Having another firm to reperform a nonattest service to the extent necessary for it to take responsibility for that service.

v. The removal of an individual from an attest engagement team when that individual’s financial interests or relationships pose a threat to independence or objectivity.

w. A consultation function that is staffed with experts in accounting, auditing, independence, ethics, and reporting matters who can help engagement teams

i. assess issues when guidance is unclear or when the issues are highly technical or require a great deal of judgment; and

ii. resist undue pressure from a client when the engagement team disagrees with the client about such issues.

x. Client acceptance and continuation policies that are designed to prevent association with clients that pose a threat that is not at an acceptable level to the member’s compliance with the rules.

y. Policies that preclude audit partners or partner equivalents from being directly compensated for selling nonattest services to the attest client.

z. Policies and procedures addressing ethical conduct and compliance with laws and regulations. [No prior reference: new content]

Effective Date

24 Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.
Appendix B

Conceptual Framework for Members in Business
Appendix B

2.000.010 Conceptual Framework for Members in Business

Introduction

.01 Members may encounter various relationships or circumstances that create threats to the member’s compliance with the rules. The rules and interpretations seek to address many situations; however, they cannot address all relationships or circumstances that may arise. Thus, in the absence of an interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to the member’s compliance with the rules that is not at an acceptable level. When making that evaluation, the member should apply the conceptual framework approach as outlined in this interpretation.

.02 The code specifies that in some circumstances, no safeguards can reduce a threat to an acceptable level. For example, the code specifies that a member may not subordinate the member’s professional judgment to others without violating the “Integrity and Objectivity Rule” [2.100.001]. A member may not use the conceptual framework to overcome this or any other prohibition or requirement in the code.

Definitions Used in Applying the Conceptual Framework

.03 Acceptable level. A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member’s compliance with the rules is not compromised.

.04 Safeguards. Actions or other measures that may eliminate a threat or reduce a threat to an acceptable level.

.05 Threat(s). Relationships or circumstances that could compromise a member’s compliance with the rules.

Conceptual Framework Approach

.06 Under the conceptual framework approach, members should identify threats to compliance with the rules and evaluate the significance of those threats. Members should evaluate identified threats both individually and in the aggregate because threats can have a cumulative effect on a member’s compliance with the rules. Members should perform three main steps in applying the conceptual framework approach:

   a. Identify threats. The relationships or circumstances that a member encounters in various engagements and work assignments or positions will often create different threats to complying with the rules. When a member encounters a relationship or circumstance that is not specifically addressed by a rule or an interpretation,
under this approach, the member should determine whether the relationship or circumstance creates one or more threats, such as those identified in paragraphs .09–.14 that follow. The existence of a threat does not mean that the member is in violation of the rules; however, the member should evaluate the significance of the threat.

b. Evaluate the significance of a threat. In evaluating the significance of an identified threat, the member should determine whether a threat is at an acceptable level. A threat is at an acceptable level when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat would not compromise the member’s compliance with the rules. Members should consider both qualitative and quantitative factors when evaluating the significance of a threat, including the extent to which existing safeguards already reduce the threat to an acceptable level. If the member evaluates the threat and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the threat does not compromise a member’s compliance with the rules, the threat is at an acceptable level and the member is not required to evaluate the threat any further under this conceptual framework approach.

c. Identify and apply safeguards. If, in evaluating the significance of an identified threat, the member concludes that the threat is not at an acceptable level, the member should apply safeguards to eliminate the threat or reduce it to an acceptable level. The member should apply judgment in determining the nature of the safeguards to be applied because the effectiveness of safeguards will vary depending on the circumstances. When identifying appropriate safeguards to apply, one safeguard may eliminate or reduce multiple threats. In some cases, the member should apply multiple safeguards to eliminate or reduce one threat to an acceptable level. In other cases, an identified threat may be so significant that no safeguards will eliminate the threat or reduce it to an acceptable level, or the member will be unable to implement effective safeguards. Under such circumstances, providing the specific professional services would compromise the member’s compliance with the rules, and the member should determine whether to decline or discontinue the professional services or resign from the employing organization.

Threats

.07 Many threats fall into one or more of the following six broad categories: adverse interest, advocacy, familiarity, self-interest, self-review, and undue influence.

.08 Examples of threats associated with a specific relationship or circumstance are identified in the interpretations of the code. Paragraphs .09–.14 of this section define and provide examples, which are not all inclusive, of each of these threat categories.
.09 Adverse interest threat. The threat that a member will not act with objectivity because the member’s interests are opposed to the interests of the employing organization. Examples of adverse interest threats include the following:

a. A member has charged, or expressed an intention to charge, the employing organization with violations of law.

b. A member or the member’s immediate family or close relative has a financial or another relationship with a vendor, customer, competitor, or potential acquisition of the employing organization.

c. A member has sued or expressed an intention to sue the employing organization or its officers, directors, or employees.

.10 Advocacy threat. The threat that a member will promote an employing organization’s interests or position to the point that his or her objectivity is compromised. Examples of advocacy threats include the following:

a. Obtaining favorable financing or additional capital is dependent upon the information that the member includes in, or excludes from, a prospectus, an offering, a business plan, a financing application, or a regulatory filing.

b. The member gives or fails to give information that the member knows will unduly influence the conclusions reached by an external service provider or other third party.

.11 Familiarity threat. The threat that, due to a long or close relationship with a person or an employing organization, a member will become too sympathetic to their interests or too accepting of the person’s work or employing organization’s product or service. Examples of familiarity threats include the following:

a. A member uses an immediate family’s or a close relative’s company as a supplier to the employing organization.

b. A member may accept an individual’s work product with little or no review because the individual has been producing an acceptable work product for an extended period of time.

c. A member’s immediate family or close relative is employed as a member’s subordinate.

d. A member regularly accepts gifts or entertainment from a vendor or customer of the employing organization.
.12 **Self-interest threat.** The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, the employing organization or persons associated with the employing organization. Examples of self-interest threats include the following:

a. A member’s immediate family or close relative has a financial interest in the employing organization.

b. A member holds a financial interest (for example, shares or share options) in the employing organization, and the value of that financial interest is directly affected by the member’s decisions.

c. A member is eligible for a profit or other performance-related bonus, and the value of that bonus is directly affected by the member’s decisions.

.13 **Self-review threat.** The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member, or an individual in the employing organization and that the member will rely on that service in forming a judgment as part of another service. Examples of self-review threats include the following:

a. When performing an internal audit procedure, an internal auditor accepts work that he or she previously performed in a different position.

b. The member accepts the work previously performed by the member, alone or with others, that will be the basis for providing another professional service.

.14 **Undue influence threat.** The threat that a member will subordinate his or her judgment to that of an individual associated with the employing organization or any relevant third party due to that individual’s position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. Examples of undue influence threats include the following:

a. A member is pressured to become associated with misleading information.

b. A member is pressured to deviate from a company policy.

c. A member is pressured to change a conclusion regarding an accounting or a tax position.

d. A member is pressured to hire an unqualified individual.

**Safeguards**

.15 Safeguards may partially or completely eliminate a threat or diminish the potential influence of a threat. The nature and extent of the safeguards applied will depend on many factors. To be effective, safeguards should eliminate the threat or reduce it to an acceptable level.
.16 Safeguards that may eliminate a threat or reduce it to an acceptable level fall into two broad categories:

a. Safeguards created by the profession, legislation, or regulation

b. Safeguards implemented by the employing organization

.17 The effectiveness of a safeguard depends on many factors, including those listed here:

a. The facts and circumstances specific to a particular situation

b. The proper identification of threats

c. Whether the safeguard is suitably designed to meet its objectives

d. The party(ies) who will be subject to the safeguard

e. How the safeguard is applied

f. The consistency with which the safeguard is applied

g. Who applies the safeguard

h. How the safeguard interacts with a safeguard from another category

i. Whether the employing organization is a public interest entity

.18 Examples of safeguards within each category are presented in the following paragraphs. Because these are only examples and are not intended to be all inclusive, it is possible that threats may be sufficiently mitigated through the application of other safeguards not specifically identified herein.

.19 The following are examples of safeguards created by the profession, legislation, or regulation:

a. Education and training requirements on ethics and professional responsibilities

b. Continuing education requirements on ethics

c. Professional standards and the threat of discipline

d. Legislation establishing prohibitions and requirements for entities and employees

e. Competency and experience requirements for professional licensure

f. Professional resources, such as hotlines, for consultation on ethical issues
Examples of safeguards implemented by the employing organization are as follows:

a. A tone at the top emphasizing a commitment to fair financial reporting and compliance with applicable laws, rules, regulations, and corporate governance policies

b. Policies and procedures addressing ethical conduct and compliance with laws, rules, and regulations

c. Audit committee charter, including independent audit committee members

d. Internal policies and procedures requiring disclosure of identified interests or relationships among the employing organization, its directors or officers, and vendors, suppliers, or customers

e. Internal policies and procedures related to purchasing controls

f. Internal policies and procedures related to customer acceptance or credit limits

g. Dissemination of corporate ethical compliance policies and procedures, including whistle-blower hotlines, the reporting structure, dispute resolution, or other similar policies, to promote compliance with laws, rules, regulations, and other professional requirements

h. Human resource policies and procedures safeguarding against discrimination or harassment, such as those concerning a worker’s religion, sexual orientation, gender, or disability

i. Human resource policies and procedures stressing the hiring and retention of technically competent employees

j. Policies and procedures for implementing and monitoring ethical policies

k. Assigning sufficient staff with the necessary competencies to projects and other tasks

l. Policies segregating personal assets from company assets

m. Staff training on applicable laws, rules, and regulations

n. Regular monitoring of internal policies and procedures

o. A reporting structure whereby the internal auditor does not report to the financial reporting group

p. Policies and procedures that do not allow an internal auditor to monitor areas where the internal auditor has operational or functional responsibilities
q. Policies for promotion, rewards, and enforcement of a culture of high ethics and integrity

r. Use of third-party resources for consultation as needed on significant matters of professional judgment [No prior reference: new content]

**Effective Date**

.21 Effective December 15, 2015. Early implementation is allowed provided the member has implemented the revised code.
Chapter 2

Independence

Introduction

The AICPA Code of Professional Conduct (the Code) contains the rules that guide all AICPA members in the performance of their professional responsibilities. In this chapter, we will discuss in greater detail the threats to independence caused by things like financial interests, inter-entity investments, loans, trustee and executor relationships, and joint closely held investments.

We will also describe which actions you should take if you are considering employment with an attest client, and finally, we will discuss the types of nonattest services, fee arrangements, and business relationships that create threats to independence.

Learning Objectives

At the end of this chapter, you will be able to:

- Assess the importance of independence, when independence is required, and why you must be independent of an attest client both in fact and in appearance.

- Explain the purpose and basic structure of the AICPA Conceptual Framework for AICPA Independence Standards and how to apply it.

- Identify the financial, family, and employment relationships that threaten compliance with the independence rule.

- Identify the criteria that distinguish an association of accounting firms as a “network.”

- Analyze the nonattest services and business relationships that threaten independence.

- Evaluate fee issues and their effect on independence and objectivity.

- Assess other matters that may threaten independence, such as indemnification clauses and litigation.
AICPA Independence Standards and the Conceptual Framework

AICPA professional standards require independence—both in fact and appearance—for all attest engagements. *Attest services* often culminate in the accountant’s expression of an opinion or some other form of assurance that the information being reported on, for example, a financial statement, is free of material misstatements. The investing public or other interested parties, such as creditors, financial analysts, and vendors, may rely on the accountant’s report. Thus, the accountant should be unbiased in forming his or her judgments when performing attest services and forming the opinion.

An *attest client* is an entity whose financial statements or other information is being audited, reviewed, or attested to. *Attest engagements* include the following:

- Financial statement audits
- Financial statement reviews
- Audits of internal control over financial reporting (as required by SOX section 404) performed under PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated With an Audit of Financial Statements* (AICPA, PCAOB Standards and Related Rules Auditing Standards)
- Engagements performed under the AICPA Statements on Auditing Standards (SASs) or Statements on Attestation Standards (SSAEs)

An audit of a company’s financial statements is a common example of an attest service. In this chapter, the terms *attest client, audit client, and client* are synonymous.

*Independence*, in fact, is sometimes referred to as independence “of mind”—meaning the auditor’s state of mind in performing professional services. Since this is impossible to gauge with complete accuracy, the standards also incorporate the notion of the “appearance” of independence to the “reasonable and informed third party” (that is, the likelihood that a person who is aware of the relevant facts and circumstances would conclude that threats to the independence of a member [or his or her firm] are not at an acceptable level, thus impairing independence).

The AICPA Conceptual Framework for Independence

For many years, the AICPA Code has employed a “threats and safeguards” approach to analyzing independence threats that is similar to the framework approach described in Chapter 1. And, like the frameworks described in Chapter 1, members *must* employ this approach when evaluating matters that the Code does not specifically address.
Here’s a quick recap of the approach: First, a member should identify threats to independence arising from particular circumstances; for example, a self-interest threat exists when a member has a financial interest in a client. Then, the member should consider whether there are “safeguards” that could reduce or eliminate the threat to an acceptable level. Some examples of safeguards are removing an individual from an engagement team, disposing of a financial interest, or having an independent partner perform a second review of the work. If safeguards do not adequately reduce or eliminate the threat, independence would be impaired. The independence rules address many situations in which this is the case and state so. That is, a member of the audit team could never hold a financial interest in their client; no safeguards—other than disposal of the investment or the person’s exit from the audit team—are sufficient to eliminate that threat.

But what if an individual who serves on an audit engagement team has a close personal friend who is the assistant controller of his audit client? This particular set of circumstances is not addressed in the Code; however, the auditor could apply the Framework to evaluate whether threats to independence are of such magnitude, after applying any appropriate safeguards, that independence is impaired. The auditor would consider, for example, whether his relationship with the assistant controller causes a familiarity threat that threatens his objectivity in performing the audit. An important part of the analysis is considering the appearance of independence to outside parties who are aware of the relevant facts and circumstances. In this instance, the auditor might consider the closeness of the relationship, how visible the relationship is to third parties, how frequently the friends interact, and so on.

Another important factor is the type of client involved in the matter. The framework uses the term “public interest entity” to describe the type of client that might require stronger safeguards than another type of client to eliminate a threat or reduce it to an acceptable level. A public interest entity includes (1) listed entities (such as an SEC registrant) and (2) entities subject to the same independence requirements as listed entities (banks subject to Federal Deposit Insurance Corporation Improvement Act [FDICIA] rules).

Listed entities include any entities—including those outside the U.S.—whose shares, stock, or debt are quoted or listed on a recognized stock exchange or are marketed under the regulations of a recognized stock exchange or equivalent body.

If the auditor believes that a significant threat does exist, then he or she should consider, among other things, not serving on the audit team, and possibly other safeguards to reduce or eliminate the threat.

**Independence Relationships**

Independence rules focus on the relationship between certain individuals in a firm (which we will refer to as the covered member) and the attest client, or in some cases, an “affiliate” of the client.

In applying the independence rules, it is vital to know who must be independent of the client or its affiliate. Certainly the firm and various individuals in the firm must be independent, but what about the covered member’s spouse, dependents, or other close relatives? We will explain the instances in which additional individuals in the firm will also be subject to the rules.
Definition of a Covered Member

In the first part of this section of the chapter, we will define the covered member and learn who must be independent with respect to a particular client. Not only will you be required to be independent at times, but other people and entities will sometimes be subject to the rules as well. Anyone who meets the definition of a covered member must avoid certain financial and business relationships with the attest client in order to maintain independence.

Covered Member

You will be considered a covered member if you fall into one of the categories of persons who are presumed to be able to influence the client’s attest engagement. This means that you will be subject to the highest level of restrictions, especially if you participate on the client’s attest engagement.

Your firm is also considered to be a covered member. Any entities that you and/or other covered members control are also considered covered members, that is, subject to the full gamut of the independence rules.

Detailed Definitions

The following diagram illustrates the various individuals and entities that meet the definition of a covered member, and therefore, must be independent.
All of the following meet the definition of a covered member:

**Firm.** A firm is a form of organization permitted by law or regulation that is engaged in the practice of public accounting, the characteristics of which conform to resolutions of the Council of the AICPA.

**Nonattest partners (including partner equivalents) and managers.** A partner or manager who provides 10 or more hours of nonattest services to an attest client in any fiscal year.

**Note:** *Partner includes partner equivalents.* A partner is a proprietor, shareholder, equity or non-equity partner, or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned. Partner equivalents are persons authorized to act on behalf of the firm without partner approval. For example, partner equivalents may sign audit reports or engagement letters for the firm.
Partners in the attest office. Partners (and partner equivalents) who practice in the same office in which the lead engagement partner practices in connection with a client’s attest engagement.

Persons who can influence the engagement. An individual in a position to influence the attest engagement is one who

- evaluates the performance or recommends the compensation of the attest engagement partner;
- directly supervises or manages the attest engagement partner, including all successively senior levels above that individual in the firm;
- consults with the attest engagement team regarding technical or industry-related issues specific to the engagement; or
- participates in or oversees quality control activities, including internal monitoring, with respect to the specific attest engagement, including all successively senior levels in the firm.

Attest engagement team. Those individuals participating in the attest engagement, including those who perform concurring and engagement quality reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, regardless of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists, as discussed in AU-C section 620, Using the Work of an Auditor’s Specialist (AICPA, Professional Standards), and individuals who perform only routine clerical functions, such as word processing and photocopying.

Controlled entity. A controlled entity is any entity, for example, a partnership, corporation, trust, joint venture, or pool, whose operating, financial, or accounting policies can be controlled by one or more covered members (including the firm). To determine whether an entity or an individual can “control” another entity, use the definition of control provided by generally accepted accounting principles (GAAP) for consolidation purposes (Financial Accounting Standards Board [FASB] Accounting Standards Codification [ASC] Section 810, Consolidation).
Case Study: James & Jon, P.C.

The following is a case study to help you identify individuals who meet the definition of a covered member. You will be introduced to a client situation and will meet several people who work in a CPA firm. Your task will be to decide whether each person you meet does or does not meet the definition of a covered member. As you work on this case study, you may want to refer back to the pyramid of definition.

You are a manager in the quality control group of the firm, James & Jon, P.C. The firm’s primary office is located in Santa Rosa, California, and there are a total of five offices in various cities along the West Coast. Recently, the firm acquired a new client—RLR Design—a privately held advertising and graphic arts company. Your firm will perform an audit of RLR’s financial statements. The Petaluma office personnel will perform the audit work.

Your assignment is to review the firm’s personnel roster and to send letters to each person advising them whether they need to be independent of RLR Design.

The following are several people who work at the firm, together with a description of their titles and some of their duties. For each of these individuals, decide whether the person is or is not a covered member for purposes of applying the independence rules.

Constance James

Constance James, managing partner of the Petaluma office, will have no client responsibilities of any kind relating to the RLR engagement.

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

Review Question

1. Is Constance James a covered member who must be independent of RLR?
   a. Yes, because she is a partner in the Petaluma office.
   b. Yes, because she is a partner in the firm.
   c. No, because she provides no services to RLR.
   d. No, because she is a member of management.
Robert H. Olsen

Robert H. Olsen, audit manager, who is located in the firm’s San Diego office, will have no client responsibilities of any kind relating to the RLR engagement.

manager. A professional employee of the firm who has continuing responsibility for the planning and supervision of engagements for specified clients.

Review Question

2. Is Robert H. Olsen a covered member who must be independent of RLR?

   a. Yes, because Robert is a manager in the firm.
   b. Yes, because the Petaluma office is within 100 miles of the San Diego office.
   c. No, because Robert provides no services to RLR.
   d. No, because Robert is a manager in the San Diego office.

Kuniko Uchida

Kuniko Uchida, tax accountant. Located in the Petaluma office, she will help prepare the tax return and assist the client in computing the tax provision for RLR Design.

Review Question

3. Is Kuniko Uchida a covered member who must be independent of RLR?

   a. Yes, because she provides services to RLR.
   b. Yes, because she is located in the Petaluma office.
   c. No, because she performs no attest services for RLR.
   d. No, because she is only providing assistance on these engagements.
Felipe Arturo

Felipe Arturo, e-business consulting manager. Located in the Petaluma office, he will provide approximately 25 hours of consulting services to the client on a quarterly basis.

Review Question

4. Is Felipe Arturo a covered member who must be independent of RLR?
   a. Yes, because he will provide more than 10 hours of consulting services to RLR.
   b. Yes, because he is a consulting manager.
   c. No, because he provided no attest services to RLR.
   d. No, because he is not a partner in the firm.
Family Relationships

Your family’s interests, employment, and other relationships may create self-interest or familiarity threats to your independence because of the presumed closeness of their interests to yours. In fact, the independence rules generally extend from a covered member to the covered member’s immediate family, that is, the covered member’s spouse (or equivalent) and the people he or she supports financially (children, parents or even non-relatives).

For example, your spouse’s investment would be treated as if it was yours—your interests are considered inseparable. Exhibit 2-1 offers definitions of spousal equivalent and dependent.

Exhibit 2-1
Spousal Equivalent and Dependent

spousal equivalent. In determining whether an individual is a spousal equivalent, one must look to the closeness of the bond between the covered member and the individual. For example, persons in domestic partnerships or common law marriages, cohabitants, and others in close committed relationships that are in substance the equivalent of marriage would generally meet this criterion.

dependent. In general, a dependent is any individual for whom the covered member provides more than half of his or her financial support.
Key Positions

Your immediate family’s employment may create threats to your independence. For example, if you provide tax services throughout the year to your spouse’s employer and she is the chief executive officer of that company, the threats will be considered so significant that they may not be sufficiently reduced by safeguards. Your independence would be considered impaired.

However, not all of your immediate family’s employment creates such significant threats. So the question is, “Under what circumstances do threats reach that level?” Under the rules, if your immediate family holds a “key” position, threats will be considered significant and impair your independence. The position is a “key position” if he or she

- has primary responsibility for significant accounting functions that support material components of the financial statements;
- has primary responsibility for preparing the financial statements; or
- can exercise influence over the contents of the financial statements, for example, as a member of the board of directors, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

In general, you should not rely solely on job titles to determine whether a position held by a covered member’s spouse or dependent will impair independence. In considering the employment of immediate family, you must ultimately look to the nature of the individual’s responsibilities and not just his or her title.

If your family member holds a different type of position with an attest client, and you believe the situation creates threats to your independence, you should evaluate the facts and circumstances using the conceptual framework.
Case Study: James & Jon, P.C.—Manager’s Spouse Considers a Position With an Attest Client

Jack Garry receives a call from a recruiting agency offering him a new position with Vertex, a mid-sized company in Toledo, Ohio and audit client of James & Jon, P.C. His spouse, Kathy, is a manager in the consulting practice of James & Jon, P.C. The position is an entry-level position in the company’s internal audit group. Jack would report to the internal audit manager and help formulate, test, and monitor internal control over financial reporting. Does Jack’s position create significant threats to Kathy’s independence? Kathy provides occasional consulting services to Vertex.

Review Question

5. Which of the following should Kathy consider in evaluating this situation?

a. Whether the scope and duties of the entry-level position create threats to Kathy’s independence due to a real or perceived familiarity threat.
b. Whether the scope of Kathy’s services will involve the same subject matter for which Jack is responsible.
c. Both a and b are relevant considerations.
d. Neither a nor b are relevant considerations.

Family Relationships

Review Question

6. Linda has two young children and is a covered member with respect to ABC Company. When are her children no longer considered to be immediate family who are subject to the same rules as Linda?

a. When they turn 18.
b. When they get married.
c. When they are no longer her dependents.
d. When they are no longer students.
Close Relatives

Some of the independence rules relating to employment of immediate family also apply to close relatives of certain covered members. Close relatives include the following:

- Nondependent children
- Brothers and sisters
- Parents

In some cases, financial and employment relationships of a covered member’s close relatives create significant threats to independence. Persons falling into this category are

- people on a client’s attest engagement team,
- people able to influence a client’s attest engagement, and
- Partners in the office where the lead engagement partner practices in connection with the client’s attest engagement.

Review Questions

7. Which of the following statements is true?
   a. All partners in the same office as the lead attest engagement partner for a client meet the definition of covered member.
   b. Only managers who work on the attest engagement meet the definition of covered member.
   c. All staff members who provide nonattest services to a client are covered members.

8. Doris George is a covered member with respect to Dorian Inc. Of the following, who must also comply with the independence rules?
   a. Doris’ former spouse, Frank.
   b. Doris’ friend, whom she supports financially.
   c. Doris’ first cousin, Louis.

9. Key positions are determined by which of the following?
   b. Job responsibilities.
   c. The materiality of the salary.
Attest Engagements

In this section, we will discuss what is meant by the term *attest engagement*, that is, engagements that require independence from clients. The following table provides examples of services that require independence and those that do not.

<table>
<thead>
<tr>
<th>Independence Is Required When You Perform:</th>
<th>Independence Is Not Required If You Perform Only:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statement audits</td>
<td>A compilation; however, you must disclose your lack of independence in the compilation report</td>
</tr>
<tr>
<td>Financial statement reviews</td>
<td>Tax preparation and advice that is not a part of a financial statement audit or review</td>
</tr>
<tr>
<td>Other attestation services as defined in the attestation standards</td>
<td>Financial planning</td>
</tr>
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<td></td>
<td>Other consulting services</td>
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</table>

**When Are Professionals Required to Be Independent?**

The requirement to comply with the independence rules begins when a firm accepts a new attest client. Independence rules will continue to apply for the entire duration of the attest relationship, called the *professional engagement*, which could span many years.

Compliance with the rules may only end when the firm or the client terminates the professional engagement. This means either the firm or the client provides formal notice or the firm issues the final attest report if the report is issued after the notice of termination. In other words, the professional engagement is ongoing and does not end with the issuance of a report and recommence with the signing of the following year’s engagement letter.

The firm and its professionals must be independent during the period of the professional engagement and the period covered by the financial statements. Some of the independence rules (for example, business relationships and directorships with clients) apply to the period covered by the financial statements, while others (for example, financial interests) do not.
Here are two examples:

- A partner was on a client’s board of directors during 2013, but resigned from the board before her firm accepted an engagement to audit the 2013 financial statements.
  - Even though she resigned before the professional engagement period began, the partner’s service as a board member during the period covered by the financial statements would be considered to impair the firm’s independence.
  - This is because the firm would be auditing a period during which a partner was serving in a decision-making capacity for the client (that is, management participation threat). Resignation in these circumstances would not sufficiently mitigate the threat to the firm’s independence.

- A covered member owned shares in the client but disposed of the shares before the professional engagement period.
  - In this case, the threats would be eliminated because financial interest rules do not apply to the period covered by the financial statements; only to the professional engagement period.

**Review Questions**

10. Which of the following are considered to be an attest engagement under the AICPA independence rules?
   
   a. Services rendered under the attestation standards.
   b. Audits of financial statements.
   c. Reviews of financial statements.
   d. All of the above.

11. On October 11, 2014, ROC Accountants signed an engagement letter to begin auditing XYZ Corp. for the 12 month period ended December 31, 2014. Audit planning is scheduled to commence on November 4, 2014. What is the earliest date on which ROC would be required to be independent of XYZ?
   
Financial Interests

Independence is considered impaired if a covered member has or is committed to acquire a direct financial interest in an attest client. For a direct financial interest, there is no materiality threshold—that is, no safeguards reduce or mitigate the self-interest threats to independence to an acceptable level. Any covered member’s direct investment in a client, even a single share of stock, is presumed to impair independence. Some may argue that a small investment in a client could not possibly impact the auditor’s independence; however, this is an area where the perception of having any interest, no matter how small, taints the appearance of your independence.

For an indirect financial interest, there is a materiality threshold. An indirect interest is a financial interest in a client that you hold through another entity.

How large an investment is considered material? The independence rules do not establish a quantitative benchmark for materiality. It is a matter of judgment and includes both quantitative and qualitative factors. In practice, confusion sometimes exists when covered members try to determine whether their indirect financial interest is material or not. Illustration 2-1 reinforces the idea that an indirect interest is measured according to the covered member’s ultimate investment in the audit client affiliate.

In this example, the covered member is a limited partner in a partnership. The partnership invests in many entities, including an audit client. Materiality is determined according to that portion of the covered member’s investment that is ultimately invested in the client.
In illustration 2-1, the covered member has invested $100,000 in a limited partnership that is not a client. The partnership spreads this $100,000 among several investments. If one percent of the partnership’s assets are allocated to the client, then the covered member’s indirect investment is $1,000. It is this $1,000 investment, not the $100,000, that is compared to the covered member’s net worth to determine materiality.

However, if the covered member supervised or participated in the limited partnership’s investment decisions, or instead was a general partner, then the financial interests held by the partnership would be considered direct financial interests. That is, even an *immaterial* investment in a client would impair independence.

**Independence Rules for Interests Held Through Mutual Funds**

Owning shares in a mutual fund is considered to be a direct financial interest in the mutual fund. The underlying investments of a mutual fund, that is, companies whose stocks make up the fund’s portfolio, are considered to be indirect financial interests.

If a mutual fund is diversified, ownership of five percent or less of the outstanding shares of the fund would not be considered a material indirect financial interest in the underlying investments.
(To determine if the mutual fund is diversified, the covered member may refer to the fund’s prospectus or Section 5[b][1] of the Investment Company Act of 1940.)

If you or your immediate family own more than five percent of the outstanding shares of a diversified mutual fund, or if the mutual fund is not diversified, then you should evaluate the underlying investments of the mutual fund to determine whether you hold a material indirect financial interest in any of the underlying investments.

**Independence Rules for Interests of Immediate Family Members**

The independence rules, in general, also apply to a covered member’s immediate family (spouse, or equivalent, and dependents). This includes rules on financial interests. In other words, if you are a covered member with respect to a client, you will not be permitted to have a direct financial interest, such as a stock investment. With limited exceptions, your immediate family will also be prohibited from having investments in that client.

**Five Percent Rule**

Certain financial relationships, due to their magnitude, are presumed to pose a greater threat to independence than others and therefore apply more broadly to persons other than covered members. For example, if *any partner and professional employee* in a firm owns financial interests in an attest client that constitute more than five percent of that client’s outstanding equity, threats to independence are considered to impair independence.

**Exception for Unsolicited Financial Interests**

Independence may not be considered impaired if a financial interest is acquired *unexpectedly* through a gift or an inheritance. To mitigate self-interest threats to independence, the covered member should dispose of the financial interest as soon as practicable, generally within 30 days. If this is not possible, the threat is considered reduced to an acceptable level if the member does not participate on the attest engagement *and* the investment is immaterial to his or her net worth. Otherwise, independence is impaired.
Former Association With a Client

What threats to independence arise when a professional who has worked for an attest client comes to work for the firm? Does the professional have to get rid of any investments in the client before joining the firm? What about loans, or participation in the client’s benefit plans? Here are the rules:

First, a former employee (or otherwise associated person, such as a board member) would impair the firm’s independence if, during any period that included his or her former affiliation with that client, the individual

- participated in the *attest engagement*, or
- was an *individual in a position to influence the attest engagement* for the client.

Disassociation From Client

In addition to avoiding the aforementioned activities, persons who were associated with a client must also *disassociate* from the client before becoming a covered member by:

- disposing of any financial interests in the client;
- collecting or repaying any loans to or from the client except if specifically exempted under the rules;
- ceasing to participate in the client’s benefit plans (subject to limited exceptions);
- liquidating or transferring all vested benefits in the client’s compensation and benefit plans, and so on, at the earliest date permitted under the plan (subject to limited exceptions); and
- considering the application of the Conceptual Framework for Independence Standards to threats created by *any other interests or relationships* with the client.
Case Study: Former Association With a Client

As the manager in charge of independence for James & Jon, P.C., you have progressed beyond being a mere expert and are now considered a guru and have been put in charge of responding to e-mail inquiries regarding independence issues for firm personnel.

You have another e-mail waiting to be answered.

To: Independence Guru
Re: New Manager

We are thinking of hiring a manager into our technology consulting practice here in the Huntington Beach Office. For a brief time, she worked for an audit client of this office. During the time she worked for the client, she acquired 10 shares of its stock, which she still owns. She will not work on this client’s audit or be in a position to influence the audit; however, she will play an important part in a consulting project which will probably take her about 40 hours to complete. If we hire her as a manager, would the investment impair independence?

Review Question

12. What response would you send to this person?

   a. Not necessarily. Threats to independence will be at an acceptable level as long as the manager does not participate in the engagement and is unable to influence the engagement.
   b. Yes. As a manager who will provide nonattest services to the client, she is a covered member and her financial interests in the client must be immediately disposed of.
   c. No. The manager is a covered member, but clearly the 10 shares of stock are inconsequential and will, therefore, not impair independence.
Affiliates of Attest Clients

The Code requires members to be independent of attest clients as well as certain affiliates of a financial statement attest client. For example, a covered member may have an investment in a non-client (or a tax or consulting client) that has a significant relationship with a financial statement attest client. If that non-client would be considered an affiliate of the client, the same independence restrictions (with some exceptions) that apply to the attest client also apply to the non-client.

A financial statement attest client is an entity whose financial statements are audited, reviewed, or compiled (if the member’s compilation report does not include a disclosure regarding lack of independence) (Hereinafter called the client).

Ten types of relationships with a firm’s client are deemed to be affiliates:

- An entity that a client can control
- An entity in which a client (or an entity controlled by the client) has a direct financial interest that gives the client significant influence over the entity and that is material to the client
- An entity that controls a client when the financial statement attest client is material to the entity
- An entity with a direct financial interest in the client when that entity has significant influence over the client, and the interest in the client is material to the entity
- A sister entity of a client if client and sister entity are each material to the entity that controls both
- A trustee deemed to control a trust client that is not an investment company
- The sponsor of a single employer employee benefit plan client
- Any union or participating employer that has significant influence over a multiple or multi-employer employee benefit plan client
- An employee benefit plan sponsored by either a client or an entity controlled by the client
- An investment adviser, general partner, or trustee of an investment company client (fund), if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund
• **Note: control(s).** The term control(s) follows the definition in FASB ASC 810 for commercial entities and FASB ASC 958-805-20 for not-for-profit entities.

• **significant influence.** The term significant influence follows the definition in FASB ASC 323-10-15.

**What is the Significance of this Rule?**

If a company audits Company A, and A controls Company B, then B is an affiliate of A. The significance is that under the independence rules, the firm, and its people should apply the same independence rules to both A and B *unless* one of the rule’s exceptions applies. Broadly, these exceptions relate to the following:

- Some loans to or from an individual who is an officer, director, or 10 percent or more owner of an affiliate
- Nonattest services provided to an affiliate that do not threaten independence with respect to the attest client under the Conceptual Framework for Independence, for example, self-review or management participation threats
- A covered member’s subsequent employment with an affiliate
- Employment of a covered member’s close relatives or immediate family members by an affiliate
Loans To and From Clients

In general, as a covered member, loans you make to or receive from an attest client or from the client’s officer, director, or 10 percent or greater stockholder may raise self-interest threats to your independence. Certain types of loans from financial institutions may be grandfathered or otherwise permitted. For these loans, threats to independence are considered to be at an acceptable level and do not impair independence.

<table>
<thead>
<tr>
<th>General Category</th>
<th>What Is Allowed</th>
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<tbody>
<tr>
<td>Permitted Loans</td>
<td>Permitted loans include</td>
</tr>
<tr>
<td></td>
<td>• car loans that are fully collateralized by the vehicle,</td>
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<tr>
<td></td>
<td>• credit cards and overdraft reserve accounts in which the balance is</td>
</tr>
<tr>
<td></td>
<td>reduced each credit cycle to $10,000 or less, and</td>
</tr>
<tr>
<td></td>
<td>• loans that are fully collateralized by cash deposits at the same financial</td>
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<tr>
<td></td>
<td>institution or by the cash surrender value of an insurance policy.</td>
</tr>
<tr>
<td></td>
<td>As a covered member, you may obtain a permitted loan from an attest client</td>
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<tr>
<td></td>
<td>without impairing independence. All other loans impair independence unless</td>
</tr>
<tr>
<td></td>
<td>they meet the criteria for a grandfathered loan as described in the</td>
</tr>
<tr>
<td></td>
<td>following table.</td>
</tr>
<tr>
<td>Grandfathered Loans</td>
<td>Home mortgages, secured loans, and immaterial unsecured loans do not create</td>
</tr>
<tr>
<td></td>
<td>significant threats to your independence if you meet all of the following</td>
</tr>
<tr>
<td></td>
<td>safeguards:</td>
</tr>
<tr>
<td></td>
<td>• You obtained the loan prior to becoming a covered member.</td>
</tr>
<tr>
<td></td>
<td>• You obtained the loan before the financial institution became an attest</td>
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<tr>
<td></td>
<td>client. (For example, you obtained the loan from a non-client and the loan</td>
</tr>
<tr>
<td></td>
<td>was later sold to an attest client or the financial institution became</td>
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<td></td>
<td>restricted as a result of a merger or similar transaction.)</td>
</tr>
<tr>
<td></td>
<td>• You obtained the loan before May 31, 2002, and met the transitional</td>
</tr>
<tr>
<td></td>
<td>requirements.</td>
</tr>
<tr>
<td></td>
<td>• The terms of the original loan do not change after the dates listed</td>
</tr>
<tr>
<td></td>
<td>previously, other than those required in the original loan agreement. (For</td>
</tr>
<tr>
<td></td>
<td>example, the interest rate automatically adjusts periodically in an</td>
</tr>
<tr>
<td></td>
<td>adjustable rate mortgage.)</td>
</tr>
</tbody>
</table>

Note: An AICPA PEEC task force is evaluating the current rules on loans and leases with attest clients to determine their appropriateness and to consider whether changes are needed to address any revised accounting standards on leases.
Loans To and From Clients: Case Study

The following are some cases of loans between a covered member and a financial institution that is an attest client (or an affiliate of one). Recall that under the affiliate rule discussed, if the loan is with a person (for example, a director, officer, or 10 percent or greater shareholder) associated with an affiliate (not an attest client), and the covered member is aware of the situation, then he or she should evaluate possible threats to independence resulting from the loan under the conceptual framework.

After reading the description, determine the loan’s impact on independence.

Review Questions

A new staff accountant obtains an automobile loan under normal terms and conditions from an audit client to purchase a BMW sports car. The car is material to his net worth; it is his net worth as is the amount borrowed. He is a covered member of the lender.

13. Does this loan impair independence?

   a. No, because it is fully secured by the automobile.
   b. No, if it was used to purchase a foreign car.
   c. Yes, because it is material to the staff’s net worth.
   d. Yes, if the sticker price exceeds $40,000.

A manager obtained her MBA prior to joining the firm in 2013. While going to school, she obtained student loans under the lender’s normal terms and conditions that are not material to her net worth. She is a covered member of the lender that made the loan.

14. Does this loan impair independence?

   a. No, because the money was used to obtain a student loan.
   b. No, because the loan is not material to the manager’s net worth and was obtained prior to her joining the firm.
   c. Yes, if the manager obtained it within five years of joining the firm.
   d. Yes, because the manager is a covered member.
A tax partner obtained a personal loan from a business associate in 2010. In 2014, the business associate became a director of the partner’s client, which is also an audit client of the firm.

15. Does this loan impair independence?

a. Possibly; because she is aware of the situation, the partner should evaluate the loan under the conceptual framework.
b. Yes, the partner should renegotiate the loan as soon as possible.
c. No, because the lender is a colleague, not an attest client.
d. No, because the partner acquired the loan before the lender became a director of an audit client.

A staff member has a credit card from an attest client with respect to which he is a covered member. The balance on his current credit card statement is $10,100 and is material to his net worth.

16. Does this loan impair independence?

a. No, because credit card loans do not create threats to independence.
b. No, because the staff member rarely uses the credit card.
c. Yes, because the monthly purchases are material to the staff person’s net worth.
d. Yes, if the staff person does not maintain a current balance of $10,000 or less.
Joint Closely Held Investments

A covered member’s joint closely held investment with an attest client or persons associated with the client may create self-interest threats to independence.

A *joint closely held investment* is one that is subject to control, as defined by GAAP for consolidation purposes (FASB ASC 810). It exists if the covered member and the client (or the client’s associated persons) individually or jointly control the investment. *Associated persons* include officers, directors, or stockholders who are able to exercise significant influence over the client.

In these cases, if the investment is material to the covered member’s net worth, threats are considered to be at an unacceptable level and would impair independence.

The following facts help to illustrate the rule:

Alistair, a partner of Mayfair CPAs, co-owns (50/50) an apartment building with Chongui Kuang, the CFO of Alistair’s review client. Further, the investment is material to Alistair’s net worth. In this case, threats to independence are significant and may not be sufficiently reduced by safeguards. Independence is considered impaired.
Networks and Network Firms

Some accounting firms practice within membership associations called networks in the Code. A network firm is required to be independent of financial statement audit and review clients of other network firms in the same network (unless use of a client’s audit or review report is restricted).

For all other attest clients, practitioners should evaluate known threats to independence that may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. The independence requirements apply to any entity within the network that is a network firm as defined in the Code.

Network Firm Criteria

The firms cooperate for the purpose of enhancing their abilities to provide professional services and one of the following conditions also exists:

- Member firms (or entities controlled by member firms) share a common brand name or common initials as part of the firm’s name.
- Member firms are under common control as defined under GAAP (FASB ASC 810) with other member firms through ownership, management, contractual, or other means.
- Member firms share profits or costs.
- Member firms share a common business strategy, which involves ongoing collaboration among the firms. Firms are held accountable for implementing the strategy and for their performance pursuant to that strategy.
- Member firms share a significant portion of professional resources, for example, technical departments, technical manuals, and training systems.
- Member firms must adhere to common quality control policies and procedures, which are monitored by the association.

A firm that only refers work to or receives referrals from other member firms, and does not meet any of the above criteria, would not be considered to be operating within a network.
Nonattest Services

Performing nonattest services for an attest client may raise self-review, management participation, or advocacy threats to independence. The Code lays out general requirements and interpretations (by type of service) designed to ensure threats are at an acceptable level and do not impair independence. Members should meet the general requirements, described in the following section, for each engagement and evaluate their independence using the conceptual framework if the Code does not provide specific guidelines.

General Requirements

First, to avoid any misunderstanding between the member and the client, members should establish and document in writing a clear understanding with the client regarding the nature of the nonattest services. The following table summarizes this requirement.

<table>
<thead>
<tr>
<th>Your Responsibilities</th>
<th>Your Client’s Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Establish and document in writing the understanding with the client regarding:</td>
<td>Responsible for:</td>
</tr>
<tr>
<td>• Objectives of the engagement.</td>
<td>• Accepting responsibility for the services</td>
</tr>
<tr>
<td>• Services to be performed.</td>
<td>• Designating an individual with suitable skill, knowledge, and/or experience, preferably a senior management-level individual, to oversee services performed</td>
</tr>
<tr>
<td>• Member’s responsibilities.</td>
<td>• Evaluating adequacy and results of services</td>
</tr>
<tr>
<td>• Client’s acceptance of its responsibilities.</td>
<td>• Making management decisions and assuming all management responsibilities</td>
</tr>
<tr>
<td>• Any limitations of the engagement.</td>
<td></td>
</tr>
</tbody>
</table>

Client Responsibilities

Before performing nonattest services, the independence rules require you to determine whether the client will be able to meet all of the responsibilities listed and can make an informed judgment on the results of your nonattest services. If the client is unwilling or unable to assume these responsibilities, then your provision of the nonattest services creates an unacceptable management participation threat that impairs your independence.

Management should designate an individual with suitable skills, knowledge, and/or experience to oversee the services you will perform. Should management fail to do this, independence would
be impaired. When assessing management’s designated individual, you should be satisfied that the individual understands the services to be performed sufficiently to oversee them. This person should have suitable skills, knowledge, and/or experience to understand the nature, objective, and scope of the service.

For example, if you were performing nonattest services related to deferred taxes, the client would \textit{not be} required to possess a level of technical expertise equal to yours. However, the designated individual should understand the basis for the deferred tax assets or liabilities and the effect of the deferred taxes on the financial statements.

There are no hard and fast rules on who should be the designated individual. In assessing whether the designated individual has suitable skills, knowledge, and/or experience to oversee a nonattest service, the member might consider factors such as the individual’s

- understanding of the nature of the service,
- knowledge of the client’s business,
- knowledge of the client’s industry, and
- general business knowledge.

\textbf{Document Your Understanding With the Client}

You are required to document your understanding with the client regarding the items described in the previous list. This documentation may take any form you wish, for example, an engagement letter or a memo. The failure to prepare the required documentation generally would not impair independence provided the understanding with the client had been established. However, the failure to document the understanding with the client would be considered a violation of the Compliance With Standards rule.

What if a nonattest client later becomes an attest client? Suppose that you provided only tax services to a client during 20X3. In 20X4, the client approaches you and asks if you would be able to audit its 20X3 financial statements. When performing tax services in 20X3, you did not document your understanding with the client. May you accept the attest engagement?

The answer is “yes,” provided the following:

- You did, in fact, establish the required understanding with the client and comply with the other general requirements of the rules. If you did not comply with these general requirements, then you were not independent during the period covered by the financial statements, and you cannot accept the attest engagement.

- Upon acceptance of the attest engagement, you prepare documentation demonstrating your compliance with the general requirements during the period covered by the financial statements.
Management Responsibilities

When performing nonattest services for a client, you must not assume management responsibilities or make management decisions as these create unacceptable management participation threats that impair independence. The following are some examples of activities that would impair your independence.

<table>
<thead>
<tr>
<th>Unacceptable Independence Threat If Member…</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Authorizes</strong></td>
<td>Authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client, for example, negotiating a transaction in your client’s absence, or having the authority to do so</td>
</tr>
<tr>
<td><strong>Prepares</strong></td>
<td>Preparing source documents, in electronic or other form, evidencing the occurrence of a transaction</td>
</tr>
<tr>
<td><strong>Takes Custody</strong></td>
<td>Having custody of client assets</td>
</tr>
<tr>
<td><strong>Supervises</strong></td>
<td>Supervising client employees in the performance of their normal recurring activities</td>
</tr>
</tbody>
</table>
| **Other** | • Determining which recommendations of the member should be implemented  
  • Reporting to the Board of Directors on behalf of management  
  • Serving as a client’s stock transfer or escrow agent, registrar, general counsel, or its equivalent |
Case Study: James & Jon, P.C.—The Meeting

The partner in charge of quality control at the CPA firm James & Jon, P.C., sends you to a meeting in his place. The purpose of the meeting is to discuss ways your firm can expand its practice development activities. The following are her instructions regarding the meeting.

Partner in Charge of Quality and Control

“Everyone else at the firm is going to want to expand the firm’s services as much as possible. Your job is to make sure the firm doesn’t impair its independence. You’re there to make sure the firm doesn’t perform any prohibited services or even look like they’re assuming management responsibilities. Don’t be afraid to tell them no.”

The Agenda

Besides you, there are three others at this strategic planning session. All of the others are partners.

Charles Kinbote, partner in charge of General Ledger Services, which provides bookkeeping and write-up services to clients. He would like to streamline procedures so that James & Jon employees do not have to obtain client’s approval to correct journal entries and other source documents.

Joan Shade, partner in charge of CFO Outsourcing, which provides high-level finance and treasury personnel on a temporary basis. She is interested in expanding the practice responsibilities to allow James & Jon employees to negotiate financing transactions on behalf of clients.

Nick Carraway, partner in charge of Forensic Accounting Services, which provides a wide variety of litigation support and investigative services. He sees a practice development opportunity in having the firm perform a variety of these services for all types of clients, including in some cases “expert witness” services.
Improving Bookkeeping and Write-Up Services

Mr. Kinbote has an idea for his practice area. Here is what he says.

Efficiency in Service Delivery

“We’ve got a growing practice, but profitability is flat. Before we look to expand the practice, we need to be more efficient in delivering the services we already provide.”

Too Much Time Spent On Client Approval

“The most inefficient part of our process is that we have too much back and forth with the client. They give us their journal entries and ledgers with supporting documentation and we’re supposed to take that information and prepare monthly or quarterly financial statements, right? The problem is, there are errors in their information we need to correct them before we do the input. Every time we find a mistake, we have to contact the client and make sure it’s okay to change it. That takes time and slows down the process.”

Speed Up Process By Making Changes Without Client Approval

“What I want to do is change our policy so that we can just make the changes we know need to be made. Without client approval. That’s what they are paying us for.”

The other partners at the table are enthusiastic for Mr. Kinbote’s proposal. They think it is wise to streamline operations before expanding the practice and think his idea is a good one.

What is wrong with Mr. Kinbote’s proposal? Why would the new policy impair the firm’s independence if the services were performed for a client?

Write your answer below. Make sure you provide a detailed explanation for your answer.
CFO Outsourcing

Ms. Shade makes a presentation on policy changes she would like to see made for her CFO Outsourcing service.

Clients Need Help Implementing Recommendations

“The problem with our services is that our clients don’t always follow through on our recommendations. Here’s an example. We had a client that needed to restructure their debt. We told them how to do it, and we even introduced them to bankers and some investors. The problem is they didn’t have enough experience to get the deal done. Bottom line is the restructuring doesn’t happen, or it gets done in a way that doesn’t help the client that much at all. And then they end up blaming us.”

Negotiating Deals Would Ensure Proper Implementation

“What we should do is expand our services so we do everything from start to finish. We sell them on the need to refinance, we find the banker, and then we negotiate the deal. When we’re done, we close the deal. It’s like this. It’s a turn-key operation, see. The client has a restructuring issue; we go out and come back with a new loan. They don’t even have to get their hands dirty. If we do it that way, we’re sure the deal works, and we don’t look bad because the implementation of our plan failed.”

The other partners think Ms. Shade is on to something promising. Why not offer a more complete line of services? The firm has much more experience negotiating the terms of a refinancing than the client does.

What is wrong with Ms. Shade’s idea? Why would the expansion of services impair the firm’s independence if they were performed for a client?

Write your answer below. Make sure you provide a detailed explanation for your answer.
Ideas for Litigation Support and Investigative Services

Mr. Carraway makes the following observations and recommendations about his forensic accounting services.

Wants to Offer Litigation Support and Expert Witness Services

“There is a lot of work out there. A lot of our clients, or, I should say, potential clients, want to engage us to provide litigation support initially. But at some point they may want us to provide expert witness services and we need to be able to move into the role quickly.”

Not everyone in the room agreed with Mr. Carraway. They were concerned about the attest clients the services would be provided to and whether the firm would be assuming an advocacy role.

Would this be consistent with the firm’s role as auditor?

Write your answer below. Make sure you provide a detailed explanation for your answer.
Case Study: James & Jon, P.C.—The Meeting—Suggested Solutions

Bookkeeping Services

What is wrong with Mr. Kinbote’s proposal? Why would the new policy impair the firm’s independence if the services were performed for a client?

Mr. Kinbote’s proposal is not a good one because it would put firm employees in the position of approving changes to accounting data on behalf of the client. The client must review and approve all changes made to the information originally provided to the member, in this instance, coded source documents, journal entries, and ledgers. Otherwise the firm is acting as management and creating unacceptable management participation threats to its independence. While there need not be a continual back and forth with the client, the member must apprise the client on a regular and consistent basis of these changes so that the client can approve the member’s changes.

The lack of this type of communication between the member and the client would indicate that the member is making decisions on behalf of management that would impair independence.

The following table lists the types of bookkeeping services that do or do not create unacceptable self-review and/or management participation threats to independence.

<table>
<thead>
<tr>
<th>Bookkeeping Services That Do Not Create Unacceptable Threats to Independence</th>
<th>Bookkeeping Services That Do Create Unacceptable Threats to Independence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Record transactions if management has determined or approved the appropriate account classifications, or post coded transactions to a client’s general ledger.</td>
<td>Determine or change journal entries, account codings or classifications for transactions or other accounting records without obtaining client approval.</td>
</tr>
<tr>
<td>Prepare financial statements based on information in the trial balance.</td>
<td>Authorize or approve transactions (for example, approve vendor invoices for payment).</td>
</tr>
<tr>
<td>Post client-approved entries to a client’s trial balance.</td>
<td>Prepare source documents.</td>
</tr>
<tr>
<td>Generate unsigned checks using source documents or other records the client provided and approved.</td>
<td>Make changes to source documents without client approval.</td>
</tr>
<tr>
<td>Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client, provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the effect the entries have on the financial statements.</td>
<td>Take responsibility for signing or co-signing client checks.</td>
</tr>
<tr>
<td>Maintain a client’s bank account or otherwise have custody of client funds.</td>
<td></td>
</tr>
</tbody>
</table>

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Financial Advisory Services

What is wrong with Ms. Shade’s idea? Why would the expansion of services impair the firm’s independence if they were performed for a client?

Ms. Shade’s proposal is not a good one because it puts the firm in the position of making management decisions for the client and exercising authority on the client’s behalf, impairing the firm’s independence due to an unacceptable management participation threat. It is one thing to help the client through a negotiating process, but Ms. Shade proposes that the firm provide a “turn-key” service in which the client is not even involved.

Litigation Support and Investigative Services

What is wrong with Mr. Carraway’s proposal? Would his proposal be consistent with the firm’s role as auditor?

Mr. Carraway’s proposal to move quickly from litigation support work to an expert witness role may work for nonattest clients, but this would not be allowed for attest clients under the Code because expert work is considered to create the appearance of an “advocacy” threat to the firm’s independence. (Note: this would not be the case if the firm acted as a “fact witness” for a client regarding work it had previously performed.)

Concluding the Meeting

Well, you didn’t make any friends at the meeting, but you definitely helped the firm maintain its independence.

The Code addresses several other types of nonattest services including the following:

- Appraisal, valuation and actuarial services
- Benefit plan administration
- Business risk consulting
- Corporate finance consulting
- Executive or employee recruitment
- Forensic accounting
- Information systems design, implementation and integration
- Internal audit
• Investment advisory
• Tax services

Review Questions

17. When performing nonattest services for clients, which of the following is the member’s responsibility?
   a. Evaluate the adequacy of the services performed.
   b. Establish an understanding with the client as to the services to be performed.
   c. Design and implement the company’s internal controls.

18. Rogers CPA is engaged to perform bookkeeping services for a client. Which of the following activities will impair Rogers’ independence?
   a. Supervise the client’s employees as they perform their normal recurring activities.
   b. Post client-approved entries to the client’s trial balance.
   c. Advise the client on current accounting issues.

19. Which of the following activities would be least likely to create unacceptable threats to a member’s independence?
   a. Consummate a transaction on behalf of the client with potential investors.
   b. Prepare financial statements based on the client’s trial balance.
   c. Prepare source documents for the client.

20. Mermaid Co. engages Olsen CPAs to help improve the operating effectiveness of certain internal controls. Olsen also audits Mermaid’s financial statements. Which of the following creates a management participation threat to Olsen’s independence?
   a. Provide research materials to Mermaid’s management.
   b. Set policy for Mermaid.
   c. Make recommendations to Mermaid.

Providing Multiple Nonattest Services to the Same Client

The Code provides guidelines on how to maintain independence when providing nonattest services to an attest client, but what if a firm performs multiple nonattest services during the same period for a client? In this situation, the firm should evaluate the services in the aggregate to ensure that any significant threats are reduced to an acceptable level before performing the services. Otherwise, independence would be considered to be impaired. This rule becomes effective for engagements covering period beginning on or after December 15, 2014.
Other Relationships With Attest Clients

In this section, you will learn how to identify the relationships between firm personnel and clients that are presumed to threaten independence. Certain types of fee arrangements and how they may threaten a member’s objectivity are also discussed.

The following table summarizes the independence rules that expressly prohibit some relationships between the covered member and the client because they create unacceptable threats to the member’s independence.

<table>
<thead>
<tr>
<th>Description</th>
<th>Summary of Rules</th>
</tr>
</thead>
</table>
| Trustee, executor or administrator | In certain instances, the covered member cannot serve as trustee of any trust or executor or administrator of any estate in which the trust or estate had or was committed to acquire any direct or material indirect financial interest in an attest client and one of the following conditions have been met:  
  i. The covered member (individually or with others) had the authority to make investment decisions for the trust or estate;  
  ii. The trust or estate owned or was committed to acquire more than 10 percent of the client’s outstanding equity securities or other ownership interests; or  
  iii. The value of the trust’s or estate’s holdings in the client exceeded 10 percent of the total assets of the trust or estate. |
| Board member, officer, member of management, or employee | *Partners and professionals* in the firm may not be associated with the client as a director, officer, or *employee*, or in any capacity equivalent to that of a member of *management*. |
| Promoter, underwriter, or voting trustee | *Partners and professionals* in the firm may not be associated with the client as a promoter, underwriter, or voting trustee. |
Executor or Trustee

Professionals are sometimes asked to serve as executors or trustees under the wills or trusts of officers of attest clients. Often, they are covered members because they either serve on the engagement or have oversight responsibilities in the firm, for example, a firm’s managing partner. Presumably, the officer involved owns stock in the client, and, thus, eventually, the estate or trust holds or will hold stock in that client.

Generally, this situation would not threaten independence; not yet anyway. While a covered member is prohibited from actually serving as an executor of an estate that has or was committed to acquire a direct or material indirect financial interest in a client, the mere fact that he or she has been named as such does not impact independence. However, problems can arise. Assume that the officer passes away. The investments owned by that individual pass to his or her estate.

Now the covered member has a problem; he is an executor of an estate that has a direct financial interest in a client. As executor, he is authorized to make all necessary decisions for the estate; hence the investments are treated as if they were his own. Independence is impaired. Independence also would be impaired if the estate had a material indirect financial interest in the client.

If the covered member exercised his or her authority as executor to sell the investment in the client, then independence would no longer be impaired because the estate would no longer have a financial interest in the client.

However, the covered member may now have an even bigger problem. Suppose the covered member authorized the estate to sell its investment in the client. The covered member did this to preserve his independence, but this may conflict with his fiduciary responsibilities as the executor. That is, the sale of the investment may have satisfied the independence rules, but, at the same time, may have been a poor investment decision for the estate. In short, becoming a trustee or executor can create independence and other problems for a covered member.
Employment or Business Relationships

You learned earlier that certain relationships, due to their magnitude, extend beyond covered members to all partners and professionals in a firm. For example, if any partner or professional employee in the firm has a financial interest in an attest client exceeding five percent of the entity’s outstanding equity securities, independence would be considered to be impaired.

Similarly, independence is also considered to be impaired if any partner or professional employee of a firm is simultaneously associated with a client as a

- director, officer, or employee;
- promoter, underwriter, or voting trustee; or
- trustee of any pension or profit-sharing trust of the client.

The rule exempts partners or professionals who take positions as adjunct faculty with an educational institution that is an attest client. In these cases, threats to independence will be at an acceptable level if all of the following safeguards are met:

- The individual does not hold a key position at the educational institution.
- The individual does not participate on the attest engagement team and is not in a position to influence the attest engagement.
- Employment is part-time and non-tenured.
- The individual does not participate in any employee benefit plans sponsored by the educational institution, unless participation is required.
- The individual does not assume any management responsibilities or set policies for the educational institution.

In addition, partners or professional employees are subject to certain requirements when they accept, or even just consider, certain employment or other positions with an attest client.
Seeking Employment With an Attest Client

Members of an attest engagement team and those who can influence attest engagements have to apply certain safeguards if they seek employment from the client. The safeguards, designed to mitigate undue influence and self-interest threats to independence are as follows:

- Individual promptly reports any employment negotiations with the client to the appropriate person in the firm
- Individual removes him or herself from the engagement until the employment offer is rejected or the individual no longer seeks employment with the client

The job-seeker should also evaluate whether the position at the client is a “key position.” (Recall that a key position allows a person to influence financial statements or significant accounting records.)

If employment with the client will be in a key position, there are several more steps in the process; some even take place after the individual leaves the firm, as described in the following section.

**Taking a Key Position at an Attest Client: What Are the Other Safeguards?**

To avoid familiarity, self-interest, undue influence, and management participation threats to independence, the following safeguards apply:

- Any amounts due to the former employee for a previous interest in the firm and for retirement benefits should be based on a fixed formula; these amounts may not be material to the firm.
- Former employee does not influence the firm’s operations or financial policies.
- Former employee does not participate or appear to participate in the firm’s business, for example, have an office in the building or continue to provide professional services to the firm’s clients.
Fee Arrangements

Fee arrangements between a member and certain of the firm’s attest clients may violate the Code because they are deemed to impair the member’s objectivity. The two types of fee arrangements are contingent fees and commissions.

Contingent Fees

A contingent fee is defined as an arrangement in which either

- no fee is charged unless a specified result is attained; or
- the amount of the fee depends on the results of your services.

For example, suppose you performed a consulting engagement to decrease a client’s operating costs, and the fee was based on the amount of cost savings achieved by the client. That fee arrangement would be considered a contingent fee.

You may not perform for a contingent fee any professional services for or receive such a fee from a client for whom you perform

- an audit or review of a financial statement;
- a compilation of a financial statement when you do not disclose a lack of independence in the report which you expect someone to rely on; or
- an examination of prospective financial statements.

Also, you may not prepare an original or amended tax return or a claim for a tax refund for a contingent fee for any client.

There are two main exceptions to the prohibition of contingent fees. The following fees are not regarded as being contingent and, therefore, are permitted for the aforementioned types of attest and tax clients: (1) In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies; or (2) Fees fixed by a court or other public authority.
Commissions

A commission is a fee you receive for recommending or referring products or services from one third party to another. The ethics rules prohibit you from receiving a commission for either

- recommending a client’s products or services to a third party, or
- recommending to a client any product or service of another party.

The definition of a *client* when referring to commissions is different from the term *attest client* used in the independence rules. For the purposes of applying the ethics rules on commissions, a client is an entity for which you perform

- an audit or review of a financial statement,
- a compilation of a financial statement when you do not disclose a lack of independence in the report which you expect someone to rely on, or
- an examination of prospective financial statements.

Commissions and contingent fees are generally permitted for transactions involving certain persons or entities:

- Owners, officers, or employees of an attest client; and
- Non-attest client employee benefit plans that are sponsored by an attest client.

In those situations where you are permitted to receive a commission, you must disclose that fact to the person to whom you recommend or refer the product or service.

Unpaid Fees

Does a client’s failure to pay fees on a timely basis threaten your independence? The Code says “yes”—undue influence, self-interest, or advocacy threats are possible if fees are outstanding for a long time. A longstanding AICPA position is as follows: If fees remain unpaid for over one year, independence is considered impaired because the debt creates a self-interest threat due to the member’s stake in the client’s continued viability.

It does not matter whether the fees are billed or unbilled, or whether the fees have been converted into a note receivable. If the client has not paid its fees for over one year as of the date of the attest report, independence is impaired and the report may not be issued.

If the member is assured that the client will pay their prior year unpaid fees in full prior to release of the report, the member may commence the engagement.
Review Questions

Dan, a covered member of XYZ Co., serves as a trustee of a trust that is committed to acquire a direct financial interest in XYZ. Once purchased, the value of the trust’s holdings in XYZ will be approximately 20 percent of the trust’s total assets.

21. Which of the following statements best describes the application of the AICPA rule to these facts?

   a. Dan may serve as the trustee until the trust purchases the interest in the client.
   b. Dan may serve as the trustee if the interest will not be material to him.
   c. Dan may not serve as the trustee under these conditions.

22. Deen CPAs accepts a commission from Lara Corp, a financial statement review client, for referring Lara to an insurer. Which of the following statements is true?

   a. The commission is prohibited because a review client paid the fee for Deen’s referral of business to a third party.
   b. The commission is prohibited if the fee structure is material to Deen and will be paid to Deen over a period of time.
   c. The commission is permitted if Deen discloses to Lara that it will be receiving the fee.
   d. The commission is permitted because Deen does not perform an audit of Lara’s financial statements.
Questions to Consider and Lessons Learned

The purpose of this chapter was to review the highlights of the AICPA independence rules.

Questions to Consider

- As a lead partner on an attest engagement, have I evaluated all potential threats to independence, including by using the Conceptual Framework?

- Do I ensure that my firm has prepared the appropriate documentation the code requires, before I provide nonat test services to an attest client?

- When my firm provides multiple nonattest services to a client, do I ensure that the services are evaluated in the aggregate to reduce threats to an acceptable level?

- Am I sufficiently aware of the independence requirements that apply to me personally as a member of an audit firm?

Lessons Learned

- Apply the Conceptual Framework for Independence when the rules do not specifically address your facts and circumstances.

- Contact the AICPA’s ethics hotline with questions about independence.

- Understand when the independence rules apply; for example, personal financial interests apply to covered members and certain family members, but significant investments (more than five percent) apply to all professionals in the firm.

- If you are a covered member, ensure that all loans held with financial institution attest clients are either permitted or grandfathered in accordance with the rules, and do not renegotiate grandfathered loans.
Solutions to Review Questions

1. a. Correct. Constance James needs to be independent. As a partner in the Petaluma office and even more so, the managing partner, she is able to influence the outcome of the RLR engagement.
   b. Incorrect. There are other factors that should be considered.
   c. Incorrect. The fact that Constance has no client responsibilities does not exempt her from the independence requirements.
   d. Incorrect. The fact that Constance is a member of management does not exempt her from the independence requirements—in fact, this is quite relevant.

2. a. Incorrect. The fact that Robert is a manager in the firm does not automatically make him a covered member with respect to RLR
   b. Incorrect. The distance between offices in not a relevant factor as long as they are considered to be separate offices as defined in the AICPA Code.
   c. Correct. Only those managers who participate in the attest engagement, provide 10 or more hours of nonattest services, or are otherwise able to influence the engagement need to be independent.
   d. Incorrect. The fact that Robert does not work in the Petaluma office is not a relevant fact.

3. a. Correct. Kuniko Uchida must be independent. Anyone who participates in the RLR Design attest engagement, that is, calculates the client’s tax provision, must be independent.
   b. Incorrect. Kuniko’s location in the firm is not a relevant factor.
   c. Incorrect. Even though she is doing the tax work, Kuniko is involved in work related to the audit, that is, calculation of the client’s tax provision, and is considered to be participating in the attest engagement.
   d. Incorrect. The fact that Kuniko is providing assistance to the engagement team is not a relevant factor.

4. a. Correct. Felipe Arturo must be independent. He will provide over 10 hours of nonattest services to RLR Design, so he has to be independent of that client.
   b. Incorrect. There are other factors that should be considered.
   c. Incorrect. He may still need to be independent even if he performs no attest services for the client and is not a CPA.
   d. Incorrect. The fact that he is not a partner is not a relevant factor in this case.
5.  
   a. Incorrect. This is something Kathy should consider. However, another answer provides a better response.  
   b. Incorrect. Kathy should consider this. However, another answer more adequately addresses the question.  
   c. Correct. Kathy should consider both the scope of her services and the scope and duties of her spouse in the new position.  
   d. Incorrect. Better responses to the question are provided.

6.  
   a. Incorrect. Age is never a determining factor for applying the independence rules.  
   b. Incorrect. The marital status of one’s children will not affect the application of the independence rules.  
   c. Correct. Children who are no longer dependent cease to be immediate family under the rules.  
   d. Incorrect. Whether or not one is a student is not considered when determining one’s standing as immediate family, that is, dependents.

7.  
   a. Correct. All partners (or equivalent) that practice in the office in which the lead engagement partner practices in connection with the attest engagement are considered to be covered members.  
   b. Incorrect. Those in managerial positions may be covered members if they provide nonattest services to the client or are able to influence the client’s attest engagement in some other way.  
   c. Incorrect. Staff personnel are generally considered to be covered members only when they participate in a client’s attest engagement.

8.  
   a. Incorrect. Except for extraordinary circumstances, a former spouse need not comply with the independence rules.  
   b. Correct. The rules of independence apply to the covered member, his or her spouse (whether or not a dependent), and other dependent people (whether or not related).  
   c. Incorrect. A cousin is not considered an immediate family member.

9.  
   a. Incorrect. Job titles are not the ultimate determinant of whether a person is employed in a “key” position.  
   b. Correct. In assessing whether a position is “key,” one must consider the responsibilities of the position.  
   c. Incorrect. Salary levels are irrelevant when applying the independence rules.
10.  
   a. Incorrect. It is true that attestation services such as agreed-upon procedures engagements are considered attest engagements under the AICPA independence rules. However, these are not the only kinds of attest engagements.  
   b. Incorrect. Audits of financial statements are attest engagements for which independence is required. However, these are not the only kinds of attest engagements.  
   c. Incorrect. In a review engagement, the practitioner provides negative assurance, so this service is considered an attestation for the purposes of applying the independence rules. However, this is not the only kind of attest engagement.  
   d. Correct. The independence rules apply to several different types of attest services that members can perform for their clients.  

11.  
   a. Correct. ROC should be independent for the period of professional engagement and the period covered by the financial statements. If ROC had certain business relationships during the period they will audit, their independence may be considered impaired.  
   b. Incorrect. ROC should be independent when the period of professional engagement begins but certain activities they engaged in prior to that period could also impact their independence.  
   c. Incorrect. ROC should be independent during the period of professional engagement, which begins upon signing the engagement letter, and for the period covering the financial statements under audit.  
   d. Incorrect. Independence is required during the period of professional engagement as well as the period covered by the financial statements.  

12.  
   a. Incorrect. Any manager who will provide 10 or more hours of nonattest services to the client meets the definition of a covered member.  
   b. Correct. Covered members are prohibited from having a direct financial interest in a client, regardless of how small the investment might be. The first thing you should recognize is that the manager meets the definition of covered member because she will provide over 10 hours of nonattest services to the client. She has a direct financial interest in the client. It does not matter when or how or how much of this investment she has. Any direct financial interest by a covered member in a client creates an insurmountable threat to independence.  
   c. Incorrect. Stock ownership is a direct financial interest, and all direct financial interests in an attest client are prohibited.  

13.  
   a. Correct. An auto loan does not impair independence if it is obtained under the lender’s normal terms and conditions and is fully secured by the vehicle.  
   b. Incorrect. Other factors should be considered in applying the rule to these facts.  
   c. Incorrect. Materiality is not a relevant factor in applying this rule.  
   d. Incorrect. The vehicle’s sticker price is not a relevant factor in applying this rule.
14. a. Incorrect. The rule does not grant any special exceptions for student loans.
   b. Correct. A grandfathered/covered member loan does not impair independence if the loan is immaterial to her net worth and she meets the other requirements for grandfathering.
   c. Incorrect. This is not a relevant factor in applying this rule.
   d. Incorrect. This factor alone does not mean the loan doesn’t impair independence.

15. a. Correct. When aware, a covered member should evaluate possible threats to independence caused by a lending relationship with an officer, director, or 10 percent or greater shareholder of an audit client’s affiliate.
   b. Incorrect. This should not automatically be assumed.
   c. Incorrect. These rules apply to both persons and entities that extend loans to covered members.
   d. Incorrect. The timing of the loan does not mean independence is unaffected.

16. a. Incorrect. This is not a true statement.
   b. Incorrect. This is not a relevant factor in applying this rule.
   c. Incorrect. Materiality of the monthly spending is not considered in applying this rule.
   d. Correct. If the staff maintains a balance of $10,000 or less on a current basis, taking into consideration the payment due date and any available grace period, the loan does not impair independence.

17. a. Incorrect. It is important that the adequacy of the services be evaluated, but this responsibility rests with the client, not with the auditor.
   b. Correct. The member is required to establish an understanding with the client concerning the services to be performed. The other two choices are management’s responsibility.
   c. Incorrect. It is the client’s responsibility to design and implement the company’s internal controls.

18. a. Correct. Supervising client employees in the performance of their normal recurring activities impairs a member’s independence.
   b. Incorrect. A member may post entries to the trial balance as long as the client approves them.
   c. Incorrect. Advising the client on accounting issues does not impair independence.

19. a. Incorrect. You may not consummate a transaction on behalf of an attest client.
   b. Correct. A member may prepare financial statements from a client’s trial balance without impairing independence.
20.
   a. Incorrect. Providing research materials is not considered to be a management responsibility. Rather, it is generally considered to be a normal part of an attest engagement.
   b. Correct. Setting policy is considered a management responsibility that the CPA must not perform for an attest client.
   c. Incorrect. Making recommendations to an attest client does not create a management participation threat.

21.
   a. Incorrect. Independence is impaired once the trust commits to purchasing an interest in XYZ.
   b. Incorrect. Because the interest in XYZ is direct, this fact is not relevant.
   c. Correct. The trust’s commitment to purchase a direct interest in XYZ impairs Dan’s independence because the interest will exceed 10 percent of the trust’s total assets.

22.
   a. Correct. Since Mermaid is a review client, Deen is prohibited from receiving a commission for either (a) recommending to Mermaid services or products that a third party will provide, or (b) recommending Mermaid’s services or products to others.
   b. Incorrect. Deen would not consider these factors in applying the AICPA rules.
   c. Incorrect. In this case, disclosure would not be an appropriate action for Deen to take.
   d. Incorrect. This rule applies equally to reviews and audits of Mermaid’s financial statements.
Appendix

Conceptual Framework for Independence
Appendix


Introduction

.01 It is impossible to enumerate all relationships or circumstances in which the appearance of independence might be questioned. Thus, in the absence of an independence interpretation that addresses a particular relationship or circumstance, a member should evaluate whether that relationship or circumstance would lead a reasonable and informed third party who is aware of the relevant information to conclude that there is a threat to either the member’s or firm’s independence, or both, that is not at an acceptable level. When making that evaluation, a member should apply the conceptual framework approach as outlined in this interpretation to analyze independence matters. A member may also wish to consider the conceptual framework approach described in this interpretation to gain a better understanding of the conclusions reached in other interpretations in ET section 1.200, “Independence.” [Prior reference: “Other Considerations” section of paragraph .02 of ET section 101]

.02 The code specifies that in some circumstances no safeguards can reduce an independence threat to an acceptable level. For example, the code specifies that a covered member may not own even an immaterial direct financial interest in an attest client because there is no safeguard to reduce the self-interest threat to an acceptable level. A member may not use the conceptual framework to overcome this prohibition or any other prohibition or requirement in an independence interpretation.

Definitions Used in Applying the Conceptual Framework for Independence

.03 Acceptable level. A level at which a reasonable and informed third party who is aware of the relevant information would be expected to conclude that a member’s independence is not impaired.

.04 Impair(ed). In connection with independence, to effectively extinguish independence. When a member’s independence is impaired, the member is not independent.

.05 Safeguards. Actions or other measures that may eliminate a threat or reduce a threat to an acceptable level.

.06 Threats. Relationships or circumstances that could impair independence.
Conceptual Framework Approach

.07 The conceptual framework approach entails identifying threats and evaluating the threat that the member would not be independent or would be perceived by a reasonable and informed third party who is aware of the relevant information as not being independent. The member must eliminate or reduce that threat to an acceptable level to conclude that the member is independent. Threats are at an acceptable level either because of the types of threats and their potential effect or because safeguards have eliminated or reduced the threat, so that a reasonable and informed third party who is aware of the relevant information would perceive that the member’s professional judgment is not compromised.

.08 Refer to paragraph .07 of the “Conceptual Framework for Members in Public Practice” [1.000.010.07] for a detailed description of the conceptual framework approach. [Prior reference: ET section 100-1]

Documentation

.09 When the member applies safeguards to eliminate or reduce significant threats to an acceptable level, as described in paragraph .07c of the “Conceptual Framework for Members in Public Practice” [1.000.010.07], the member should document the identified threats and safeguards applied. Failure to prepare the required documentation would be considered a violation of the “Compliance With Standards Rule” [1.310.001] rather than the “Independence Rule” [1.200.001] if the member can demonstrate that safeguards were applied that eliminated or reduced significant threats to an acceptable level. [Prior reference: “Other Considerations” section of paragraph .02 of ET section 101]

Threats

.10 Many different relationships or circumstances (or combinations of relationships or circumstances) can create threats to compliance with the “Independence Rule” [1.200.001]. It is impossible to identify every relationship or circumstance that creates a threat. Many threats fall into one or more of the following seven broad categories: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence.

.11 Examples of threats associated with a specific relationship or circumstance are identified in the interpretations of the code. Paragraphs .12–.18 in this section define and provide examples, which are not all inclusive, of each of these threat categories. In certain circumstances, the code specifies that because of the type of threat and its potential effect, either no safeguards can eliminate or reduce the threat to an acceptable level, or a member would need to apply specific safeguards to eliminate or reduce an independence threat to an acceptable level. When independence interpretations in the code address one of these examples, a specific reference to the independence interpretation is provided in brackets after that example. If an example does not contain a specific reference to an independence interpretation, a member should use this “Conceptual Framework for Independence” interpretation to evaluate whether a threat is significant.
Adverse interest threat. The threat that a member will not act with objectivity because the member’s interests are in opposition to the interests of an attest client. An example is either the attest client or the member commencing litigation against the other or expressing the intent to commence litigation. [1.290.010]

Advocacy threat. The threat that a member will promote an attest client’s interests or position to the point that his or her independence is compromised. Examples of advocacy threats include the following:

a. A member promotes the attest client’s securities as part of an initial public offering. [1.295.130]

b. A member provides expert witness services to an attest client. [1.295.140]

c. A member represents an attest client in U.S. tax court or other public forum. [1.295.160]

Familiarity threat. The threat that, because of a long or close relationship with an attest client, a member will become too sympathetic to the attest client’s interests or too accepting of the attest client’s work or product. Examples of familiarity threats include the following:

a. A member of the attest engagement team has an immediate family member or close relative in a key position at the attest client, such as the attest client’s CEO. [1.270.020 and 1.270.100]

b. A partner or partner equivalent of the firm has been a member of the attest engagement team for a prolonged period.

c. A member of the firm has recently been a director or an officer of the attest client. [1.277.010]

d. A member of the attest engagement team has a close friend who is in a key position at the attest client.

Management participation threat. The threat that a member will take on the role of attest client management or otherwise assume management responsibilities for an attest client. Examples of management participation threats include the following:

a. A member serves as an officer or a director of the attest client. [1.275.005]

b. A member accepts responsibility for designing, implementing, or maintaining internal controls for the attest client. [1.295.030]

c. A member hires, supervises, or terminates the attest client’s employees. [1.295.135]
.16 **Self-interest threat.** The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, an attest client or persons associated with the attest client. Examples of self-interest threats include the following:

a. A member has a direct financial interest or material indirect financial interest in the attest client. [1.240.010]

b. A member has a loan from the attest client, an officer or a director of the attest client, or an individual who owns 10 percent or more of the attest client’s outstanding equity securities. [1.260.010]

c. A member or his or her firm relies excessively on revenue from a single attest client.

 d. A member or member’s firm has a material joint venture or other material joint business arrangement with the attest client. [1.265]

.17 **Self-review threat.** The threat that a member will not appropriately evaluate the results of a previous judgment made, or service performed or supervised by the member or an individual in the member’s firm and that the member will rely on that service in forming a judgment as part of an attest engagement. Certain self-review threats, such as preparing source documents used to generate the attest client’s financial statements [1.295.120], pose such a significant self-review threat that no safeguards can eliminate or reduce the threats to an acceptable level.

.18 **Undue influence threat.** The threat that a member will subordinate his or her judgment to that of an individual associated with an attest client or any relevant third party due to that individual’s reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member. Examples of undue influence threats include the following:

a. Management threatens to replace the member or member’s firm over a disagreement on the application of an accounting principle.

b. Management pressures the member to reduce necessary audit procedures in order to reduce audit fees.

c. The member receives a gift from the attest client, its management, or its significant shareholders. [1.285.010]

**Safeguards**

.19 Safeguards may partially or completely eliminate a threat or diminish the potential influence of a threat. The nature and extent of the safeguards applied will depend on many factors, including the size of the firm and whether the attest client is a public interest entity. To be effective, safeguards should eliminate the threat or reduce it to an acceptable level.
The following are three broad categories of safeguards:

a. Safeguards created by the profession, legislation, or regulation.

b. Safeguards implemented by the attest client. It is not possible to rely solely on safeguards implemented by the attest client to eliminate or reduce significant threats to an acceptable level.

c. Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements.

The effectiveness of a safeguard depends on many factors, including those listed here:

a. The facts and circumstances specific to a particular situation

b. The proper identification of threats

c. Whether the safeguard is suitably designed to meet its objectives

d. The party(ies) that will be subject to the safeguard

e. How the safeguard is applied

f. The consistency with which the safeguard is applied

g. Who applies the safeguard

h. How the safeguard interacts with a safeguard from another category

i. Whether the attest client is a public interest entity

Examples of various safeguards within each category are presented in paragraphs .21–.23 of the “Conceptual Framework for Members in Public Practice” [1.000.010]. The examples presented in these paragraphs are not intended to be all inclusive. In addition, threats may be sufficiently mitigated through the application of other safeguards not specifically identified in these paragraphs. [Prior reference: ET section 100-1]

Effective Date

The addition of partner equivalents to paragraph .14b is effective for engagements covering periods beginning on or after December 15, 2014.
Chapter 3

SEC and PCAOB Independence Rules

Introduction

At the beginning of this course, we said that various independence standard-setting bodies establish a variety of rules. We have just finished our discussion of the AICPA rules contained in the AICPA Code of Professional Conduct (the Code).

Now, it is time to turn our attention to another set of rules, those that apply to auditors of SEC registrants and issuers. Remember that these rules may apply in addition to the AICPA, state board, or other rules with which you are required to comply. In some cases, they may differ from the AICPA rules.

Learning Objective

After reading this chapter, you will be able to:

- Identify the major provisions of the SEC and the PCAOB independence rules that are stricter than and/or differ from the AICPA rules.
- Recognize PCAOB rules that are applicable to audits of non-public broker-dealers effective June 1, 2014.
Overview of SEC and PCAOB Independence Rules

Applicability of SEC and PCAOB Rules

If you recall, the set of rules that applies to you depends on the type of entity you are auditing. If you are performing services for a privately held entity that is not subject to government oversight, then you will be required to follow the rules of the AICPA and your state board. However, if you are auditing: a company that files reports with the SEC (an SEC registrant), a public company (an issuer), or a company that is otherwise subject to the SEC independence rules, for example, an FDIC-insured bank with $500 million or more in assets or a private broker-dealer, then you must also comply with the SEC and, in some cases, PCAOB independence rules.

If your client is an SEC registrant, then you should follow the rules of the AICPA and the SEC. If your client is also an issuer, you will be required to comply with standards of the PCAOB. In addition, certain SEC rules apply only to issuers. Some non-issuers, such as non-public broker-dealers, hedge funds, or investment advisors, may be required to register with the SEC even though they do not issue securities to the public. Auditors of issuers and non-public broker-dealers must also register with the PCAOB.

In this section, we will refer to SEC registrants as SEC audit clients. If a rule only applies to SEC registrants that are also issuers, that will be stated.

Note: Effective June 1, 2014, the audits of non-public broker-dealers become subject to certain PCAOB independence rules (discussed where relevant throughout this chapter).

Rule 2-01

The SEC’s independence rules are found in the following:

- Rule 2-01 of Regulation S-X. The SEC last revised this rule in January 2003
- FAQ – Application of the Commission’s Rules on Auditor Independence (December 13, 2004)
- Additional guidance can be found at section 602 of the SEC Codification of Financial Reporting Releases
PCAOB Standards

For further information about the PCAOB independence rules, go to the following website:

- pcaobus.org/Standards/EI/Pages/default.aspx

Similarities and Differences Between AICPA and SEC Rules

Many of the SEC rules relating to independence are similar to the AICPA rules. Where the SEC rules are substantially similar to the AICPA rules, they will not be addressed in this section of the course. Rather, this section will focus on rules that are additional to and/or more restrictive than the AICPA rules. Exhibit 3-1 identifies the rules that are similar in substance.

Exhibit 3-1
Similarities Between AICPA and SEC Rules

- Definition of a covered person (recall that the AICPA rules use the term covered member)
- Definitions of key position and immediate and close family members
- Prohibition against five percent or greater ownership of client
- Previous association with client
- Inter-entity investments
- Holdings in clients through mutual funds
- Direct financial interests

Organization of SEC Rules

The SEC rules establish a general standard of independence, and then identify particular circumstances, by way of detailed rules, in which your independence is considered to be impaired. Under the general standard, independence is considered to be impaired when you are either not independent “in fact” or when, in light of all the relevant facts and circumstances, a reasonable investor would conclude that you would not be capable of acting without bias. According to the rule, circumstances not specifically set forth in the detailed rules may be measured against the general standard.
Basic Principles of the SEC Independence Rules

In addition, you should always consider four basic principles, specifically, any interest or relationship you (or your firm) may have with the client, or whether providing a certain non-audit service to the client

- creates a mutual or conflicting interest between the firm and the client,
- places the firm in a position where it subsequently audits its own work,
- results in the firm acting as management or as an employee of the client, or
- places the firm in a position where it acts as an advocate for the client.

Family Relationships

Earlier in this course, you learned that the AICPA independence rules also apply to certain family members. In general, the SEC rules for immediate family mirror those of the AICPA. (One difference is that the AICPA provides additional guidance to members whose immediate family participates in certain employee benefit and compensation plans and arrangements.)

Financial Interests and Close Family Members

Under SEC rules, a covered person’s close family member (spouse or equivalent, dependent, parent, sibling, nondependent child, or any group of those persons) impairs independence if he, she, or they own greater than five percent of the client’s outstanding equity securities, that is, are required to file Form 13D or 13G with the SEC.

In addition, the close family of any partner in the firm will impair a firm’s independence if the family member controls the client.
Review Questions

1. Which of the following statements about the application of SEC independence rules to the audit of an SEC registrant is true?
   
a. If a circumstance is not specifically addressed in the rules, you must assume that independence is impaired.
   b. The four basic principles should be considered in all cases, in addition to the specific rules.
   c. The rules do not apply to auditors of non-public broker-dealers or investment advisors.
   d. If the AICPA and state board rules apply, the SEC rules would not also apply.

2. Which of the following is one of the fundamental principles that the SEC may look to in evaluating independence in a particular situation?
   
a. Whether the firm acts as an advocate of the client.
   b. Whether the firm has a recent history of independence violations.
   c. Whether the firm has adequate independence training for its personnel.
Employment Relationships

Former Partners and Professionals

Various employment matters may impair independence. For example, a former firm partner or professional may take a key position with an SEC audit client. In addition, the SEC imposes a “cooling-off period” on auditors who assume key financial oversight positions with issuers. This and some other SEC rules are stricter than the AICPA rules.

Let us assume that a professional employee of AB Accountancy (AB) assumes either an accounting role, such as an assistant controller or accounts payable manager with a client, or, perhaps a partner of AB takes a financial reporting oversight role, for example, CFO at an SEC audit client.

To maintain independence, what must happen?

1. The partner or professional cannot influence the firm’s operations or financial policies. (This condition also applies under the AICPA rules.)

2. A partner must be paid in full by the firm for his or her capital balance.

3. Amounts due to the partner or professional cannot depend on the firm’s future revenues or profitability, for example, payment arrangements should be fixed.

4. If not fully funded, AB must fully fund the partner or professional’s retirement account, that is, through a “Rabbi” trust or similar vehicle.

5. Are there any exceptions to this rule? Yes. A former employee, not a partner or equivalent, who disassociated from the firm more than five years ago, would not need to meet these requirements, except that payments due to the former employee must be fixed and immaterial.

Members of the audit team must meet a higher standard: the SEC requires a “cooling-off period” of one year before an audit team member may begin working for the client in a financial reporting oversight role, for example, as the issuer’s CFO, CEO, Internal Audit Director, or as a member of the board of directors. (Note: This rule applies only to auditors of issuer clients.)
Affiliate of an Audit Client

Earlier in this course, we defined *client* under the AICPA rules. As you learned, *financial statement attest client* may include certain *closely associated entities* that are not attest clients (some are not clients at all). Similarly, the SEC rules apply to SEC audit clients and their *affiliates*; however the definitions are different. Under SEC rules, an affiliate of the audit client generally is defined as an entity

- that has control over the audit client, or over which the audit client has control, or that is under common control with the audit client, for example, an audit client’s parents, subsidiaries, and sister companies;
- that has significant influence, generally ownership between 20 and 50 percent, over the audit client when the audit client is material to the entity;
- over which the audit client has significant influence when the entity is material to the audit client; or
- in an investment company complex when the audit client is a part of that complex. For example, if an SEC-registered mutual fund is an audit client, then all of the other funds in that fund family and certain other entities, for example, banks or brokerage firms, will be considered to be affiliates.
Financial Relationships

In many respects, the SEC rules on financial relationships are similar to those of the AICPA, but some additional restrictions also exist.

Some Additional SEC Restrictions

<table>
<thead>
<tr>
<th>Relationship With Client</th>
<th>Summary of SEC Rule</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan to or from SEC audit client</td>
<td>Only mortgages and similar loans related to a covered member’s <em>primary residence</em> may be grandfathered, unless the loan meets special grandfathering provisions.</td>
</tr>
<tr>
<td>Business relationships with SEC audit client</td>
<td>Prohibits direct or material indirect business relationships with client (or persons associated with client), except as a consumer in the ordinary course of business.</td>
</tr>
<tr>
<td>Insurance policies from SEC audit client</td>
<td>Prohibits a covered person from having an insurance policy unless</td>
</tr>
<tr>
<td></td>
<td>• the policy was obtained at a time when the individual was not a covered person, and</td>
</tr>
<tr>
<td></td>
<td>• the likelihood of the insurer becoming insolvent is remote.</td>
</tr>
<tr>
<td>Depository accounts, for example, checking or savings accounts with SEC audit client</td>
<td>Permitted; however, covered persons may not have accounts that exceed federally or state-insured limits.</td>
</tr>
<tr>
<td>Broker-dealer accounts with SEC audit client</td>
<td>Permitted; provided the account does not hold any asset other than cash or securities and is fully insured by the Securities Investor Protection Corporation (SIPC). The loan prohibitions also apply to broker-dealer accounts.</td>
</tr>
</tbody>
</table>
Non-Audit Services

The term *non-audit* services generally includes accounting, tax, and consulting services, for example, bookkeeping, tax compliance, or valuation services. When your firm provides these services to an SEC audit client, the rules impose limits on the nature and scope of those services. Your firm may even be prohibited from providing certain types of services for the client.

**The SEC Rules**

SEC rules for non-audit services tend to be stricter than the AICPA rules, especially in the following areas:

- Bookkeeping services.
- Valuation, appraisal, and actuarial services
- Tax services
- Financial information systems design
- Human resource services
- Legal and expert services
- Internal audit outsourcing

Certain requirements apply only to SEC audit clients that are issuers. They are

- audit partner rotation, and
- restrictions on certain types of audit partner compensation.

Recall that one of the SEC’s basic principles says that an accounting firm should not audit its own work (*self-audit*). The following services raise self-audit concerns:

- Bookkeeping (including payroll)
- Valuation, appraisal, and actuarial
- Financial information systems design and implementation
- Internal audit
Therefore, unless an auditor reasonably concludes that the results of the services will not be subject to his or her firm’s audit procedures, performing these services will impair independence.

**Bookkeeping Services Including Payroll Processing**

In addition to raising self-audit issues, certain aspects of bookkeeping services, for example, authorizing electronic payments, constitute management functions. For these reasons, bookkeeping services are generally prohibited. Specifically, the SEC prohibits

- maintaining or preparing the audit client’s accounting records,
- preparing the audit client’s financial statements that are filed with the SEC or form the basis of financial statements filed with the SEC, and
- preparing or originating source data underlying the audit client’s financial statements. Examples of source data underlying the audit client’s financial statements include tax provision and stock-based compensation computations.

Continuing with the fictional firm, AB, the following describes some of the services the SEC and/or the PCAOB have considered problematic for independence.

**Financial Information Systems Design and Implementation**

AB could not design or implement a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client’s financial statements taken as a whole. However, the firm may be able to provide design and implementation services related to a system that has no bearing on the company’s financial reporting. An example would be a membership database that does not interface with the financial reporting system.

**Valuation and Appraisal Services, Including Fairness Opinions, and Contribution-in-Kind Reports**

Appraisal and valuation services include any process whereby AB values a client’s assets or liabilities and the rules generally prohibit the performance of valuation or appraisal services or any service involving a fairness opinion or a contribution-in-kind report for an audit client.

Like information system design and implementation, services that are solely for non-financial reporting purposes, for example, cost segregation and transfer pricing services for tax purposes, are generally allowable.
**Actuarial Services**

Generally, AB should not provide an actuarial-related service if it will determine an amount that will be recorded in the client’s financial statements or related accounts. AB may help the client to understand the methods, models, assumptions, and inputs used by another party in determining those amounts.

**Internal Audit Outsourcing Services**

AB generally may not perform internal audit outsourcing services if they relate to the client’s internal accounting controls, financial systems, or financial statements. Internal audit outsourcing raises not only self-audit issues, but also concerns of performing management or employee functions for a client.

**Human Resource-Related Services**

AB should not perform the following human resource-related services because they are considered to constitute the performance of management functions:

- Performing searches for prospective candidates for managerial, executive, or director positions
- Negotiating employment matters on the client’s behalf
- Testing or evaluating prospective employees
- Recommending that a client hire a specific candidate for a specific job

If requested by a client, AB may interview candidates and advise the client on the candidates’ competence for financial accounting, administrative, or internal control positions.

**Legal Services**

The SEC rules prohibit legal services, which are defined as any service provided to an audit client that requires the service provider to be licensed, admitted, or otherwise qualified to practice law in the applicable jurisdiction. Some foreign jurisdictions may require legal credentials to perform certain types of tax services. However, as long as AB, a U.S. accounting firm, would be permitted to provide these services, it would also be permitted under the SEC’s rules.

**Expert Services**

AB should not provide expert services, for example, forensic accounting services, to a client, or a legal representative of the client, for purposes of advocating the client’s interests in litigation or in regulatory or administrative proceedings or investigations. Serving as a fact witness in a matter is generally allowable, which is similar to the AICPA position.
**Personal Tax Services for Financial Reporting Executives**

Under a PCAOB standard applicable to issuers, AB should not provide personal tax services to financial reporting executives of its issuer audit clients. What does the rule say?

In essence, independence is impaired if, during the audit or professional engagement period, an accounting firm or any affiliate of the firm provides tax services to a person in a financial reporting oversight role (FROR) or to the person’s spouse or dependents.

What is the PCAOB’s rationale for this rule? The PCAOB believes that providing tax services to persons responsible for the client’s financial reporting creates the appearance of a mutual interest between the audit firm and the company’s management.

What is a person in an FROR? A person in an FROR exercises influence over the people who prepare financial statements or the contents of the financial statements, including related information in SEC filings, such as management’s discussion and analysis. Members of senior management, who are directly responsible for setting accounting policies or designing internal accounting controls, the CEO, controller, CFO, and director of internal audit, clearly are in FRORs. But a person’s title or job description may not tell the whole story. When determining whether a person is in an FROR, carefully evaluate the substance of the person’s role.

**Aggressive or Confidential Tax Transactions**

AB should also avoid certain involvement with the client in connection with a confidential or aggressive tax transaction. Another PCAOB rule states that independence is impaired if a firm provides services to an audit client involving marketing, planning, or opining *in favor of* a confidential transaction or an aggressive tax position.

**Note:** Beginning June 2014, this PCAOB rule also applies to a firm’s broker-dealer audit clients.

In a confidential transaction, the client pays a fee to an advisor and agrees (at the advisor’s request) not to disclose the advisor’s strategy, tax treatment, or structuring. The IRS believes that confidential arrangements suggest a potentially abusive transaction. If AB recommends to the client a transaction whose significant purpose is tax avoidance, it may be deemed an aggressive tax transaction.

What is the reasoning behind this rule? The PCAOB believes that opining in favor of such a transaction causes the auditor and the client to have a mutuality of interests in the results of the transaction due to the high likelihood that the tax authority will disallow the transaction. The rule does not apply when an auditor’s services involve opining *against* a tax position because this would not align the interests of the firm and the client.
Audit Committee Pre-Approval

A client’s audit committee is required to pre-approve all services performed by its auditor prior to the engagement. (Similar to the last rule, this rule also becomes applicable to non-public broker-dealers in June 2014.) The full audit committee may pre-approve services on an engagement-by-engagement basis or less frequently according to the committee’s policies and procedures.

In addition, PCAOB rules require auditors of issuer audit clients to perform certain additional procedures before they perform tax and internal control-related services. These additional procedures are as follows:

- Provide the audit committee a written description of the scope of the proposed services, fee and other arrangements, and the potential effect on independence.
- Discuss the services, fee, and other arrangements, and their possible bearing on independence with the audit committee.
- Document the substance of that discussion.

Other Non-Audit Services: Private Client to Become Public

AB could retroactively become subject to SEC independence rules when its private audit client files an initial public offering or will be acquired by a public company.

Since registration with the SEC requires multi-year audited financial statements, AB may find that it cannot continue as auditor because its independence is impaired for prior periods included in the filing under the more restrictive SEC independence rules.

Review Questions

3. Deena is a covered person with respect to an SEC audit client. Is she prohibited from having a broker-dealer account with the client?

   a. Yes, because the client would have custody of Deena’s assets.
   b. Yes, because the SEC prohibits all financial interests with clients.
   c. No, provided Deena does not invest in or borrow money from the client and the value of the assets in the account does not exceed the insured or protected levels for the account.
   d. No, there should be no restrictions on this type of an account.
4. Which of the following statements regarding the SEC rules for non-audit services is true?

a. Fees from non-audit services cannot exceed audit fees.
b. The client’s audit committee must pre-approve the auditor’s non-audit services.
c. The SEC must approve certain non-audit services before they are performed.

5. May Leider Electric (an SEC registrant) engage AB, its auditor, to perform information technology-related services under the SEC’s independence rules?

a. Yes, if the services have no bearing on Leider Electric’s financial reporting and related systems.
b. No, the SEC has a strict prohibition against information technology services.
c. Only if Leider’s audit committee approves the services.
d. Only if AB hires an outside consultant to perform a concurring review of the services before the next audit.

6. Under the SEC rules, which of the following non-audit services would AB most likely be permitted to provide to an SEC audit client?

a. Business valuation services used to measure the impairment of goodwill.
b. Valuation services provided solely as part of a tax-planning engagement.
c. Actuarial services used to determine pension costs and related liability.

7. Devo, Inc., an SEC registrant, requests AB’s assistance in performing human resource services. Which of the following services may AB perform for Devo, Inc., without violating the independence rules?

a. Searching for qualified financial executives.
b. Negotiating an appropriate salary for an incoming manager.
c. Advising the client on whether a particular candidate has the proper qualifications for a specific position.
Business Relationships

The SEC rules on business relationships state that direct and material indirect business relationships with SEC audit clients adversely affect independence. This rule applies not only to the audit client but also to persons associated with the client in a decision-making capacity, such as officers, directors, or substantial shareholders. According to the SEC, business relationships impair independence because they create a mutuality of interests with the client, which is inconsistent with one of the principles underlying the SEC’s rules.

Note: Accounting firms and their professionals may purchase goods and services from SEC audit clients provided such purchases are made as a consumer in the ordinary course of business on the same terms and conditions as other similarly situated customers.

Examples of Prohibited Relationships

The following are examples of relationships between a covered person and an SEC audit client, including the client’s officers, directors, and substantial shareholders, that cause independence to be impaired:

- Joint business ventures
- Joint marketing agreements
- Agreements to jointly perform services for clients
- Agreements to share costs or profits
- Limited partnership agreements
- Leasing interests, except for immaterial landlord-tenant relationships
Other Rules

Audit Partner Rotation (Audits of Issuers)

To prevent certain partners from becoming too familiar with their audit clients over time, lead and concurring review partners on issuer audit engagements must rotate off the engagement team after five years of service to a client.

Upon rotation, partners must remain off the engagement team for another five-year period. They should not continue to have contact with the client; however, they may confer with the subsequent engagement team on a limited basis to assist with the transition.

Other partners, who make decisions on significant accounting, audit, or other reporting matters or who also have contact with the issuer’s management and audit committee, must rotate after seven years of continuous service to the client and then remain off the engagement for two years. (Partners whose service is limited to consulting with the engagement team on technical accounting, auditing, or similar issues are not required to rotate.)

Restrictions on Certain Types of Compensation Arrangements

Audit partners, other than specialty partners such as tax partners serving on the audit engagement team for an issuer, may not be directly compensated for selling non-audit services to that issuer.

Note: The audit partner rotation and compensation rules do not apply to firms with fewer than 10 partners and fewer than five issuer audit clients.
Other Matters

Contingent Fees

The SEC believes that contingent fees impair independence because they create a mutuality of interests between the firm and an SEC audit client. The rule only permits auditors to perform services for a contingent fee when the determination of the fee is taken out of the hands of the accounting firm and its audit client. So, for example, if the auditor’s fee is determined by an outside body, such as a court, that is acting in the public interest, a contingent fee would be permissible.

Concentration of Fees

The Commission’s staff historically has raised questions regarding the independence of firms, which, as a general rule of thumb, derive more than 15 percent of their total revenues from one SEC audit client or group of such clients. The Commission’s staff believes that a concentration of fees in excess of that limit may cause the firm to be overly dependent on a client or a group of related clients.

Unpaid Fees

According to the SEC, if an audit client does not pay its fees for an extended period of time, the unpaid fees give the firm a direct interest in the results of the entity’s operations. Generally, independence is impaired if prior-year professional services fees are not paid prior to the commencement of any engagement requiring independence.

Assume that AB has not collected its prior-year fees when this year’s audit engagement has commenced. The client commits to pay the fees in full, and the firm is reasonably assured that it will collect those fees before the current report is issued. In these instances, the firm’s independence would not be lost.

However, if the client is filing a registration statement with the SEC, the fees must be paid before the engagement begins.

Indemnification Clauses

When AB and its SEC audit client enter into an agreement of indemnity that provides AB immunity from liability for the firm and its personnel’s negligent acts. AB is not independent. In addition, an interpretation of the AICPA Code indicates that a member’s use of a prohibited indemnification clause in connection with an audit performed under the SEC rules or the rules of another regulatory body would constitute an act discreditable to the profession.
Review Questions

8. Which of the following people, in addition to the lead audit engagement partner, are required to rotate from the engagement after five years?
   
   a. Industry consultants to the engagement.
   b. Engagement managers.
   c. Concurring review partners.

9. The PCAOB restriction on personal tax services pertain to which of the following persons and their immediate families?
   
   a. Executives in financial reporting oversight roles.
   b. All executives of the company.
   c. Accounting department employees.
Communicating Independence Matters

Auditors must comply with PCAOB Rule 3526, Communication With Audit Committees Concerning Independence, before accepting a new audit engagement and annually thereafter.

<table>
<thead>
<tr>
<th>Summary of PCAOB Rule 3526</th>
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<tbody>
<tr>
<td><strong>When to communicate</strong></td>
</tr>
<tr>
<td><strong>To whom</strong></td>
</tr>
</tbody>
</table>
| **What to communicate in writing** | All relationships between the auditor and the client, including the auditor’s and client’s affiliates, that could reasonably be thought to bear on independence  
A statement confirming that the firm is independent of the company in accordance with the Securities Acts |
| **What to communicate verbally** | Matters identified in the written communication |
| **What to document**        | The substance of the discussion with the audit committee |

Review Questions

10. Status Photos wants to engage Daily, CPAs as their auditors for the year ended December 31, 2014. What must happen under PCAOB Rule 3526?

   a. Daily must explicitly state that all covered persons in the firm have complied with all relevant ethical requirements.
   b. Daily must provide a list of all firm members who must be independent of the client.
   c. Daily must describe in writing all the relationships with Status Photos that may reasonably be expected to affect their independence.

11. Sterling CPAs is named as the auditors of ABC Corp. Under PCAOB independence rules, when must Sterling communicate with ABC’s audit committee about independence?

   a. Quarterly and prior to being engaged.
   b. Annually and prior to be engaged.
   c. When engagement team personnel rotate off the engagement.
   d. If Sterling resigns from the audit engagement.
Maintain Your Independence

If you are a partner or professional employee of a firm whose clients are subject to the SEC independence rules, it is up to you to make sure you are independent of all SEC audit clients (and their affiliates) with respect to which you are a covered person, and, in some cases, all SEC audit clients of your firm, for example, certain significant business or financial relationships, as required under those rules. Keep in mind that even after you leave a firm, your activities may still impair the firm’s independence.

Your Firm’s Responsibilities

Although you are primarily responsible for your compliance with the independence rules, your firm plays an important role in helping you comply. Your firm should maintain the following policies and tools to facilitate your compliance:

- **Written independence policies and procedures** – Your firm’s independence policies and procedures should describe your obligations for maintaining independence as a member of the firm. Firms that provide attest services to SEC audit clients are required to have policies in place that provide for sanctions when members of the firm violate these policies.

- **Independence training** – Your firm should require you to attend training on the independence rules when you join the firm and periodically thereafter.

- **Annual independence confirmations** – Upon joining a public accounting firm and annually thereafter, you should confirm your compliance with the independence rules in writing. (Your compliance statement also applies to interests and relationships of your immediate family members, who are generally subject to the same independence rules as you.)

- **Restricted entity list** – This is a listing of all the firm’s restricted entities, that is, entities for which independence is required in your firm. For these purposes, the term restricted entities includes all SEC audit clients of the firm and their affiliated entities, as determined by the SEC rules, for example, a subsidiary of a client.
Questions to Consider and Lessons Learned

The purpose of this chapter was to provide you an overview of the SEC’s independence rules.

Questions to Consider

- How can you stay aware of the full realm of independence requirements that exist under the SEC’s rules?
- Where can you find the full text of the SEC and PCAOB rules and related guidance?
- What PCAOB independence and ethics rules apply to auditors of broker-dealers?

Lessons Learned

- Carefully document decisions made regarding independence under the SEC and PCAOB independence rules.
- Consider the four basic precepts underlying the SEC rules when evaluating independence.
- Ensure that your client’s audit committee pre-approves all proposed services to the audit client before the services are provided.
- You must communicate with the audit committee of a prospective SEC audit client about independence before your firm accepts the client and annually thereafter, and you should document the substance of that communication.
Solutions to Review Questions

1.  
   a. Incorrect. Independence may or may not be impaired under the rules if a circumstance is not specifically addressed.  
   b. Correct. You should always consider the four basic principles, in addition to the specific rules.  
   c. Incorrect. The SEC rules apply to both non-public broker-dealers and investment advisors.  
   d. Incorrect. The SEC rules should also be considered when you are auditing an SEC registrant, regardless of the other rules involved.

2.  
   a. Correct. This is one of the four principles mentioned by the SEC. The others are whether the firm (1) has a mutual or conflicting interest with the client, (2) audits its own work, or (3) acts as management or an employee.  
   b. Incorrect. The firm’s recent history is irrelevant when evaluating possible independence violations.  
   c. Incorrect. As part of its quality control programs, the SEC requires firms to train their personnel on independence matters, but this is not one of the principles they will consider in evaluating whether an independence violation has occurred.

3.  
   a. Incorrect. You are permitted to have such an account under certain circumstances.  
   b. Incorrect. The SEC does not prohibit all financial interests with clients.  
   c. Correct. As long as the account does not hold any asset other than cash or securities, the contents of the account are insured, and you comply with the SEC’s loan provisions, you are generally permitted to have such an account.  
   d. Incorrect. Certain restrictions apply to covered persons holding these types of accounts.

4.  
   a. Incorrect. The SEC independence rules do not restrict the fees CPAs can earn from non-audit services to audit clients.  
   b. Correct. Proxy disclosures about fees for non-audit services are also required.  
   c. Incorrect. The SEC does not approve non-audit services; only the audit committee is required to pre-approve non-audit services.

5.  
   a. Correct. The SEC rules do not prohibit a firm from working on IT systems that are unrelated to the financial reporting process, as long as they are approved by the issuer’s audit committee before they are performed.  
   b. Incorrect. In general, firms are prohibited from providing IT consulting services, unless the results of the services will not be subject to your firm’s audit procedures.  
   c. Incorrect. Leider Electric’s audit committee should only approve the services if they are permitted under the SEC’s independence rules.  
   d. Incorrect. There is no such requirement under the SEC’s rules.
6.  
a. Incorrect. A firm is prohibited from providing valuation services unless it is reasonable to conclude that the results will not be subject to your firm’s audit procedures, and presumably, work related to the valuation of goodwill would be subject to audit procedures.
b. Correct. Since these services are performed solely for tax purposes, they would generally be permitted.
c. Incorrect. The results of these services would be subject to audit procedures, and therefore, would be prohibited.

7.  
a. Incorrect. These services are specifically prohibited.
b. Incorrect. Negotiations on behalf of the entity constitute acting in the capacity of management and are prohibited.
c. Correct. The firm may advise the entity on the candidate’s competence, but the firm may not recommend a specific candidate for a specific job at the SEC audit client.

8.  
a. Incorrect. These individuals are not subject to rotation requirements.
b. Incorrect. Engagement managers are not subject to rotation requirements unless they function as partners on engagements; for example, they sign audit reports.
c. Correct. Once these individuals rotate off the engagement, they must remain off the engagement team for five years.

9.  
a. Correct. The rules apply to executives in financial reporting oversight roles (with certain exceptions) and to their immediate family members.
b. Incorrect. Executives who are not in financial reporting oversight roles are not subject to this rule.
c. Incorrect. Not all accounting department employees will be in financial reporting oversight roles.

10.  
a. Incorrect. Daily is not required to make such a statement under this rule.
b. Incorrect. Daily is not required to provide this information to its clients under this rule.
c. Correct. Auditors are required to communicate in writing with Status Photo’s audit committee a description of all relationships that Daily believes may reasonably be thought to affect their independence.
11.  
   a. Incorrect. Sterling may choose to communicate quarterly but they are not required to do this.
   b. Correct. The PCAOB rule requires communication at least annually and prior to being engaged.
   c. Incorrect. Engagement personnel are required to rotate off the engagement every five to seven years, depending on their role on the engagement, but Sterling’s communications with ABC’s audit committee is required on a different schedule.
   d. Incorrect. Sterling is not required to make a specific disclosure to ABC’s audit committee under the independence rules if Sterling resigns from the audit engagement.
Chapter 4

Independence Rules of Other Regulators

Introduction

In your career, you may encounter independence rules of other regulatory bodies, such as the Government Accountability Office (GAO) or the Department of Labor (DOL). If you work for a banking institution or perform audits of banks or other financial institutions, such as insurance companies, your work will be subject to significant government regulation and oversight. You may also perform services that are subject to international ethics standards, especially independence.

In this chapter, we will discuss these other rules, including how they compare or contrast with the AICPA Code of Professional Conduct (the Code).

Learning Objectives

At the end of this chapter, you will be able to:

- Identify the major provisions of the GAO independence rules, including the newly adopted conceptual framework.
- Identify the major provisions of the DOL independence rules.
- Recognize the additional ethical requirements that apply to attest services performed for banking and insurance institutions.
- Describe the basic structure of the International Ethics Standards Board for Accountants (IESBA) Code and the ways in which it differs or is the same as the AICPA Code.
- Describe new or revised IESBA standards.
Overview of the GAO Independence Rules

The GAO independence and ethics rules apply to auditors who perform attest services under Generally Accepted Government Auditing Standards (GAGAS), which are described in the GAO publication, Government Auditing Standards (GAS, or the “Yellow Book”). These standards apply both to auditors employed by the government and to auditors in public accounting and their firms. For more information, visit www.gao.gov/yellowbook

Ethical Principles in Government Auditing

The Yellow Book stresses five ethical principles: the public interest, integrity, objectivity, professional behavior, and the proper use of government information, resources, and position.

This course has specifically addressed the first four principles, since the public interest, integrity, objectivity, and professional behavior are fundamental principles in the AICPA Code.

The fifth principle is the proper use of government information, resources, and position which, though not explicitly expressed in a rule, would be expected of professionals under the AICPA Code.

Since GAO audits are performed in a governmental setting, auditors must be mindful of several factors described in the Yellow Book. The following are some highlights:

- The fifth principle stresses that government information, resources, and positions are to be used for official purposes and not inappropriately for the auditor’s personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audited entity or the audit organization. This concept includes the proper handling of sensitive or classified information or resources.

- As “accountability professionals,” accountability to the public for the proper use and prudent management of government resources is an essential part of auditors’ responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public’s expectations for auditors.

GAO Independence Principles and Rules

Chapter 3 of the Yellow Book establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under GAS. As the Yellow Book states, “These general standards, along with the overreaching ethical principles presented in Chapter 1, establish a foundation for credibility of auditors’ work. These general standards emphasize the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of staff; and quality control and assurance.”
Under the Yellow Book, in all matters relating to audit work, whether government or public, audit organizations and their professionals must be independent. Like the AICPA Code and other rules, auditors must avoid the appearance of such impairments to their independence. The key changes that took place in the GAO’s independence rules were

- incorporation of a conceptual framework for addressing independence,
- greater alignment of non-audit services rules with AICPA rules, and
- withdrawal of the Staff FAQ document on non-audit services.

Some of the GAO’s independence rules apply to public accounting firms as well as governmental bodies, and some to only one or the other. Thus, we will use the following naming convention to differentiate between the two:

- We will refer to public accounting firms as firms or audit firms, and to governmental organizations, such as municipalities, federal agencies, and so on, as audit organizations.
- When we discuss the entities audited by audit firms, we will use the terms client, audit client, or attest client.
- To describe the entities audited by audit organizations, that is, governments, we will use the term audited entity.

**Conceptual Framework**

The GAO independence rules include a conceptual framework for assessing situations in which specific guidance does not exist in the Yellow Book. The framework is very similar to the one in the AICPA Code.

Let us look at an illustration of the application of the conceptual framework to an independence matter under GAO rules.
**Using the Conceptual Framework for Independence: Threats to Independence**

Once you identify a potential threat to your independence, you should evaluate the significance of that threat to determine a course of action. In the following dialogue, Jim Henderson, an audit manager working for a regional accounting firm located in Phoenix, discusses a question about his independence with Mark Page, the firm’s director of audit.

---

**Jim:** “Mark, I have a question about independence. Can you help me?”

**Mark:** “Sure, what can I help you with?”

**Jim:** “Well, my stepfather works for an audit client, the city of Silverado. I’ve been asked to serve on the audit, which is performed under governmental standards and I need to know if his employment will prevent me from working on this audit.”

**Mark:** “What does he do for the city?”

**Jim:** “He’s in charge of human resources, not anything financial in nature. So I am hoping this will have no bearing on my independence.”

**Mark:** “There’s no specific guidance on this type of situation in the Yellow Book so we should evaluate these facts in light of the conceptual framework for independence, which was recently added. We are required to apply the framework whenever we encounter an issue or circumstance that is not prohibited under the rules, but may threaten our independence. One threat included in the framework is the familiarity threat which results when, for example, a close family member’s employment with a client leads an auditor to take a position that is not objective, or would be perceived as not being objective.”

---

Jim, Audit Manager  
Mark, Director of Audit
Then, we need to consider whether the threat to your independence is significant. When a close relative is an employee of a client, we look to see whether the relative can exert significant influence over the subject matter of the audit. On its face, I don’t think this is the case; however, we should look more closely at what your stepfather actually does in his role as head of HR.”

Jim: “So, the next steps are to get that information. Will we need to document this matter?”

Mark: “It’s always a good practice to document any assessment of your independence and our firm policy requires it. The GAO standards require us to document our consideration whenever we apply the framework and conclude that safeguards were required to reduce significant threats to independence.”

The following are some other examples of situations that may threaten your independence:

- A close friend is a director or officer of the audit client, or is employed by the client (familiarity threat).
- You have a direct financial interest that is not material to your net worth (self-interest threat).
- You serve on a committee that could affect operations of the entity or program being audited (management participation threat).
- You have deep-rooted ideas about the objectives of a program being audited, such as social or political biases or convictions (bias threat).
- Your firm wishes to perform certain nonaudit services for the client, but it is unclear whether those services would result in the audit team subsequently auditing its own work (self-review threat).
- Management is pressuring the audit team to complete the audit in an unreasonable period of time (undue influence threat).

**Using the Conceptual Framework for Independence: Applying Safeguards**

Under the conceptual framework, once a threat to independence is identified, the auditor should determine whether or not the threat is significant. A threat is considered significant if it would compromise the auditor’s professional judgment or even create the appearance that the auditor’s judgment would be compromised.
If a threat is considered significant, the auditor is required to apply safeguards to eliminate the threat or reduce the threat to an acceptable level. By acceptable level, we mean the threat no longer threatens the auditor’s professional judgment.

In the following dialogue, two members of an audit team discuss a situation concerning a threat to the firm’s independence that requires the application of safeguards.

Jonathan: “Bob, we need to talk about something that has been bothering me all week.”

Robert: “OK, what is it?”

Jonathan: “I’m feeling a fair amount of pressure from the senior accountant and controller.”

Robert: “I’m glad you’re bringing this up. I myself have not noticed that; but you have been ‘on the ground’ a lot more than I have lately. What’s been happening?”

Jonathan: “They are constantly making remarks about the amount of testing we’re doing and how high their fees are going to be. And I can barely get a straight answer from either of them. It has become a big problem. That is why I am bringing it to your attention. I know we have to be careful about maintaining our independence and I am feeling pretty pressured…Should I be concerned?”

Robert: “It sounds as if you were able to do your work before, but now it has become more difficult. In that case, in my opinion, the situation could seriously threaten, at least in appearance, your objectivity. The conceptual framework requires auditors to apply safeguards when they encounter significant threats to their independence. In this instance, it is clear we need to discuss the matter with the appropriate people in our firm. We’ll probably need to take this up with the client’s CFO and, if necessary, the CEO and the audit committee.”

Significant threats to your independence may impede your ability to perform a proper audit.

Audit firms should have policies and procedures for identifying threats to independence and resolving significant threats under the conceptual framework as part of their quality control systems.
Government Entities: External Auditors

Auditors working in government entities can be affected by their employer’s placement within the government and the structure of the government entity being audited. The independence standard applies to auditors in government entities whether they report to third parties externally (external auditors), to senior management within the audited entity (internal auditors), or to both.

Some of these organizations are subject to constitutional or statutory safeguards that protect their independence. The following are a few examples from the Yellow Book:

- Governmental structures in which a government audit organization is at a level of government other than the one of which the audited entity is part (federal, state, or local), for example, U.S. auditors auditing a New York State government program

- Governmental structures in which a government audit organization within a different branch of government from that of the audited entity (for example, legislative auditors auditing an executive branch program)

Internal Auditor Independence

Some federal, state, and local government entities employ auditors to work for management. These auditors may be subject to administrative direction from persons involved in the entity management process. These government auditors perform internal audit functions and are encouraged to use the Institute of Internal Auditor’s International Standards for the Professional Practice of Internal Auditing in conjunction with GAGAS.

A government internal auditor can be presumed to be free from independence impairments if the head of the audit organization

- is accountable to the head or deputy head of the government entity or to those charged with governance;
- reports the audit results both to the head or deputy head of the government entity and to those charged with governance;
- is located organizationally outside the staff or line-management function of the unit under audit;
- has access to those charged with governance; and
- is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.
Review Questions

1. Trott & Company, CPAs, is performing an audit of Sunshine County under GAS. Which of the following situations would most likely prompt the firm to consider whether their independence is impaired?
   
   a. Sunshine’s controller demands that the firm complete the audit in three weeks less than Trott & Co. needs to complete the audit.
   
   b. Sunshine’s board of governors wants to meet with the team to discuss the status of the audit.
   
   c. Sunshine’s accounting clerk, whose work the auditors have already reviewed, has made last minute plans to go on vacation.
   
   d. Sunshine’s internal auditors have questions about some of Trott & Co.’s inquiries and arrange a meeting with them.

2. George Lem works for the San Antonio Buildings Department as an internal government auditor. He and his boss, Theresa Rose, report to the department’s governing body. A statute gives Theresa sole authority over the selection, retention, advancement, and dismissal of her department’s staff. Would George and Theresa be considered organizationally independent of the Buildings Department?
   
   a. No, because internal government auditors can never be considered independent of their employers.
   
   b. No, because the internal audit function is so poorly staffed.
   
   c. Yes, if the internal audit function meets all of the safeguards outlined in the Yellow Book.
   
   d. Yes, if the internal audit function also follows guidelines put forth by the Institute of Internal Auditors.

Non-Audit Services

The Yellow Book imposes certain requirements the auditor must meet before agreeing to provide a non-audit service to an audited entity (the client). These requirements include the following:

- The auditor should determine whether providing such a service would create a threat to independence, either by itself or in the aggregate. Critical to the determination is management’s ability to effectively oversee the non-audit service to be performed.

- The auditor should determine that the client has designated an individual who possesses suitable skills, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. The auditor should document the consideration of management’s ability to effectively oversee the non-audit services.

- The auditor must not assume any management responsibilities. (Examples of management responsibilities are provided.)
• The auditor should establish and document the understanding with the client’s management or those charged with governance regarding the following:
  – Objectives of the non-audit service
  – Services to be performed
  – Client’s acceptance of its responsibilities
  – Auditor’s responsibilities
  – Any limitations of the non-audit service

The Yellow Book differentiates routine activities that auditors perform in conjunction with an audit, for example, providing advice or assistance to the entity on an informal basis as part of the audit, and non-audit services. For example, activities such as financial statement preparation, cash to accrual conversions, and reconciliations would not be considered routine activities, but rather non-audit services subject to the independence requirements. Examples of routine activities directly related to an audit are provided in Paragraph 3.41 of the Yellow Book.

Under the Yellow Book, an auditor who previously performed non-audit services for an entity that is a prospective subject of an audit should evaluate the effect of those non-audit services on independence before accepting an audit. If the non-audit services were performed in the period to be covered by the audit, the auditor should (1) determine if the non-audit service is expressly prohibited by GAS, and if not, (2) determine whether a threat to independence exists and address any threats noted in accordance with the conceptual framework.

The Yellow Book addresses several specific non-audit services, including financial statement preparation, internal audit services, internal control monitoring, and valuation services, among others.

The standards include four specific requirements for documenting compliance with independence requirements:

• Document threats to independence that require the auditor to apply safeguards, along with safeguards applied, in accordance with the conceptual framework for independence.

• Document the safeguards if an audit organization is structurally located within a government entity and is considered independent based on those safeguards.

• Document consideration of management’s ability to effectively oversee a non-audit service to be provided by the auditor.

• Document the auditor’s understanding with the client about the non-audit service.
**GAO Illustration: Non-Audit Services**

Imagine you are on an engagement team that audits a small city. The client recently lost a key employee and is soliciting your firm’s help to close its books on a temporary basis. The client would like your firm to help close the books each month. Specifically, the client is asking for your firm to maintain the depreciation records for the fixed assets and to do all of the adjusting and closing entries each month.

**Case Study Question**

1. What do you think? May your firm perform these services under the Yellow Book and still maintain its independence? Use the space below to write in your answer and make sure you provide a detailed explanation. Consider whether you need to apply the conceptual framework to this situation. When you have finished, go to the end of the chapter for feedback.
Case Study Suggested Solution

1. You would need more details to determine whether or not these services would be permitted.

   For example, management must review and approve the adjusting and closing entries your firm prepares and take full responsibility for them. This means that management must be fully competent to review your work and take responsibility for it. You must also document your assessment of management’s ability to effectively oversee the non-audit services. If you determined that you needed to apply safeguards under the conceptual framework because threats were not at an acceptable level, then you should also document your application of the framework, including the specific safeguards applied to eliminate the threat(s) or reduce the threat(s) to an acceptable level. This is in addition to the documentation of your understanding with the client about the non-audit service.

Non-Audit Services: Documentation Practice Aid

The AICPA’s Government Audit Quality Center (GAQC) developed a practice aid to assist auditors in their preparation of documents supporting their use of the conceptual framework to nonaudit services engagements. See the following website:
www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/Pages/YellowBookAuditToolsandAids.aspx

Recap and Other Facts

You should evaluate your independence under the Yellow Book via its four interrelated sections, providing the following:

- A conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments
- Requirements for and guidance on independence for audit organizations that are structurally located within the entities they audit
- Requirements for and guidance on independence for auditors performing non-audit services, including indication of specific non-audit services that always impair independence and others that would not normally impair independence
- Requirements for and guidance on the documentation necessary to support adequate consideration of auditor independence

The Conceptual Framework provides a means for auditors to assess their independence in light of unique circumstances and assists auditors in maintaining independence of both mind and appearance. It can be applied to many circumstances that create threats to independence and
allows auditors to address threats to independence that result from activities that the Yellow Book does not specifically prohibit.

Auditors should apply the conceptual framework at the audit organization (that is, the CPA firm), audit engagement, and individual auditor levels to

- identify threats to independence;
- evaluate the significance of the threats identified, both individually and in the aggregate; and
- apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, then independence would be considered impaired.

The framework describes threats to independence and examples of safeguards to eliminate threats or reduce them to an acceptable level.
Overview of the DOL Independence Rules

Professionals in public accounting who perform audits of employee benefit plans under the Employee Retirement Income Security Act (ERISA) are subject to the independence rules of the DOL.

The DOL established independence requirements for employee benefit plan audits in the 1970s under Regulation 2509.75-9, Interpretive Bulletin Relating to Guidelines on Independence of Accountants Retained by Employee Benefit Plan. AICPA rules also apply to employee benefit plan attest clients. DOL rules are generally more restrictive, so it is important to know these requirements.

In particular, the DOL defines a *member* in much broader terms than the AICPA’s *covered member*. The DOL’s definition includes all owners, partners, or shareholders in the firm, all professional employees participating in the audit, and all professional employees located in an office of the firm participating in a significant portion of the audit. So, what restrictions apply to a member under the DOL rules?

A *member* is not independent if during the period of the financial statements, the period of professional engagement, or at the audit report date, the member or member’s firm

- had or was committed to acquire a direct or material indirect financial interest in the plan or plan sponsor,
- was connected with the plan or plan sponsor as a promoter, underwriter, or investment advisor, or
- was employed by the plan or plan sponsor as a voting trustee, director, or employee.

DOL rules provide little detail and can be unclear, for example, the bulletin states that independence is impaired if an accountant or a member of an accounting firm maintains financial records for the employee benefit plan but does not elaborate on what is meant by “maintaining financial records.”

The bulletin also indicates that the DOL “will give appropriate consideration to all relevant circumstances, including evidence bearing on all relationships between the accountant or accounting firm and that of the plan sponsor or any affiliate thereof.”

In 2012, the AICPA Employee Benefit Plan Audit Quality Center (EBPAQC) issued the “DOL and AICPA Independence Rule Comparison,” which provides a side-by-side analysis of the rules and how, in certain instances, the rules differ. This tool is available on the AICPA’s website at www.aicpa.org/InterestAreas/EmployeeBenefitPlanAuditQuality/Resources/AccountingandAuditingResourceCenters/AuditorIndependence/DownloadableDocuments/DOL_AICPA_Independence_Rule_Comparison.pdf.
Review Question

3. Which of the following types of services does the DOL address in its interpretive bulletin?

   a. Information technology services.
   b. Maintenance of financial records.
   c. Valuation services.
   d. Internal audit outsourcing.
Overview of Banking and Insurance Regulators

FDIC

If you serve clients in the financial services industry, you should be aware that certain agencies overseeing the industry have taken positions on auditor independence. The Federal Deposit Insurance Corporation (FDIC), at times in concert with other federal banking agencies, has issued policy statements addressing auditor independence. Policy statements have addressed internal audit outsourcing, corporate governance rules adopted as a result of Sarbanes-Oxley, and auditor indemnification.

For further information about the FDIC policy statements, visit their website: http://search.fdic.gov/search?access=p&output=xml_no_dtd&sort=date%3AD%3AL%3Ad1&site=fils&ie=UTF-8&btnG=Search&client=fils&oe=UTF-8&proxystylesheet=fils&q=auditor%20independence%20standards&ip=108.27.226.182&filter=p&ulang=en&entqr=0&entqrm

The following table\(^1\) illustrates the applicability of the AICPA, SEC, and PCAOB independence standards to financial institutions.

<table>
<thead>
<tr>
<th>Applicability of Independence Standards</th>
<th>AICPA Independence Standards</th>
<th>SEC Independence Standards</th>
<th>PCAOB Independence Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Scenario 1</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Nonpublic institutions not subject to Part 363 of the FDIC regulations or Section 562.4 of the OTS regulations</td>
<td>YES</td>
<td>NO</td>
<td>NO</td>
</tr>
<tr>
<td><strong>Scenario 2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Public and nonpublic institutions subject to Part 363 of the FDIC regulations or Section 562.4 of the OTS regulations</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
<tr>
<td><strong>Scenario 3</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Institutions and holding companies that are public companies (regardless of size)</td>
<td>YES</td>
<td>YES</td>
<td>YES</td>
</tr>
</tbody>
</table>

\(^1\) Source: FDIC website (Supervisory Insights/Accounting News: Auditor Independence).
Part 363 of the FDIC Regulations: Independent Audit and Reporting Requirements

Part 363 of the FDIC’s regulations sets forth annual independent audit and reporting requirements for insured institutions with $500 million or more in total assets. The regulations address a range of issues and indicate that auditors must comply with independence requirements of the AICPA, the SEC, and the PCAOB. If the independence requirements differ, auditors should apply the most restrictive provisions among them.

The regulations also provide that the institution’s audit committee must, among other things, appoint, compensate, and oversee the independent auditor, and meet their own independence requirements. These regulations are aligned with the SEC’s. For example, the audit committee must ensure that auditor independence and other part 363 requirements are met; that is, audit engagement letters do not contain “unsafe and unsound” limitation of liability provisions.

NAIC

The National Association of Insurance Commissioners’ (NAIC) “Model Audit Rule” incorporates several aspects of the SEC’s independence requirements, including the following:

- Prohibitions on indemnity or other agreements to release an insurer’s auditor from liability
- Audit partner rotation, that is, lead audit engagement partner assigned to an insurance company engagement must rotate after five consecutive years of service, after which he or she must remain apart from the engagement for another five years
- Restrictions on non-audit services (Insurers with direct written and assumed premiums of less than $100 million in any calendar year may request an exemption from these requirements on the grounds that applying the SEC rules would cause financial or organizational hardship on the insurer.)
- Audit committee pre-approval of permitted non-audit services and all audit and other attest services to be provided by the auditor
- A one-year “cooling off” period during which the senior members of an insurer’s audit team would be precluded from becoming a member of the board, president, CEO, controller, CFO, CAO, or any equivalent position for an insurer (applies to partners and senior managers involved in the audit)

Individual state insurance commissions have the option of adopting the Model Audit Rule (or a variation of the rules).
International Ethics Standards

Sharp increases in the number of multi-national audits being performed by U.S. accounting firms means that more CPAs are performing services under the International Federation of Accountants (IFAC) audit and attest standards. Although auditors must comply with the standards of their specific jurisdictions, familiarity with IFAC’s IESBA Code of Ethics for Professional Accountants (IESBA Code), in addition to the AICPA Code, is a critical first step. When the requirements of these two codes differ, members should comply with the more restrictive of the standards.

The IESBA Code serves as the foundation for codes of ethics developed and enforced by IESBA member bodies, such as the AICPA in the U.S. That Code is based on the conceptual framework approach to ethics compliance, which like the AICPA conceptual framework for independence, requires accountants to evaluate threats to their compliance with the Code to determine their significance, and if necessary, apply safeguards to bring those threats to an acceptable level or eliminate them completely.

Comparing the Codes

The IESBA and AICPA codes are more similar than different, and in many cases, applying the codes to the same fact pattern will yield similar results. For example, the codes are similar in areas such as independence, due care, confidentiality and the truthful reporting of information. The principles underlying each code are also similar. The IESBA ethics requirements for professional accountants in business, such as corporate accountants, are similar to those found in the AICPA Code.

Under the IESBA Code, professional accountants are required to comply with the code’s fundamental principles and apply a conceptual framework approach to determine their compliance with the fundamental principles when they know (or should know) that circumstances or relationships may compromise their compliance. While the onus is on the professional accountant to do this, the bulk of the IESBA Code describes how the conceptual framework applies in specific situations. For example, it describes:

- how providing non-assurance services, such as valuations, to an audit client may threaten an accounting firm’s independence; and

- how receiving gifts or other inducements from a superior may threaten a corporate accountant’s objectivity.
The IESBA Code provides guidance for the more common, but certainly not all, practice situations. In all other instances, once a threat is identified, the IESBA requires a professional accountant to

- evaluate the significance of the threat, that is, determine whether the threat is at an acceptable level, meaning the threat would not compromise or appear to compromise the accountant’s compliance with the principles; and

- if the threat is insignificant, that is, at an acceptable level, no further evaluation is required; or

- if the threat is significant, that is, not at an acceptable level, consider whether safeguards could eliminate or sufficiently reduce the threat to an acceptable level; and
  
  - apply safeguards, as necessary, to eliminate or sufficiently reduce the threat to an acceptable level, or
  
  - decline to perform (or discontinue) the engagement or professional services.

Like the AICPA Code, in several instances the IESBA Code states that the threats in a given situation are so significant that no safeguards can be applied to reduce or eliminate threats to an acceptable level. For example, an audit team member could not own stock in his or her client and apply safeguards to mitigate the threat to independence because the IESBA Code prohibits audit team members from investing in their clients. In other words, it explicitly states that the threat to independence is insurmountable.

As mentioned, the codes address many of the same topical areas. However, some differences exist. For example, the AICPA Code dictates how members in public practice may structure and name their accounting practices and describes several “discreditable acts” that violate the Code; the IESBA does not.

The IESBA Code provides detailed guidance on certain potential independence matters that do not appear, or are addressed differently, in the AICPA independence rules. Examples include long association of senior personnel (including partner rotation) with a client and fees—relative to size. For example, a member concerned about the significance of his or her audit fee would apply the AICPA Conceptual Framework (because no AICPA independence rule exists on the subject). Nevertheless, as both codes base their independence standards on the conceptual framework approach, the member should achieve a similar result applying either code.
The IESBA Code also imposes additional independence provisions that reflect the public’s keen interest in certain types of entities. Public interest entities (PIEs) are listed entities, for example, entities whose securities are listed on a recognized stock exchange, and entities whose auditors are required by law or regulation to comply with the same independence requirements as listed entities, which, depending on the jurisdiction, may include certain banks or pension funds. Additional provisions fall into the following areas:

- Employment of audit team member or senior/managing partner (one-year “cooling off” period)
- Long association of senior audit personnel with audit client
- Bookkeeping/payroll services
- Valuation services
- Tax calculations
- Internal audit services
- Information technology system design or implementation services
- Recruitment services
- Significant client fees

The AICPA rules do not include similar provisions for PIEs in these areas. However, the Code broadly requires members to comply with more restrictive rules applicable to their engagements, and suggests that additional safeguards may be appropriate to reduce threats to independence when applying the conceptual framework, which can bring about similar results as the IESBA PIE rules. For instance, if B Company lists its common stock on the New York Stock Exchange, it would be considered a PIE under IESBA standards. A member auditing B Company who complies with the independence rules of the SEC and the PCAOB would also be in compliance with the AICPA and the IESBA codes because the SEC/PCAOB rules are as stringent, and, in some cases, more so, than the IESBA requirements.

New and In the Works

The 2013 edition of the Code include revisions in the following three areas.

- **Breach of a requirement of the Code** – The Code more comprehensively addresses a professional accountant’s actions when encountering a breach of a Code requirement. In particular, the changes establish a robust framework for addressing a breach of an independence requirement (effective on April 1, 2014, with early adoption permitted).

- **Conflicts of interest** – The Code established more specific requirements and provides more comprehensive guidance to support professional accountants in identifying, evaluating, and managing conflicts of interest. The changes clarify the meaning of a conflict of interest under the Code. They affect both professional accountants in public practice and professional accountants in business, taking into account their different circumstances (effective on July 1, 2014, with early adoption permitted).

**Definition of Engagement Team** – Clarified that the term *engagement team* excludes individuals within the client’s internal audit function who provide direct assistance on an audit engagement when the external auditor complies with the requirements of ISA 610 (Revised 2013), *Using the Work of Internal Auditors* (effective for audits of financial statements for periods ending on or after December 15, 2014, with early adoption permitted).

**Also New**

Changes to the definition of *those charged with governance* more closely aligns the definition in the Code with that in the international auditing standards. The changes clarify that a subgroup of those charged with governance of an entity, such as an audit committee, may assist the governing body in meeting its responsibilities.

**In the Works**

*Responding to a Suspected Illegal Act*, a 2012 exposure draft (ED), proposed new requirements that address a professional accountant’s responsibilities regarding the disclosure of suspected illegal acts committed by a client or employer. The proposals describe the circumstances in which a professional accountant is required or expected to override confidentiality and disclose the act to an appropriate authority. The ED proposes adding two new sections addressing illegal acts to the Code—one each for professional accountants in public practice and professional accountants in business—the new sections clearly delineating the expected course of action for a professional accountant to take if those charged with governance do not respond to the issue appropriately.

Questions to Consider and Lessons Learned

This chapter discussed some key points about the independence rules of the GAO, the DOL, the FDIC, the IFAC, and state insurance regulators.

Questions to Consider

- When are clients subject to other regulatory independence requirements?
- Where can I find other regulatory independence requirements?
- How can I stay current with other regulatory independence requirements?

Lessons Learned

- Know when additional independence rules apply to a client.
- Apply specific regulations (when required) in addition to the AICPA rules; that is, apply the most restrictive rules.
Solutions to Review Questions

1.  
   a. Correct. Pressure exerted by the client to perform the audit in an unreasonable period may impair the firm’s independence.  
   b. Incorrect. On its face, this would be a reasonable request and not necessarily cause to believe pressure was being exerted on the auditors.  
   c. Incorrect. Based on these facts, the auditors would not likely believe this had any bearing on their independence.  
   d. Incorrect. This appears to be a reasonable situation that would not cause the firm to consider their independence.

2.  
   a. Incorrect. Under certain conditions, internal auditors in government may be considered independent.  
   b. Incorrect. Staffing levels would not have any bearing on independence.  
   c. Correct. If the internal audit function meets several safeguards provided for in the Yellow Book, it will be considered to be independent.  
   d. Incorrect. While GAS encourages internal auditors to follow these guidelines, this would not necessarily make them independent.

3.  
   a. Incorrect. The bulletin does not address information technology services.  
   b. Correct. The bulletin indicates that auditors should not maintain a plan’s financial records.  
   c. Incorrect. The bulletin does not address valuation services.  
   d. Incorrect. The bulletin does not address internal audit outsourcing.
Chapter 5

Ethics Rules for Tax Practice

Introduction
Professional ethics rules require you to comply with all professional standards promulgated by bodies designated by the AICPA Council. Therefore, if you are performing audit, review, management consulting, tax, or other services, you must also refer to the applicable technical requirements in each area. In this chapter, we will cover briefly the ethics rules for tax practice. These rules apply to all members.

Learning Objectives
At the end of this chapter, you will be able to:

- Identify the organizations that set and enforce the ethics rules affecting tax practice.
- Describe the AICPA Statements on Standards for Tax Practice (SSTS).
- Identify provisions of the IRS Circular No. 230.
- Apply preparer penalty provisions included in the Internal Revenue Code (IRC).
Standard-Setting Bodies and Regulators

The primary rules of conduct for federal tax practice that apply to AICPA members are promulgated by three entities: the AICPA, the U.S. Congress, and the IRS, a government agency which is a bureau of the U.S. Department of the Treasury. In addition, CPAs in tax practice may be subject to the rules of other regulators as well.

For example, other significant regulators could include the applicable taxing authority, for example, state, foreign, and local taxing authorities; the state board of accountancy; the state bar; the state CPA society; and the American Bar Association.

AICPA Code of Professional Conduct

Many rules found in the AICPA Code of Professional Conduct (the Code) apply to tax practice, including the following, among others:

- Due professional care
- Competence
- Contingent fees
- Confidential client information
- Independence
- Records retention

The AICPA Council designates bodies to promulgate technical standards under the rules, and the bylaws require adherence to those rules and standards. The Tax Executive Committee promulgates the SSTS, which are enforceable under the General Standards and Compliance With Standards rules of the AICPA Code.

AICPA members are subject to disciplinary proceedings if they are alleged to have engaged in certain acts deemed to violate the AICPA rules of conduct, including the SSTS or the bylaws. Investigations of a member’s conduct are designed to provide due process to the member and consideration of all relevant facts and circumstances. Possible results of an investigation include a letter of required corrective action, an admonishment, or suspension or termination of AICPA membership. Terminations, suspensions, and admonishments are subject to publication.

To enhance efficiencies, the AICPA engages in a joint ethics enforcement program with many of the state CPA societies. As you can see, certain bylaws allow for automatic termination or suspension of AICPA membership rights, for example, a member who is found by a court to
have committed a crime that discredits the profession or who fails to cooperate with the AICPA in a disciplinary proceeding.

In addition, a member who willfully fails to pay his or her personal taxes or files a fraudulent tax return, for himself or a client, is also subject to disciplinary action without a hearing.

**AICPA Bylaw Section 7.3 Disciplinary Action Without a Hearing**

Membership in the Institute shall be suspended or terminated without a hearing for disciplinary purposes, or a member may be subjected to other disciplinary actions, as provided in section 7.3.1 and section 7.3.2, under such conditions and by such procedure as shall be prescribed by the Council.

Federal tax law is codified in the IRC. Section 7805(a) of the IRC authorizes the Secretary of the Treasury to promulgate rules and regulations necessary to enforce the U.S. tax laws.


This governs federal tax practice before the IRS by CPAs, enrolled agents, attorneys, enrolled retirement plan agents, appraisers and actuaries. The preparer penalty provisions appear in the IRC.

In 2012, the IRS proposed revisions to Circular No. 230 that were pending at the time this course was updated which include the following:

- Simplification of the “covered opinions” rule
- Broadening the scope of the procedures required to help a firm comply with Circular No. 230 provisions
- Expansion of the categories of violations subject to expedited proceedings
- Updating the regulation prohibiting a practitioner from negotiating a taxpayer’s check to include all forms of payment, electronic and otherwise

The IRS director of the Office of Professional Responsibility (OPR), operating under the IRS Commissioner’s office and the Treasury Department, may censure, suspend, or disbar a practitioner from practicing before the IRS if the practitioner is shown, among other things, to be incompetent or disreputable.

Certain disciplinary actions taken against practitioners will result in notification to certain parties. This is addressed in section 10.80 of Circular No. 230.
Section 10.80 Notice of Disbarment, Suspension, Censure, or Disqualification

On the issuance of a final order censuring, suspending, or disbarring a practitioner or a final order disqualifying an appraiser, the director of the Office of Professional Responsibility may give notice of the censure, suspension, disbarment, or disqualification to appropriate officers and employees of the Internal Revenue Service and to interested departments and agencies of the federal government. The director of the Office of Professional Responsibility may determine the manner of giving notice to the proper authorities of the state by which the censured, suspended, or disbarred person was licensed to practice.

Also, in certain matters involving egregious behavior, for example, fraud or breach of trust, the IRS may immediately suspend a practitioner. The AICPA bylaws provide an “automatic” disciplinary provision, which allows it to impose disciplinary sanctions on a member found by the IRS (or another relevant regulator or similar body) to have committed a serious violation of the profession’s standards.

For example, a six-month suspension by the IRS for non-payment of taxes would result in a six-month suspension of AICPA membership without a hearing, which would also be subject to publication in The CPA Letter or in another publication.

Other Rules and Regulators

Depending on the types of engagements in which CPAs and their firms engage, CPAs in tax practice may be subject to the rules and regulations of other bodies, including the following:

- State Accountancy Board or CPA Society
- State Bar Association
- Securities and Exchange Commission (SEC)
- Public Company Accounting Oversight Board (PCAOB)
- Department of Labor (DOL)
- Government Accountability Office (GAO)
- Others

Many of these bodies also engage in investigative and disciplinary activities with respect to the CPAs and firms under their jurisdictions. In addition, many state accountancy boards have incorporated the SSTS into their regulations.
Competence and Due Professional Care

The case studies in this chapter take place in a CPA firm, SemperBarnes, LLP, a mid-sized accounting practice with six offices. SemperBarnes’s primary service offerings are accounting, auditing, tax, advisory, valuation and litigation support services. The firm’s client base is mainly privately held companies, but also includes not-for-profits, benefit plans, individuals, and a small number of public registrants.

Harold Barnes, CPA, is a senior tax partner and co-founder of the firm; he is also the main character in our case studies. Harold is in charge of the firm’s tax practice, including its quality control policies and procedures. He also serves as the firm’s primary consultant on tax engagements. Today, Harold Barnes is following up on a review he did of a corporate tax return prepared by an engagement team led by David Thompson, CPA, and a junior partner who was recently admitted to the firm. Harold has asked David to join him in his office to discuss the return.

Harold: “David, thanks for coming by. I have reviewed the tax return you prepared for the Dunlop account and have some questions. In particular, I am curious about one of the calculations. I’m not sure I agree with your classification of certain items.”

David: “I’m surprised to hear you say that; the client said they had the exact same transaction last year so the staff pulled last year’s work papers and modeled the calculation after that. We also researched the Code to ensure there had been no recent decisions or rulings that would affect the calculations and there were none.”

Harold: “Did you review and agree with the analysis used for the calculations on last year’s return and do you feel that you reviewed enough of the underlying documents for this year’s transaction to conclude that the same analysis should apply this year?”

David: “We looked at some of the analysis and documents; not absolutely everything though. I felt comfortable relying on last year’s work; after all, you were the tax partner!” (pausing, getting a little defensive) “And, since demands on my time and my manager have been huge lately, and the client said that the transaction was the same as last year’s….”
Case Study Question

1. Do you think David exercised due diligence in preparing the tax calculation?
   
a. Yes, David followed last year’s calculation and obtained the client’s representation that the transaction was the same, which should suffice.

b. No, David should have reviewed last year’s analysis and enough of the underlying documentation, obtaining assistance, if needed, with any technical issues.
Case Study Suggested Solution

1. a. Incorrect. David needed to make a better effort to establish tax law and the facts, obtaining assistance, if needed, with any technical issues.
   b. Correct. In addition to reviewing last year’s return, David needed to review and agree with the analysis used for the calculations on last year’s return and to review enough of the underlying documents for this year’s transaction to conclude that the same analysis should apply this year. He should have sought technical assistance, if needed.

Some Aspects of Due Professional Care

Establish facts:

- Determine which facts are relevant.
- Evaluate reasonableness of assumptions or representations.
- Relate the applicable law to the facts.
- Arrive at a conclusion based on law and facts.

Also,

- review prior year tax returns; and
- for new clients, or as needed for existing client engagements, review the permanent file.

Harold: “David, regardless of who worked on a job before you, even a very senior person such as myself, you need to exercise due professional care. Since the client is new to you, you should review not only the prior year return, but also the permanent file, for example, legal documents such as deeds, trusts, and incorporation documents, and any documents related to your review of the client’s current year tax situation.

In addition, just because the client believes that a transaction is identical to one they had in a prior year does not mean that for tax purposes it necessarily is. I know this client well. They would not try to mislead you, but they may leave something out that’s relevant from a tax perspective. It’s your job to dig in.

Since you are new to the firm, let’s talk a bit about the practice aids and research you and the staff used to prepare this return. I think perhaps you just need to get more attuned to the tools we have available and the way we generally do things.”
Some Aspects of Competence

- Complying with professional standards
- Applying knowledge and skill with reasonable care and diligence
- Having both the technical qualifications and the ability to supervise and evaluate the work of others
- Knowing the profession’s standards, the techniques, and the technical subject matter involved, and making sound judgment in applying such knowledge

In some cases, even a competent person should perform additional research or consult with others when performing professional services.

*If a member is unable to gain sufficient competence through these means, the member should suggest, in fairness to the client and the public, the engagement of someone competent to perform the needed professional service, either independently or as an associate.*

**Harold:** “There was one other item I wanted to discuss. It has to do with your preliminary suggestions regarding a trust the Dunlop family is establishing with both their attorney’s advice and our input. We placed you on this account not realizing this type of issue would arise; have you done much work with charitable remainder trusts?”

**David:** “No, but I have worked extensively with other types of trusts. Do you disagree with the classification?”

**Harold:** “I am not sure. I have not worked in the trust area for a few years so I plan to give these documents to Gina so she can give us her opinion. If we are dealing with a charitable remainder trust, she’ll work with you. In the meantime, I would suggest that you check into training opportunities. This is a very complex area of the Code; very specialized, and the risks of making an error are too great. Our firm’s policies will not allow you to serve as responsible partner on this account unless you are fully competent to do this work.

And by the way, please don’t hesitate to ask for help when you find yourself encountering something new or different. Our firm has worked hard to develop consulting resources, both within and outside the firm, and we pride ourselves on our consultative culture. By asking for help, you will be helping to protect the client from incurring penalties or losing out on tax savings. You also help protect the firm and yourself from liability and other adverse consequences.”
Conflicts of Interest

After the meeting with David, Harold joins a colleague from the firm for lunch at a local restaurant.

*Harold:* “Did you hear? We just landed a new tax and valuation services client, Callway Industries. They’re headquartered in Alexandria, Virginia. They may also use us for litigation support.”

*Linda:* “Really? Doesn’t Sid have a relative who works for Callway? Possibly in their tax department?”

*Harold:* “That’s right. We might not be able to use Sid on the account. He would be a natural with his manufacturing background but there could be a conflict of interest.”

Review Question

1. What do you think? Is there a potential conflict of interest?

   a. This is not an issue since an audit or attest work will not be performed.
   b. This may be a problem depending on the specifics.
   c. This is a definite problem and Sid should not be placed on this account.

*Harold:* “Both the AICPA rules and the Circular 230 rules require that we address all potential conflicts of interests. We are required to perform all services, including tax, in an objective manner. Now, if Sid believes he cannot perform the services objectively because of his relative’s employment, he would not serve on the account.

But, if he believes that this will not cause him to lose his objectivity, he may be able to. It depends on whether Callway and any other appropriate parties, such as the board of directors, will give their consent. If they object to it, it’s a non-starter.”
IRS Circular 230: Section 10.29, Conflicting Interests

1. Read the following Circular 230 rule, and then indicate which portion of the rule applies to the Callway situation.

(a) Except as provided by paragraph (b) of this section, a practitioner shall not represent a client in his or her practice before the Internal Revenue Service if the representation involves a conflict of interest. A conflict of interest exists if:

(1) The representation of one client will be directly adverse to another client; or
(2) There is a significant risk that the representation of one or more clients will be materially limited by the practitioner’s responsibilities to another client, a former client or a third person or by a personal interest of the practitioner.

(b) Notwithstanding the existence of a conflict of interest under paragraph (a) of this section, the practitioner may represent a client if:

(1) The practitioner reasonably believes that the practitioner will be able to provide competent and diligent representation to each affected client;
(2) The representation is not prohibited by law;
(3) Each affected client gives informed consent, confirmed in writing.

(c) Copies of the written consents must be retained by the practitioner for at least 36 months from the date of the conclusion of the representation of the affected clients and the written consents must be provided to any officer or employee of the Internal Revenue Service on request.

(Approved by the Office of Management and Budget under Control No. 1545-1726.)

a. Sid may have a conflicting interest because his representation of Callway may be directly adverse to another client.
b. Sid may have a conflicting interest because his representation of Callway may be materially limited by his personal interest.
Suggested Solution

1. 
   a. Incorrect. This is not a matter involving two clients with adverse interests.
   b. Correct. Section 10.29(a)(2) states that a conflict exists if, among other things, there is significant risk that the representation of a client will be materially limited by a personal relationship of the practitioner.

_Linda_: “I remember a conflict situation I had several years ago when I was providing services for a married couple that was breaking up. Both wanted me to continue to do work for them.”

_Harold_: “Right. These situations also come up with partnerships that split up. It depends on the specific facts and circumstances and our comfort level whether we think we can continue to perform our services objectively. It’s really a matter of professional judgment. Do we reasonably believe we can provide competent and diligent representation to each of the affected clients?

If we decide to move forward and perform services where a potential conflict exists, we must remember: Circular 230 requires that each affected client waive the conflict and provide informed consent confirmed in writing. We are required to keep the consent from _each directly interested party_ on file for at least three years. We had a divorced couple’s returns audited last year and the IRS asked to see the consent forms.

Well, look at the time, I have to run. I have a staff training session on the IRS penalty provisions and it starts in 15 minutes.”
Statements on Standards for Tax Services

The SSTS are enforceable ethics standards under the AICPA Code (General Standards and Compliance With Standards rules) which apply to all AICPA members providing tax services, whether in public practice or in private industry.

These standards apply to work performed in foreign and domestic tax jurisdictions, at all levels of government (federal, state, and city), and complement other standards of tax practice, for example, the penalty provisions of the IRC. They address important practice issues encountered by tax practitioners and provide valuable guidance.

In 2000, the AICPA Tax Executive Committee adopted the original eight statements to provide helpful authoritative guidance on how tax practitioners should perform their work under the AICPA Code.

The SSTS were based largely on the Statements on Responsibilities in Tax Practice (SRTP), a set of advisory opinions issued between 1964 and 1977.

The SSTS were made enforceable standards because courts, state accountancy boards, the IRS, and others were interpreting the non-authoritative SRTP as de facto ethics standards for tax practice.

Since their issuance in August 2000, AICPA members have sought clarification on the SSTS. Effective January 1, 2010, the Statements have been updated and clarified to make them more understandable. Also, Statement No. 1, Tax Return Positions, was revised in light of recent legislative and regulatory changes. In addition, Statement No. 6 and Statement No. 7 were consolidated, as their content significantly overlapped.

SSTS No. 1: Tax Return Positions

Primary question addressed: “What standard must a member meet to recommend a tax return position and sign a tax return?”

- **Non-Disclosed Tax Positions** comply with the tax return reporting standard of the applicable taxing authority. If no such standard exists or the taxing authority’s standard is lower than the realistic possibility standard, that is, the member believes in good faith that the position has at least a realistic possibility of being sustained administratively or in the courts, if challenged, then the realistic possibility standard applies.

- **Disclosed Tax Positions** comply with the tax return reporting standard of the applicable taxing authority. If no such standard exists or the taxing authority’s standard is lower than

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the reasonable basis standard, that is, the member believes in good faith that there is a reasonable basis for the position, then the reasonable basis standard applies.

- When relevant, members should advise taxpayers of the disclosure requirements and how to avoid penalties through disclosure.

**Interpretation 1-1**

The first interpretation of tax standard No. 1 states that the realistic possibility standard is met when the position is warranted under existing law, or it can be supported by a good faith argument, that is, it is based on a reasonable interpretation of the law. To determine whether the realistic possibility standard has been met, generally, you would do the following:

- Establish relevant facts.
- Distill relevant questions from the facts.
- Research authoritative literature to answer those questions.
- Conclude based on your research.

**Interpretation 1-2**

The second interpretation of tax standard No. 1 is intended to clarify existing standards with respect to your responsibilities in connection with the provision of tax planning services including those situations involving tax shelters, regardless of how that term is defined. The interpretation does not change or elevate any level of conduct prescribed by any standard.

“Tax planning” includes

- prospective and completed transactions;
- written and oral advice;
- tax return positions; and
- specific tax plans developed by the member, the taxpayer, or a third party.

Appropriate due diligence steps should be applied to the evaluation of third-party opinions.
SSTS No. 2: Answers to Questions on Return

Primary question addressed: “May a member sign a tax return if one or more questions on the return have not been answered?”

- Members should make a reasonable effort to obtain information from the taxpayer needed to answer to all questions on a tax return before signing the return.
- Discuss when reasonable grounds would exist for omitting an answer to a question on a return.
- Not all questions are of equal importance; provide guidelines on the types of matters that should be of particular concern to members.

SSTS No. 3: Certain Procedural Aspects of Preparing Returns

Primary question addressed: “Must a member examine or verify information provided to him or her by taxpayers or other third parties?”

Members may rely in good faith, without verification, on information provided by taxpayers or third parties unless the information appears to be incorrect, incomplete, or inconsistent with other information that is known to the member, including information related to another taxpayer.

If information appears to be lacking in some manner, members should make reasonable inquiries of the taxpayer.

If there is a specific requirement for a tax treatment, for example, maintaining books and records or substantiating documentation, then the member should inquire to determine if the requirement has been satisfied.

Prior tax returns of the taxpayer should be referred to whenever possible.

SSTS No. 4: Use of Estimates

Primary question addressed: “May a member rely on a taxpayer’s estimates in preparing the taxpayer’s return?”

Assuming it is not prohibited by statute or rule, you may use estimated information supplied by your client, provided

- it is not practical to obtain exact data, and
- the estimate appears reasonable.
In some cases, you should advise the client to disclose the reason an estimate was used, for example, Schedule K-1 for a partnership was not received in time.

The information in the return should not be presented in a manner that is misleading concerning the degree of factual accuracy.

**SSTS No. 5: Departure From a Position Previously Concluded in an Administrative Proceeding or Court Decision**

Primary question addressed: “May a member recommend a tax return position to a taxpayer that departs from a position determined in an administrative proceeding or court decision with regards to the taxpayer’s prior return?”

- Yes, unless the taxpayer was bound by the court decision or administrative proceeding to apply the same tax position in subsequent years.
- The member must comply with SSTS No. 1, *Tax Return Positions*.
- Provide examples of circumstances in which it might be appropriate to recommend a different tax treatment to the taxpayer in a later year.

**SSTS No. 6: Knowledge of Error—Return Preparation and Administrative Proceedings**

Primary question addressed: “What should a member do if he or she discovers an error on a taxpayer’s previously filed return or one that is subject to an administrative proceeding, or learns that a taxpayer has failed to file a required tax return?”

- Upon becoming aware of an error, unless the error would have had only an insignificant effect on the taxpayer’s liability, the member should act promptly to advise the taxpayer of the error, the potential consequences of the error, and recommend that the error be corrected. (Advice may be oral.)
- If a member represents a taxpayer in an administrative proceeding that relates to the return that contains the error, the member should ask the taxpayer for agreement to disclose the error to the taxing authority.
- The taxpayer, not the member, is responsible for deciding whether to act on the member’s advice to correct the error.
- If the taxpayer fails to act on the member’s advice, the member should reconsider his or her ongoing association (employment or client relationship) with the taxpayer. Unless required under law or regulation or authorized by the taxpayer, the member may not disclose the taxpayer’s failure to act to the taxing authority.
SSTS No. 7: Form and Content of Advice to Taxpayers

Primary question addressed: “Does a member have a responsibility to communicate with a taxpayer when subsequent events affect the member’s previous advice?”

- Members are not obligated to communicate with a taxpayer about subsequent developments affecting previous advice unless he or she agreed to do so or is assisting the taxpayer with implementing the advice.

- Members should employ judgment in determining the form, for example, written or oral, and content of advice and should comply with the taxing authority’s requirements when relevant, for example, when providing written federal tax advice.

- Members’ advice should comply with the standards in SSTS No. 1, *Tax Return Positions*.

- Provide a list of factors members should consider in determining the most appropriate form of advice to provide to a taxpayer.

For more information, visit www.aicpa.org/InterestAreas/Tax/Resources/StandardsEthics/StatementsonStandardsforTaxServices/DownloadableDocuments/SSTS,%20Effective%20January%201,%202010.pdf.
Training Session: Preparer Penalties

Harold: “It looks like everyone is here. Thanks for coming. As you know, today we are going to discuss the IRC preparer penalty provisions and, specifically, how to avoid them for ourselves and our clients. I would like this to be a discussion and not a lecture, so, please, ask questions, even about the basics.”

Linda: “As long as you say that, would you mind by starting with a review of the basic penalty provisions?”

Harold: “Section 6694 of the IRC contains the basic preparer penalty provisions which apply to all federal tax returns, not just income tax returns. These penalties apply to understatements due to “unreasonable positions,” as well as to understatements due to willful or reckless conduct.

The penalty amounts are significant: the greater of $1,000 ($5,000 if the understatement is due to willful or reckless conduct) or half the income derived from preparing the return. Plus, a penalty under section 6694 could lead to a referral to the IRS Office of Professional Responsibility, which means that your license to practice might be at risk. Therefore, this is an area to watch carefully.”

As of today, section 6694(a) generally penalizes a tax return preparer if a client’s tax liability was understated and it was due to one of the following situations: (1) a non-disclosed tax position for which there was not “substantial authority,” or (2) a disclosed tax position for which there was not a reasonable basis. There is one situation where the penalty may be waived: if there was a reasonable cause for the understatement and the preparer acted in good faith.

How do you know whether a position has substantial authority? This means the weight of the authorities supporting the tax treatment is substantial compared to the weight of the authorities supporting the contrary treatment.

Though expressed differently, section 10.34 of Circular 230 contains a similar requirement as 6694. AICPA members also need to comply with the AICPA SSTS, including SSTS No. 1, Tax Return Positions, which sets forth the level of support needed in order to take a tax return position. These standards are not the same as the standards in section 6694; where federal or other requirements are more restrictive, members should apply the strictest standard.
Training Session: Willfulness and Accuracy-Related Penalties

Harold: “Obviously, no one in this firm would ever fall into this category of offenders, but the other preparer penalty under section 6694(b) is referred to as the “willfulness penalty.” It applies if

- any part of a client’s underpayment can be attributed to a willful attempt to understate the client’s tax liability, or
- where the preparer recklessly or deliberately disregarded the rules or regulations.”

If the preparer knew, or was reckless in not knowing, that a tax position was contrary to a rule or regulation, the penalty is the greater of $5,000, or half of the revenue derived from preparing the return. The IRS can also obtain an injunction which would prevent a preparer from practicing in the future if the preparer’s conduct involved fraud or gross incompetence.

The section 6662 penalty provision, referred to as the “accuracy-related penalty,” applies to taxpayers (clients). This penalty amounts to 20 percent of the portion of a client’s underpayment if it can be attributed to

- the client’s negligence or disregard of IRS rules and regulations,
- substantial understatement of tax, or
- substantial over- or under-valuation of certain assets or liabilities.

For example, the IRS may penalize a client if the client substantially misstated a valuation, for example, if the client overstates the value of a painting she donated to a museum. However, as in the case of preparer penalties, if there are extenuating circumstances, the IRS may provide a waiver if the client had reasonable cause for the position and acted in good faith.”

Linda: “Good faith and reasonable cause… What does that mean?”

Harold: “It essentially means that the taxpayer displayed ordinary business care and prudence to determine the tax liability, but perhaps due to circumstances they could not control, they were unable to comply. These matters are very fact-specific.”
Review Questions

2. Which of the following statements about the IRC penalty provisions in section 6694 is correct?

a. A preparer will be penalized under section 6694 even if the relevant tax position had substantial authority.
b. Penalties under section 6694 generally apply to understatements of tax due to “unreasonable positions.”
c. The regulation applies to the preparation of any federal tax return, but not to a claim for refund.
d. The regulation applies to the preparation of all federal, state, and local tax returns.

3. Alice, an AICPA member, failed to file and pay her personal income taxes in 2008. In 2010, the IRS Office of Professional Responsibility suspended Alice’s rights to practice before the IRS for one year. Given this situation, which of the following would be most likely to occur?

a. The IRS will require Alice to perform community service for up to five years.
b. The IRS will publish an account of the ethics violation in The CPA Letter.
c. The AICPA will suspend Alice’s membership in the AICPA for one year.
d. The AICPA will suspend Alice’s membership in the AICPA for an indefinite period.

4. Jeff West, a SemperBarnes tax partner, has provided tax services to two general partners in a real estate partnership for several years. Recently, the partnership was dissolved and both partners have asked Jeff to continue to provide services to them individually. Which of the following statements best describes the application of Circular No. 230 to this situation?

a. Jeff must draft and retain a memo indicating that both clients verbally consented to his continuing his services to each partner individually.
b. Jeff must obtain written consent from both parties to continue his services to each partner individually.
c. Jeff must seek permission directly from the IRS to continue to perform services to these individuals.
d. Jeff has no particular ethical obligations under Circular No. 230 in these circumstances.
Training Session: Professional Judgment and Firm Resources

**Harold:** We’ve talked a bit about having “substantial authority” for our tax position when the taxpayer will not be disclosing the position in the federal tax return, a decision that is subject to a fair amount of professional judgment.

So, how do we ensure that we reach an appropriate judgment on these types of matters? I know; it’s difficult even for experienced practitioners sometimes to judge which standard a tax position meets, but it is absolutely critical that we advise our clients properly, to protect us and them!

That is why the firm has invested in research tools and other resources, has developed detailed policies and procedures, including this training course, and developed various “subject matter experts” in the firm to help us make good judgments. We feel that for most matters, we are well equipped and have the expertise we absolutely need in today’s practice environment to make these judgments.

And where the firm does not have a particular expertise in-house, we have external resources available through our relationships with other accounting firms by our participation in the local state CPA society chapters.

So, do not ever hesitate to reach out for help; if we do not have it in-house, we know where to find it. And speaking of resources, I have two items. First, before we wrap up, I want to announce a new discussion board that we have added to the firm’s Intranet. The discussion board will be a forum for asking questions about tax matters; I will respond to your questions. Remember, the board is only for posting generic inquiries and sharing information. You should continue to contact me on specific client matters so those may be discussed privately.

Second, we have a handout which lists some of the tools and resources we have to help us get the job done. Here, pass these around and take a look at the SemperBarnes federal tax research and related tools.
1. Tax Library. The sources mentioned below are available online in the tax research database that the Firm employs. You should refer to the Online Tax Research Link for details on how to access and conduct efficient and effective research using the database.

a. Research Guidance and Tips
b. Research Materials:
   i. Legislative
      1. Internal Revenue Code
      2. Legislative History Documents
   ii. Judicial
      2. Citators (provides subsequent history and cross-references for particular cases)
   iii. Administrative
      1. Regulations (authoritative interpretation of IRC; includes final, proposed, and temporary regulations)
      2. IRS Pronouncements (as published in the weekly Internal Revenue Bulletin, includes revenue rulings, private letter rulings, revenue procedures, technical advice and general counsel memoranda, etc.)
   iv. Federal Tax Treatises (e.g. Federal Income Taxation of Income, Estates and Gifts, Federal Taxation of Corporations and Shareholders)
   v. Journal Articles (tax law articles appearing in professional journals)
   vi. Published and Computer Tax Services-using Key word, Code Section, Case Name, or Topic Searches
   vii. IRS Publications and Form instructions

c. AICPA Tax Practice Guides and Checklists
   i. Tax Form Preparation Guides
   ii. User Inserts
   iii. U.S. Estate Tax Return (706)
   iv. U.S. Gift Tax Return (709)
   v. Return of Organization Exempt From Income Tax (990)
   vi. Exempt Organization Business Income Tax Return Checklist (990-T)
   vii. Return of Private Foundation (990-PF)
viii. Individual Tax Return (1040)
ix. Estate and Trust Tax Return (1041)
x. Partnership Tax Return (1065)
xi. C Corporation Tax Return (1120)
xii. S Corporation Tax Return (1120S)
xiii. Employee Benefit Plan Return (5500 Series)
xiv. Miscellaneous Practice Guides
xv. State and Local Tax Practice Guides
xvi. Practice Management Forms
xvii. Tax Organizers

2. Policies and Procedures for Tax Engagements (SemperBarnes, LLP)

3. Engagement Letter Templates

4. Other
   a. AICPA Tax Center
      (aicpa.org/INTERESTAREAS/TAX/Pages/TaxHomepage.aspx)
      i. Practice support
      1. Articles on current tax law
      2. Checklists
      3. Engagement letters
      4. Webinars
      ii. Professional standards and ethics
      1. AICPA Code of Professional Conduct
      2. AICPA Statements on Standards for Tax Services
      3. IRC Reg. 6694
      4. Laws and regulations of the applicable taxing authority, for non-federal tax practice
      5. Standards and rules of state licensing boards and professional associations
      6. Other laws and regulations
      i. Circular No. 230
      ii. Latest News
      iii. About the Office of Professional Responsibility
      iv. Disciplinary Proceedings and Announcements
The Discussion Board

The next day, Harold sees some questions have been posted to the new discussion board. Read through each of the topics and the related replies.

Subject: Client Dispute from Dave

A client wants to take a certain deduction on Schedule C; I think the position requires disclosure in the return because while there is a reasonable basis, there is no substantial authority for the position. The client is giving me a really hard time. Do we need to drop the client? What if the chance of this item or the client’s return being audited is slim-to-none?

Reply from Harold

This is a very tough situation. If encountered, this type of matter must be elevated to my office for consideration of the facts and circumstances. In some cases, we may need to withdraw from the engagement, and, if we think the client’s refusal is indicative of future behavior, reconsider our relationship with the client.

If it is determined that the reporting standard of section 6694 cannot be satisfied without disclosure, we cannot sign the return unless it includes the disclosure. (These matters are also discussed in Circular No. 230 and in the SSTS.)

Also, we cannot take into consideration the likelihood of audit when considering a tax position. This should have no bearing on our analysis.

Subject: Reliance on Client Information from Linda

As a preparer, can I rely on information the client provides me, either orally or in writing, without verifying the information?

Reply from Harold

Generally, you may accept a client’s information without verifying the data unless the information appears to be incorrect, incomplete, or inconsistent based on other information submitted by the client or otherwise known to you.

Circular No. 230 and the AICPA Code, as described in the SSTS, require you to make reasonable inquiries in these circumstances to help you determine whether any applicable conditions have been met.

Although not required, generally it is a good idea to encourage the client to substantiate certain items on the tax return to help ensure that all sources of income and deductions arising from pass-through entities, for example, trusts, estates or partnerships, investing, and other activities are fully considered. Please call with any further questions.
Review Questions

5. Martina advises her tax client, Breslin Baked Goods, to disclose a matter by attaching a special form to its corporate tax return. Breslin refuses and threatens to replace Martina with another CPA. Which of the following statements best describes what Martina should do under the tax profession’s ethics standards in this situation?

a. Consider whether to withdraw from the engagement and re-evaluate the relationship.
b. Terminate the engagement and report Breslin to the IRS Office of Professional Responsibility.
c. Draft a memo for the files indicating that Breslin is a difficult client.
d. File the return in the manner specified by the client (without the disclosure).

6. Jodie prepared Form 1040, including a Schedule C, for her client Richard, a sole proprietor. Which of the following statements best describes her obligations under SSTS No. 7, Form and Content of Advice to Taxpayers?

a. She should communicate with Richard about subsequent developments affecting her previous advice, even if she is not contractually obligated to do so.
b. She should employ judgment in determining the form and content of her advice to Richard, even if the IRS or other regulators have specific requirements.
c. Her advice should always comply with the standards in SSTS No. 1, Tax Return Positions.
d. Her advice to Richard should always be in writing, and consented to by him.

7. Jon provides Robin, a tax manager at SemperBarnes, his tax documentation, which substantiates several large tax deductions he plans to take for the current tax year. Because of work Robin performs on one of Jon’s companies, she suspects that one of the deductions he is claiming may be significantly overstated. What are Robin’s ethical responsibilities in this instance?

a. Robin should discuss the matter with Jon, first obtaining consent from any other applicable parties regarding possible confidentiality of the information.
b. Robin should ignore the information that Jon provided her and instead prepare the tax return on the basis of other information known to her.
c. Both the IRS and the AICPA rules indicate that a preparer may accept information provided by the client without verification, so she should prepare the return based on Jon’s information.
d. Since Jon is ultimately responsible for all of the deductions claimed in the return, Robin should request indemnification from him against possible future penalties.
Client Records Requests

Harold arrives at his office early Tuesday morning with a cup of coffee. Sitting down at his computer, he sees he has received three e-mail inquiries. Read each email and his response.

From: DMarshall@SemperBarnes.com
Subject: Tax Client Request

Hi. I am working with Jay Smith on the Dorsey Electronic Account. We completed their corporate tax return but are hesitant to turn it over to them because of the difficulties we had collecting our fees last year. So we thought we would provide them the return but hold back on the supporting schedules until we get paid? Can we do that?
Thanks,
Danielle

To: DMarshall@SemperBarnes.com
cc: JSmith@SemperBarnes.com
Subject: Tax Client Request
Attachments: Records Retention Rules.pdf

Danielle,

Please read the document below, which contains the Circular 230 and the AICPA rules on the subject. In general, we are able to request payment for our work product before we release it to the client. Anything the client provided to us should be returned, of course. Please note the reference to applicable state rules.

However, under Circular 230, we cannot withhold information the client needs to meet their federal income tax obligations. So, we need to be careful about that. Call me if you have any further questions.
Regards,
Harold

Circular No. 230 Section 10.28 – Return of Client’s Records

(a) In general, a practitioner must, at the request of a client, promptly return any and all records of the client that are necessary for the client to comply with his or her Federal tax obligations. The practitioner may retain copies of the records returned to a client. The existence of a dispute over fees generally does not relieve the practitioner of his or her responsibility under this section. Nevertheless, if applicable state law allows or permits the retention of a client’s records by a practitioner in the case of a dispute over fees for services rendered, the practitioner need only return those records that must be attached to the taxpayer’s return. The practitioner, however, must provide the client with reasonable access to review and copy any additional records of the client retained by the practitioner under state law that are necessary for the client to comply with his or her Federal tax obligations.
(b) For purposes of this section—*Records of the client* include all documents or written or electronic materials provided to the practitioner, or obtained by the practitioner in the course of the practitioner’s representation of the client, that preexisted the retention of the practitioner by the client. The term also includes materials that were prepared by the client or a third party (not including an employee or agent of the practitioner) at any time and provided to the practitioner with respect to the subject matter of the representation. The term also includes any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner, or his or her employee or agent, that was presented to the client with respect to a prior representation if such document is necessary for the taxpayer to comply with his or her current Federal tax obligations. The term does not include any return, claim for refund, schedule, affidavit, appraisal or any other document prepared by the practitioner or the practitioner’s firm, employees or agents if the practitioner is withholding such document pending the client’s performance of its contractual obligation to pay fees with respect to such document.

From: CLilly@SemperBarnes.com
Subject: Client Records
Harold, I have looked at the AICPA and the Circular 230 rules for client records requests but I am unsure how the rules apply to my situation. The client is relocating to the West Coast and plans to hire another firm to do their tax work. We have completed the partnership tax returns and provided copies to the general partner. Joe, the GP, also wants records they provided us five years ago when we were first retained. What do we need to give him? By the way, we have not been paid yet.

And another question; since announcing the move, the limited partners, one by one, have been calling the office asking for their K-1 information. Are we required to respond to all these requests?

To: CLilly@SemperBarnes.com
Subject: Client Records
On your first question: Circular 230 requires us to return “records of the client” when the client requests them, unless the applicable state law allows us to withhold client records for fees. I do not believe state law permits us to do that, so, if the information meets any of the descriptions of “records of the client” below, we should provide them to the client.

“Records of the Client” includes information that (1) was provided to us and pre-existed our being retained, or (2) the client or a third party prepared at our request in connection with our services, or (3) we prepared and which the client needs to file their federal tax return.

On your second question: Under AICPA rules, you are only required to provide information to the client’s representative, that is, Joe—the GP; not all of the limited partners. Joe should be the conduit for the information; you should refer the partners to him.

2 The member is not required to convert records that are not in electronic format to electronic format. However if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client’s request should be honored.
From: KAdams@SemperBarnes.com  
Subject: Outsourced Tax Department  
I would like to speak with you about a possible engagement we have been discussing with one of our clients. The client, LeRack Enterprises, is asking if we can “lend” them some of our tax people to do compliance work. They have no staff, only a tax director, and it would save them a boatload of money if we could arrange this. However, my concern is this: Who would ultimately be responsible as “preparer”? Our firm (since they are our staff) or the client (since the client is “borrowing” our employees from us)?  
Kyle

To: KAdams@SemperBarnes.com  
Subject: Outsourced Tax Department  
Let’s get together and discuss this one. As you know, the IRC defines “preparer” rather broadly and this includes a professional who prepares a substantial portion of the return or claim for refund. See section 7701(a)(36).  
Also, the AICPA has an “applicability” standard in the Code (see below), which we will have to consider. We might also reach out to the AICPA on this one. I will want to get their perspective on the independence implications since this involves our audit client.

Take a look and then let us arrange a time to talk.  
Regards,  
Harold

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

Shortly after replying to the last e-mail, Harold receives a knock on his office door. He asks Linda, a fellow tax partner, to have a seat.

*Linda:* Thanks, Harold. I have a potential problem I would like to discuss with you. It is our new client, Apollon, Inc. The staff and I began digging into last year’s files and are concerned about some things we found, particularly the manner in which some of its more significant assets have been depreciated. The problem, unless addressed and corrected, will perpetuate this year and next year, too.

*Harold:* So from what you can tell the depreciation method had a significant effect on last year’s taxes and will continue to in this tax year?

*Linda:* Yes. But that was just one item that gave me pause. There were a few other things that just did not seem right to me. I will have a better feel for the situation once I have some more information.

*Harold:* So you haven’t met with the client yet.

*Linda:* No, I wanted to speak with you first. I am familiar with the AICPA guidance and the Circular 230 guidance in this area; it says that when we become aware of an error on the client’s tax return we need to advise them of the error and the potential consequences. The AICPA standards also state that we should recommend that the client take corrective action.

*Harold:* That’s right, the AICPA does not require that we put the advice in writing, but, under our firm policies, this is something we would document. Here is some more information that might apply to your client.

**AICPA SSTS No. 6, Knowledge of Error: Return Preparation and Administrative Proceedings**

For example:

A member becomes aware of client error or that client has failed to file a return. The member should advise client promptly of the actions needed to correct the error. If the error will repeat itself, the member must take steps to avoid having the error occur in future returns. The member may need to withdraw/reconsider professional relationship with client if the client will not correct the error. The member should ensure he/she complies with SSTS No. 1, *Tax Return Positions*. 
**Best Practice Alert**

Document the discussion with the client regarding the nature of a discovered error or omission and the corrective actions that should be taken. If the client will not heed the advice, reconsider the professional relationship with the client. If it appears that fraud or other criminal behavior may be involved, (1) advise the client to immediately seek legal counsel before he takes any further action and (2) consider whether to withdraw. Be aware that any communication with the client could be subject to a summons or subpoena. Document all actions very carefully and maintain the documentation in the client’s file.

*Linda:* My concern is that the client may not want to amend the return. There will be significant costs to them in doing so. I also understand that I have no obligation, regardless of the client’s action or inaction, to disclose the matter to the IRS or any other tax authority.

*Harold:* Yes. In fact, confidentiality rules preclude us from doing so. Unless a client gives us permission to disclose their information, we are subpoenaed to testify in court, or are obligated under some professional, regulatory, or judicial requirement, generally we cannot. Did you discuss this with their previous accountant?

*Linda:* No, not yet. We spoke with him when we first were considering the client but he did not indicate that he had any problems or disputes with them. I plan to call him.

*Harold:* Good idea. Ask him to obtain the client’s permission to discuss last year’s tax return. If the client declines his request, this tells us the prior accountant may have had a dispute with them, which led to his termination or withdrawal. But let’s not jump to conclusions. Talk to the accountant first and see where that leads. Let me know how it goes. Depending on how this unfolds, we may need to call our attorney.

Here, take a look at the AICPA rules for client confidentiality and IRC Section 7216.

**AICPA Confidential Information Rule**

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 the Compliance with Standards and Accounting Principles rules,

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.

IRC Section 7216 – Disclosure or Use of Taxpayer Information

In addition to the AICPA rule on confidentiality, tax practitioners should comply with IRC Section 7216, which prohibits a tax return preparer from “knowingly or recklessly” disclosing or using tax return information without the explicit, written consent of the client.

The “disclosure” and “use” of tax return information are very broadly defined. These regulations generally require preparers to get permission (in written or electronic form) from the taxpayer before using or disclosing tax return information. Violators could be charged with a criminal misdemeanor, which carries a maximum penalty of $1,000 or one year in prison, or both, plus costs of prosecution.

Section 7216

Two IRS revenue rulings provide guidance on regulations under section 7216 (Disclosure or Use of Information by Preparers of Returns) of the IRC:


The IRS also released proposed temporary guidance on Section 7216 for public comment available at www.federalregister.gov/articles/2010/01/04/E9-31114/amendments-to-the-section-7216-regulations-disclosure-or-use-of-information-by-preparers-of-returns.

The temporary regulations provide limited ways in which practitioners may disclose or use certain taxpayer information without explicit permission from the client. They also modify certain rules under section 7216 and supersede the interim guidance in Notice 2009-13 and are effective for uses and disclosures of tax return information occurring after January 4, 2010.

Another Training Session

In the following training session, Harold discusses the firm’s plans to outsource certain tax compliance work next season to another firm and the ethical requirements that SemperBarnes will need to meet.

*Harold:* So, the firm has agreed to move forward with an outsourcing agreement with another firm to help relieve some of the pressure we all experience during tax season. Professionally, we
have a lot of obligations related to using an outside service provider. The AICPA has several requirements regarding outsourcing in general, and we also need to consider whether these folks are “tax return preparers” under the IRC.

There is a lot to put in place in terms of controls and meeting our professional responsibilities. As I mentioned earlier, section 7216 of the IRC provides a criminal penalty with respect to the disclosure or use of tax return information. A civil penalty also could apply under section 6713 of the Code.

I’ve prepared a hand-out; please pass that around. I’ll give you a moment to read a summary of the AICPA rules.

**AICPA Ethics Interpretation on Outsourcing**

Members may outsource the performance of some of their services to third-party providers. When they do, they are required to notify the client of the outsourcing arrangement, provide appropriate oversight of the work performed by the service providers, take action to ensure that the third-party providers maintain the confidentiality of client information, and ensure that all services performed conform with applicable professional standards. Certain interpretations in the AICPA Code apply when you outsource the performance of your services to “third-party service providers.”

A “third-party service provider” (service provider) is any entity that the member individually or collectively with his or her firm does not control and any individual who is not employed by the member. Accordingly, the standards apply to all independent contractors used by the firm.

**Notification to Clients**

AICPA rules require that, prior to sharing confidential client information with the service provider, you inform the client, preferably in writing, that you may be using a service provider when providing professional services to that client. You are not required to inform clients of service providers who only provide administrative support services, such as record storage, software application hosting, or authorized e-file tax transmittal services.

**Responsibility for Work**

When you use a service provider to render professional services to clients, you are responsible for overseeing the service provider’s work and ensuring that all applicable professional standards are met. However, this does not mean that you must plan and supervise work consistent with requirements of another profession’s standards, for example, professional standards applying to attorneys or engineers, even though such standards may also apply to the work performed by such service providers.
Confidentiality of Information

You are required to enter into a contractual agreement with the service provider to maintain the confidentiality of the client’s information, including those who provide only administrative support services. You also should be reasonably assured that the service provider has appropriate procedures in place to prevent the unauthorized release of confidential client information. If you do not have a contractual agreement, you must obtain the client’s permission to release information to the service provider.

Note: The previous discussion relates only to the AICPA rules. Members must comply with all applicable rules regarding outsourcing. In particular, members should ensure that they comply with the requirements in section 7216 of the IRC regarding obtaining written consent from the client before disclosing tax return information.

Harold: The AICPA Code says that in all outsourcing situations, it is preferable to notify the client in writing. Since our firm’s approach is to document our compliance with ethical responsibilities, we will definitely follow that recommendation. We also must be mindful of complying with the section 7216 rules requiring written consent from the clients. Finally, I’d like you to spend a bit of time looking at some of the key provisions of Circular 230.

IRS Circular No. 230 (Subpart B Ethics Requirements)

- 10.28, Return of client’s records
- 10.29, Conflicting interests
- 10.30, Solicitations
- 10.31, Negotiation of taxpayer checks (Note: proposed revisions pending)
- 10.32, Practice of law
- 10.33, Best practices for tax advisors
- 10.34, Standards with respect to tax returns and documents, affidavits and other papers
- 10.35, Requirements for covered opinions (Note: Proposed revisions pending)
- 10.36, Procedures to ensure compliance (Note: Proposed revisions pending)
- 10.37, Requirements for other written advice (Note: Proposed revisions pending)

Standard 10.30, the rule on solicitations, is similar to the AICPA rules, but there are a few more explicit requirements to be mindful of, for example, in terms of advertising our fees
and advertising in radio and TV broadcasts. In both of these instances, the IRS rules are more prescribed than the AICPA’s rules.

Standard 10.31 states that a tax return preparer may not endorse or otherwise negotiate any check issued to a client by the government in respect of a federal tax liability. (Note: Proposed revisions pending)

Standard 10.33 encourages tax practitioners to enhance their quality controls over their advisory and compliance work. We have taken and applied these recommendations very seriously at the firm. (Note: Proposed revisions pending)

Standard 10.35 deals with “covered opinions.” In general, a covered opinion is written advice by a practitioner on one or more federal tax issues arising from (1) a transaction that is the same as or nearly the same as a transaction the IRS has determined to be a tax avoidance transaction—you may have heard it referred to as a “listed” transaction; (2) a transaction the principal purpose of which is avoidance or evasion of federal tax; or (3) a transaction a significant purpose of which is avoidance or evasion of federal tax, if the opinion is a so-called reliance opinion or a marketed opinion or if it is subject to conditions of confidentiality. Our firm steers clear of those types of transactions so we are not going to dwell on them.

IRS regulations now require tax preparers to register, pay a fee, be tested to determine their competency, and take continuing education to maintain their competency. Changes to the following sections of Circular No. 230 were included in the proposal:

- Section 10.30, Solicitation, addresses how a registered tax return preparer, that is, those newly subject to IRS oversight, may, and may not, describe their professional credentials
- Section 10.34, Standards for advising with respect to tax return positions and for preparing or signing return, is intended to align more closely to IRC section 6694, although there are differences between the two, since 10.34 is an ethical standard and section 6694 is a regulation.
- Section 10.36, Procedures to ensure compliance, broadens the current standard, which requires that certain procedures are in place in firms to ensure compliance with the regulations on “covered opinions” to include all tax return preparation activities. (Note: Proposed revisions pending)

The following is a description of the provisions on solicitations, negotiation of taxpayer checks, and best practices.
Circular No. 230 Provisions
Section 10.30 Solicitation

(a) **Advertising and solicitation restrictions.**

(1) A practitioner may not, with respect to any Internal Revenue Service matter, in any way use or participate in the use of any form of public communication or private solicitation containing a false, fraudulent, or coercive statement or claim; or a misleading or deceptive statement or claim.

(2) A practitioner may not make, directly or indirectly, an uninvited written or oral solicitation of employment in matters related to the Internal Revenue Service if the solicitation violates Federal or State law or other applicable rule, e.g., attorneys are precluded from making a solicitation that is prohibited by conduct rules applicable to all attorneys in their State(s) of licensure. Any lawful solicitation made by or on behalf of a practitioner eligible to practice before the Internal Revenue Service must, nevertheless, clearly identify the solicitation as such and, if applicable, identify the source of the information used in choosing the recipient.

(b) **Fee information.**

(1)(i) A practitioner may publish the availability of a written schedule of fees and disseminate the following fee information:

(A) Fixed fees for specific routine services.
(B) Hourly rates.
(C) Range of fees for particular services.
(D) Fee charged for an initial consultation.

(ii) Any statement of fee information concerning matters in which costs may be incurred must include a statement disclosing whether clients will be responsible for such costs.

(2) A practitioner may charge no more than the rate(s) published under paragraph (b)(1) of this section for at least 30 calendar days after the last date on which the schedule of fees was published.

(c) **Communication of fee information.** Fee information may be communicated in professional lists, telephone directories, print media, mailings, and electronic mail, facsimile, hand delivered flyers, radio, television, and any other method. The method chosen, however, must not cause the communication to become untruthful, deceptive, or otherwise in violation of this part. A practitioner may not persist in attempting to contact a prospective client if the prospective client has made it known to the practitioner that he or she does not desire to be solicited. In the case of radio and television broadcasting, the broadcast must be recorded and the practitioner must retain a recording of the actual transmission. In the case of direct mail and e-commerce communications, the practitioner must retain a copy of the actual communication, along with a list or other description of persons to whom the communication was mailed or otherwise distributed. The copy must be retained by the practitioner for a period of at least 36 months from the date of the last transmission or use.
(d) **Improper associations.** A practitioner may not, in matters related to the Internal Revenue Service, assist, or accept assistance from, any person or entity who, to the knowledge of the practitioner, obtains clients or otherwise practices in a manner forbidden under this section.

**Section 10.31 Negotiation of taxpayer checks.**

A practitioner who prepares tax returns may not endorse or otherwise negotiate any check issued to a client by the government in respect of a federal tax liability.

**Section 10.33 Best practices for tax advisors.**

(a) **Best practices.** Tax advisors should provide clients with the highest quality representation concerning Federal tax issues by adhering to best practices in providing advice and in preparing or assisting in the preparation of a submission to the Internal Revenue Service. In addition to compliance with the standards of practice provided elsewhere in this part, best practices include the following:

1. Communicating clearly with the client regarding the terms of the engagement. For example, the advisor should determine the client’s expected purpose for and use of the advice and should have a clear understanding with the client regarding the form and scope of the advice or assistance to be rendered.

2. Establishing the facts, determining which facts are relevant, evaluating the reasonableness of any assumptions or representations, relating the applicable law (including potentially applicable judicial doctrines) to the relevant facts, and arriving at a conclusion supported by the law and the facts.

3. Advising the client regarding the import of the conclusions reached, including, for example, whether a taxpayer may avoid accuracy-related penalties under the Internal Revenue Code if a taxpayer acts in reliance on the advice.

4. Acting fairly and with integrity in practice before the Internal Revenue Service.

(b) **Procedures to ensure best practices for tax advisors.** Tax advisors with responsibility for overseeing a firm’s practice of providing advice concerning Federal tax issues or of preparing or assisting in the preparation of submissions to the Internal Revenue Service should take reasonable steps to ensure that the firm’s procedures for all members, associates, and employees are consistent with the best practices set forth in paragraph (a) of this section.
Review Question

8. Bill Jefferson, CPA, prepares Taxpayer A’s Form 1040 for 2010. Taxpayer A refuses to pay Bill’s fees. Bill’s state permits him to withhold records for fees due. Which of the following records must be returned to Taxpayer A in these circumstances under Circular No. 230 and the AICPA’s Code?

   a. The preparer’s workpapers related to acceptance of Taxpayer A as a client.
   b. Taxpayer A’s 2010 Form 1040.
   c. Copies of the relevant sections of the tax code used to prepare the return.
   d. Records Taxpayer A provided Bill to perform the services.
Questions to Consider and Lessons Learned

The purpose of this chapter was to provide you with a general understanding of the ethical rules that tax practitioners must observe.

Questions to Consider

- Do I fully consider all potential conflicts of interests I may encounter in my work?
- Whom should I consult with on ethics questions?
- Am I considering the IRC penalty provisions and regulations on the confidentiality of my client’s information in my daily practice?
- Are the rules of the AICPA, the IRS, state accountancy boards, and others fully considered in my daily practice?
- How can I maintain an awareness of the rules?

Lessons Learned

- Consider documenting the advice you give your clients, especially when you or the client may be exposed to penalties and/or the advice relates to matters that are complex or unusual.
- In your federal tax practice, consider whether tax positions satisfy the substantial authority or reasonable basis standards, as appropriate, based on whether the tax position will be disclosed or not.
- Be aware of and apply the provisions of the AICPA SSTS, which are enforceable standards under the Code.
- Know how to use your firm’s tax research tools. When needed, obtain assistance with tax issues from persons in your firm and other sources.
Solutions to Review Questions

1.  a. Incorrect. Although no attest work is being performed, there is still a requirement to be objective, which under the AICPA rules means being free of conflicts of interests. The IRS also requires practitioners to address and resolve potential conflicts.
   b. Correct. Conflicts may or may not prevent a firm from providing services to a client.
   c. Incorrect. Both the AICPA and the IRS allow potential conflicts to be resolved in certain circumstances.

2.  a. Incorrect. Generally, a preparer will not be penalized if the tax position related to the understatement had “substantial authority.”
   b. Correct. Penalties apply to understatements of tax due to “unreasonable positions,” unless the reasonable cause exception is satisfied.
   c. Incorrect. Section 6694 applies to both federal tax returns and claims for refund.
   d. Incorrect. These provisions do not apply to state, local, or any other jurisdiction’s tax returns.

3.  a. Incorrect. There is no such requirement that would be imposed by the IRS.
   b. Incorrect. The CPA Letter is an AICPA publication, which the AICPA uses to publish certain disciplinary matters.
   c. Correct. The AICPA is empowered to suspend Alice’s membership for one year.
   d. Incorrect. Under these circumstances, the AICPA would not be empowered to impose this sanction.

4.  a. Incorrect. Although it may be a good practice, this is not a requirement of Circular No. 230.
   b. Correct. Circular No. 230 requires written consent from each directly affected party to overcome the conflict. The documents must be retained for three years.
   c. Incorrect. This is not required by Circular No. 230.
   d. Incorrect. Jeff does have certain ethical obligations that are described in Circular No. 230.

5.  a. Correct. Martina should consider whether to continue the engagement and re-evaluate her relationship with Breslin.
   b. Incorrect. While Martina may wish to terminate the engagement, she would not be required to report the client to the IRS.
   c. Incorrect. This may be something Martina would do, but, in and of itself, it would not be sufficient.
   d. Incorrect. Martina should not follow the client’s instructions when she knows the disclosure is required by section 6694.
6. a. Incorrect. Unless she was contractually obligated, Jodie would not be required to communicate with Richard about subsequent developments.
b. Incorrect. If there are IRS or other requirements that apply, the CPA should comply with them.
c. Correct. In all instances, she should comply with SSTS No. 1.
d. Incorrect. SSTS No. 7 does not specify whether advice should be written or oral; the standard does not address consent.

7. a. Correct. Robin should discuss the matter with Jon and make sure that she obtains all necessary consents.
b. Incorrect. Robin cannot simply ignore the information Jon provided. Some other action is required.
c. Incorrect. Once Robin is aware of information that contradicts or is inconsistent with information provided by Jon, she must act.
d. Incorrect. Jon is ultimately responsible for the contents of the return, but this would not be an appropriate response in terms of her ethical responsibilities.

8. a. Incorrect. Attorneys or enrolled agents may not be required to follow the SSTS.
b. Incorrect. The workpapers Bill used to document whether to accept Taxpayer A as a client would be considered his firm’s proprietary information are not subject to a request by the client.
c. Incorrect. Bill is under no obligation to provide Taxpayer A copies of the relevant sections of the IRC.
d. Correct. The IRS and the AICPA Code require him to return any documents that Taxpayer A needs to attach to his tax return (such as W-2 forms).
Professional Ethics Glossary

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

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

.03 Client – A client is any person or entity, other than the member’s employer, that engages a member or a member’s firm to perform professional services or a person or entity with respect to which professional services are performed. For purposes of this paragraph, the term “employer” does not include Entities engaged in the practice of public accounting; or Federal, state, and local governments or component units thereof provided the member performing professional services with respect to those entities is directly elected by voters of the government or component unit thereof with respect to which professional services are performed; or is an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or is appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

.04 Close Relative – A close relative is a parent, sibling, or nondependent child.

.05 Confidential Client Information – Confidential client information is any information obtained from the client that is not available to the public. Information that is available to the public includes, but is not limited to, information in a book, periodical, newspaper, or similar publication; in a client document that has been released by the client to the public or that has otherwise become a matter of public knowledge; on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information; released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum; maintained by, or filed with, regulatory or governmental bodies that is available to the public; or obtained from other public sources. Unless the particular client information is available to the public, such information should be considered confidential client information.

Members are advised that federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in the Code of Professional Conduct.
.06 Council – The Council of the American Institute of Certified Public Accountants.

.07 Covered Member – A covered member is

- An individual on the attest engagement team;
- An individual in a position to influence the attest engagement;
- A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis;
- A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- The firm, including the firm’s employee benefit plans; or
- An entity whose operating, financial, or accounting policies can be controlled (as defined in Financial Standards Accounting Board [FASB] Accounting Standards Codification [ASC] 810, Consolidation) by any of the individuals or entities described in (a) through (e) or by two or more such individuals or entities if they act together.

.09 Financial Institution – A financial institution is considered to be an entity that, as part of its normal business operations, makes loans or extends credit to the general public. In addition, for automobile leases addressed under interpretation 101-5, Loans From Financial Institution Clients [ET section 101.07], an entity would be considered a financial institution if it leases automobiles to the general public.

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

Incidental financial data to support recommendations to a client or in documents for which the reporting is governed by Statements on Standards for Attestation Engagements and tax returns and supporting schedules do not, for this purpose, constitute financial statements. The statement, affidavit, or signature of preparers required on tax returns neither constitutes an opinion on financial statements nor requires a disclaimer of such opinion.
.11 Firm – A firm is a form of organization permitted by law or regulation whose characteristics conform to resolutions of the Council of the American Institute of Certified Public Accountants and that is engaged in the practice of public accounting. Firm includes the individual partners thereof except for purposes of applying Rule 101: Independence [ET section 101.01]. For purposes of applying Rule 101, firm includes a network firm when the engagement is either a financial statement audit or review engagement, and the audit or review report is not restricted, as defined by professional standards.

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

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

.14 Individual in a Position to Influence the Attest Engagement – An individual in a position to influence the attest engagement is one who evaluates the performance or recommends the compensation of the attest engagement partner; directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm’s chief executive; consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement; or participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement.

.15 Institute – The American Institute of Certified Public Accountants.

.16 Interpretations of Rules of Conduct – Pronouncements issued by the division of professional ethics to provide guidelines concerning the scope and application of the rules of conduct.

.17 Joint Closely Held Investment – A joint closely held investment is an investment in an entity or property by the member and the client (or the client's officers or directors, or any owner who has the ability to exercise significant influence over the client) that enables them to control (as defined in FASB ASC 810 Consolidation) the entity or property.

.18 Key Position – A key position is a position in which an individual has primary responsibility for significant accounting functions that support material components of the financial statements; has primary responsibility for the preparation of the financial statements; or has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, or any equivalent position.

For purposes of attest engagements not involving a client’s financial statements, a key position is one in which an individual is primarily responsible for, or able to influence, the subject matter of the attest engagement, as described above.
.19 Loan – A loan is a financial transaction, the characteristics of which generally include, but
are not limited to, an agreement that provides for repayment terms and a rate of interest. A loan
includes, but is not limited to, a guarantee of a loan, a letter of credit, a line of credit, or a loan
commitment.

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

• Continuing responsibility for the overall planning and supervision of engagements for
  specified clients.

• Authority to determine that an engagement is complete subject to final partner approval if
  required.

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

.22 Member in Business – A member employed or engaged on a contractual or volunteer basis
in an executive, a staff, a governance, an advisory, or an administrative capacity in such areas as
industry, the public sector, education, the not-for-profit sector, or regulatory or professional
bodies. This does not include a member while engaged in the practice of public accounting.

.23 Network – For purposes of Interpretation No. 101-17, “Networks and Network Firms,”
[ET section 101.19] a network is an association of entities that includes one or more firms that
(a) cooperate for the purpose of enhancing the firms’ capabilities to provide professional services
and (b) share one or more of the following characteristics:

• The use of a common brand name (including common initials) as part of the firm name

• Common control (as defined in FASB ASC 810) among the firms through ownership,
  management, or other means

• Profits or costs, excluding the following:
  – Costs of operating the association
  – Costs of developing audit methodologies, manuals, and training courses
  – Other costs that are immaterial to the firm

• Common business strategy that involves ongoing collaboration amongst the firms whereby
  the firms are responsible for implementing the association's strategy and are held
  accountable for performance pursuant to that strategy

• Significant part of professional resources

• Common quality control policies and procedures that firms are required to implement and
  that are monitored by the association

• A network may comprise a subset of entities within an association if only that subset of
  entities cooperates and shares one or more of the characteristics set forth in the preceding list.
.24 Network Firm – A network firm is a firm or other entity that belongs to a network, as defined in ET section 92 paragraph .23. This includes any entity (including another firm) that the network firm, by itself or through one or more of its owners, controls (as defined in FASB ASC 810), is controlled by, or is under common control with.

.25 Normal Lending Procedures, Terms, and Requirements – "Normal lending procedures, terms, and requirements" relating to a covered member's loan from a financial institution are defined as lending procedures, terms, and requirements that are reasonably comparable with those relating to loans of a similar character committed to other borrowers during the period in which the loan to the covered member is committed. Accordingly, in making such comparison and in evaluating whether a loan was made under "normal lending procedures, terms, and requirements," the covered member should consider all the circumstances under which the loan was granted, including:

- The amount of the loan in relation to the value of the collateral pledged as security and the credit standing of the covered member.
- Repayment terms.
- Interest rate, including "points."
- Closing costs.
- General availability of such loans to the public.
- Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

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

.27 Partner – A partner is a proprietor, shareholder, equity or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent of any of the aforementioned.
.28 Period of the Professional Engagement – The period of the professional engagement begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, either by the member or the client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year's attest engagement.

.29 Practice of Public Accounting – The practice of public accounting consists of the performance for a client, by a member or a member’s firm, while holding out as CPA(s), of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council. Such standards include Financial Accounting Standards Board (FASB) Accounting Standards Codification™ (ASC), Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements of Governmental Accounting Standards, International Financial Reporting Standards and International Accounting Standards, Statements on Standards for Attestation Engagements and Statements on Standards for Valuation Services.

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

.30 Professional Services – Professional services include all services performed by a member while holding out as a CPA.

.31 Significant Influence – The term significant influence is as defined in FASB ASC 323–10–15.
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Professional Ethics: AICPA’s Comprehensive Course

By Catherine R. Allen, CPA

EXAMINATION

Important Notice

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Examination for Self-Study Credit

Directions

Please answer the following questions on the answer sheet.

1. Sarah, the controller of a large beverage supplier, supervises two employees. Her boss, Vladimir, instructs her to increase the company’s inventory balance for an amount that is material to the financial statements by crediting several small “miscellaneous” expense accounts. She does not understand why he wants her to make such entries but directs one of her staff to make them because she has been instructed to do so. Which of the following statements best describes Sarah’s actions?

   a. Sarah failed to evaluate a potential ethical issue.
   b. Sarah failed to refer the matter to the AICPA ethics hotline.
   c. Sarah failed to ensure that her staff was competent to make the entries.
   d. Sarah failed to consider the rules of other regulators.

2. Josie, an accounting supervisor in Monk & Sons Realty, instructs Maria, her employee, to make certain accounting entries in the company’s books that will affect revenue. Maria researches the matter and informs Josie that recognizing revenue is premature, but Josie insists that she record the entries. The amount of revenue is material to Monk’s financial statements. Which of the following steps should Maria take first according to the AICPA rules?

   a. Resign her position quietly.
   b. Report the matter to the senior partner in the firm.
   c. Take out a professional liability policy.
   d. Discuss the matter with Josie’s boss.

3. The recodified AICPA Code of Professional Conduct includes the following sections:

   a. Preface, Rules/interpretations applicable to members in tax practice, Rules/interpretations to members in business
   b. Preface, Rules/interpretations applicable to members in public practice, Rules/interpretations to members in business
   c. Preface, Rules/interpretations applicable to members in tax practice, Rules/interpretations to members in audit practice
   d. Preface, Rules/interpretations applicable to members in audit practice, Rules/interpretations to members in business
4. The International Federation of Accountants (IFAC)
   a. Develops international standards for taxation and information technology.
   b. Encourages member bodies to develop new and innovative types of nonattest services offerings.
   c. Is a European organization devoted to helping accountants find employment in third-world countries.
   d. Develops ethics standards for use by professional accountants based on a conceptual framework.

5. Which of the following phrases is used by the Code of Professional Conduct to describe integrity?
   a. Candid, within the constraints of client confidentiality.
   b. Forceful advocate of the client’s position.
   c. Valued business advisor to the client.
   d. Willing to subordinate judgment to achieve a proper outcome.

6. Maria, the CFO of Slolum Ski Supplies, received a watch from one of her company’s largest vendors, Colorado Ski Shoppe. She received the gift with a card congratulating her on Slolum’s recent merger with another company. Which of the following factors should Maria consider in determining whether accepting the gift would create a significant threat to her compliance with the AICPA Code?
   a. Whether she disclosed receipt of the gift to the board of directors.
   b. Whether she truly earned the gift.
   c. Whether the gift was reasonable in the circumstances.
   d. Whether the gift cost more than $100.

7. Which of the following best describes competence as defined in the Code of Professional Conduct?
   a. Infallible judgment that cannot subsequently be called into question.
   b. The application of skill and knowledge with reasonable care and diligence.
   c. Possessing an advanced college degree in the relevant professional subject matter.
   d. Rigid adherence to the professional standards of engagement performance.
8. A former client of Charlie Hayes, CPA, filed a lawsuit in state court alleging that Charlie failed to exercise due care in the performance of tax and compilation services performed in 2011. Charlie firmly believes that he performed his services with competence and diligence. In his defense, he plans to admit to making one minor error which he says was inadvertent and did not have a material effect on the client’s taxes or financial position. In light of his admission, has Charlie complied with the AICPA Code’s standard of due care and why?

a. No. He obviously did not discharge his professional responsibilities with competence and diligence.
b. No. He did not perform professional services to the best of his abilities.
c. Yes. He has chosen to be honest in reporting that he made an error.
d. Yes. The AICPA standard for due care does not require CPAs to be infallible.

9. In which of the following situations may you disclose confidential client information without violating the Code of Professional Conduct?

a. In response to a validly issued and enforceable subpoena.
b. At the request of another client that needs the information to file its tax return.
c. As an example in a seminar given for CPE credit.
d. In a proposal to a potential client.

10. Terry Industries engages Rose & Co., CPAs, to prepare its annual financial statements and tax returns. Before either of these engagements is completed, Terry terminates the relationship and asks the firm to provide all records that the client provided to the firm, the firm’s working papers, and its partially completed work product. Terry has not paid the firm for either service. Under the AICPA rule on client records requests, which records, if any, may the firm withhold from the client?

a. Client-provided records.
b. Member-prepared records.
c. Any records the firm chooses to withhold.
d. No records may be withheld from the client.

11. Which of the following statements best describes the ethics rules relating to a member’s failure to file his or her personal tax return in a timely manner?

a. The member is strongly encouraged to file his or her personal tax returns in a timely manner.
b. The failure to file a personal tax return in a timely manner must be disclosed to all clients and potential clients.
c. The failure to file a personal tax return in a timely manner is usually considered an act discreditable to the profession.
d. The member is not in violation of any ethics rules as long as the failure to file a personal tax return in a timely manner was due to a heavy workload.
12. Sympatico Accountants engages ABC Tax Preparers to prepare routine tax returns during the busy season. Which of the following should Sympatico do prior to sharing its clients’ information with ABC?

a. Inform its tax clients that the firm may be using an outside service when providing professional services.
b. List a notice in the local newspaper that the firm may be using an outside service when providing tax services to clients.
c. Ask clients to sign a waiver limiting Sympatico’s liability in the event ABC makes errors in Sympatico’s tax returns.
d. Sympatico would not be required to take any particular action in this situation.

13. Which of the following statements best describes the ethics rules relating to advertising?

a. Advertising through the use of banner ads over the Internet is considered over-reaching and is prohibited.
b. Mass e-mail advertising is not allowed because it is considered a form of harassment.
c. Advertising is permitted as long as it is not misleading.
d. Advertising over any form of mass media is prohibited.

14. Bob Martino is sanctioned by his state board of accountancy for his association with false and misleading financial statements of his employer, Jones Consulting, LLC, a private company. Which of the following situations is the least likely result of the state board’s action?

a. The state board could suspend or revoke Bob’s CPA license.
b. Bob could lose his membership in the AICPA or a state CPA society.
c. Bob could become subject to significant legal liabilities.
d. The Securities and Exchange Commission could fine Bob.

15. Members should use the Conceptual Framework for Independence to

a. Come to different conclusions than the interpretations and rulings in the Code of Professional Conduct.
b. Evaluate independence matters not addressed in the Code of Professional Conduct.
c. Understand the rules on confidential client information and acts discreditable to the profession.
d. More easily interpret conflicts of interest and subordination of judgment by a member.
16. Dorothy (an audit manager) has been assigned to the audit of Tandem Electric, Inc. Dorothy is concerned that Joanne, a friend from her college days, is on the internal audit staff of Tandem Electric. Dorothy believes she could provide services to this client in an objective manner. Which of the following statements best describes how Dorothy should apply the conceptual framework approach in this situation?

a. Dorothy should refuse to provide services to Tandem Electric because no safeguards would be effective in mitigating the threat(s) to her independence.
b. Dorothy should not participate in the audit of Tandem Electric before obtaining a written waiver from her firm’s general counsel.
c. Dorothy should consider the threats to her independence and whether safeguards may be applied that reduce the threat to an acceptable level.
d. Dorothy should document her assessment of independence, which should include a sworn statement from Joanne.

17. A two-office firm, one in Chippewa Falls and another in Fargo, has an audit client that sells medical equipment. The lead audit partner for this client conducts the engagement in the Fargo office. Stockholdings in the client by which of the following persons would not impair the firm’s independence?

a. A manager in Chippewa Falls who will provide 26 hours of non-attest services to the client this year.
b. A Chippewa Falls staff person who provides no services to the client.
c. A tax partner in the Fargo office who provides no services to the client.
d. A Fargo staff person working on the audit engagement.

18. An example of a spousal equivalent is

a. A person in a domestic partnership with a covered member.
b. A roommate and long-time platonic friend of a covered member.
c. A cousin who lives with and is supported by the covered member.
d. A former spouse of a covered member who is financially independent of the covered member.

19. The employment of your spousal equivalent at a clothing retailer that is an audit client would generally impair your independence if he or she was employed as a

a. Controller.
b. Cashier.
c. Warehouse supervisor.
d. Buyer.
20. Which of the following statements best describes the period of the professional engagement as it applies to a three-year engagement to audit a client’s financial statements?

a. It begins each year when fieldwork commences and ceases when fieldwork ends.
b. It begins when fieldwork commences and ceases when the report is issued, recommencing when fieldwork begins again for the next period.
c. It begins when the engagement letter is signed and ceases each year when the report is issued.
d. It begins when the engagement letter is signed and continues until the report for the third year is issued unless the relationship is terminated sooner.

21. Jane, a partner in a CPA firm, borrows $100,000 on a secured note from one of the firm’s bank audit clients to build a new dormer on her house. The amount of the loan is material to Jane. Jane will not provide any services to the bank and she is unable to influence the engagement. Jane practices in the same office as the lead partner on the bank’s audit. Is Jane’s independence impaired?

a. Yes. Jane obtained a loan from an audit client when she was a covered member.
b. Yes. The loan is material to her net worth.
c. No. The note is secured, related to her primary residence, and was obtained from a financial institution.
d. No. Jane is not on the attest team or able to influence the engagement.

22. When a member performs non-attest services for an attest client, management is required to designate an individual to oversee those services. Which of the following best describes the qualities that are required of that person?

a. He or she must possess the same level of expertise as the CPA.
b. He or she must be able to perform the services himself or herself.
c. He or she must have suitable skill, knowledge, and/or experience.
d. He or she must be able to supervise the CPA in the day-to-day rendering of the services.

23. A member has been asked to co-sign checks with a client employee while the company president is on a short vacation. Which of the following statements about the application of the independence rules to this situation is true?

a. Because the member will only be co-signing checks, independence is not threatened.
b. Because the member is a co-signer for a short time, independence is not threatened.
c. Because the member has entered into a joint business venture with the client, independence is impaired.
d. Because check-signing is a management function, independence is impaired.
24. Jones, a consulting manager of Miller & Co., is considering membership on an audit client’s board of directors. Jones does not provide any services to this client. Which of the following statements describing this situation is true?

a. Jones may join the board because he is not an auditor.
b. Jones may join the board because he is not a partner.
c. Jones may not join the board because the rules prohibit all professionals in the firm from serving as a director of a client.
d. Jones may not join the board because only non-managerial employees of the firm may serve as client management.

25. Jones is a member of the engagement team performing an audit of XYZ. During the engagement, the president of XYZ approaches Jones and offers her the position of CFO at the company. Jones is considering the offer. What safeguards do the independence rules require Jones to apply?

a. Remove herself from the engagement team until the offer is rejected or she is no longer seeking employment with XYZ.
b. Obtain the permission of the XYZ audit committee to remain on the engagement team.
c. Resign from the firm.
d. Decline the offer.

26. Becker & Smith, CPAs, and its client, Troper Lighting, are discussing a possible advisory engagement in which the firm would review Troper’s account receivable (A/R) system and recommend changes that would improve the company’s collection process and speed collections. Troper proposes to pay Becker & Smith a fee based on improved performance in A/R collections. Would such an arrangement raise any ethical concerns?

a. No, but only if Troper is a publicly traded company subject to SEC and PCAOB rules.
b. No, provided Becker & Smith documents the arrangement clearly in the engagement letter.
c. Yes, but only if Becker & Smith was performing other services for Troper.
d. Yes, if Becker & Smith also performed a review engagement for Troper.
27. Feld & Company, CPAs, has provided annual audit and tax advisory services to Maris Corporation for several years. Last year, Maris experienced severe cash flow problems and was unable to pay Feld in full, leaving a significant balance unpaid. Feld is ready to begin fieldwork for the upcoming audit. What options are available to Feld and Maris?

a. Feld may set up a payment plan with Maris over the next two years to settle the unpaid fees.

b. Feld may perform the audit as long as the unpaid fees relating to the prior year are paid in full before the current year report is issued.

c. Maris may give the member a note with a maturity date no later than one year after the date of the current year report.

d. Maris may have another firm perform the fieldwork and Feld will review the workpapers and issue the report.

28. All of the following are prohibited relationships between a covered person and an SEC audit client except:

a. Joint business ventures

b. Agreements to share costs or profits

c. Immaterial landlord-tenant relationships

d. Limited partnership agreements

29. Under the SEC rules, a one-year “cooling-off” period applies to which of the following professionals?

a. A tax manager participating in the client’s tax engagement who assumes an operational role with the client.

b. A lead audit partner who assumes a financial reporting oversight role with the client.

c. Professionals providing technology consulting services to the client who assume an executive role with the client.

d. Professionals providing consulting services to the client who assume a financial accounting role with the client.

30. Which of the following statements best describes the SEC rules relating to bookkeeping services?

a. Certain bookkeeping services are permitted, as long as the individuals performing these services are different from the individuals performing the audit.

b. Certain bookkeeping services are permitted, provided the fees from these services are insignificant relative to the audit fees.

c. Certain bookkeeping services are permitted, as long as the client agrees in writing to accept responsibility for the adequacy of these services.

d. An accountant generally cannot provide bookkeeping services to an SEC audit client.
31. Which of the following best describes a significant similarity between the AICPA and IESBA Codes?

   a. Both Codes incorporate the conceptual framework approach for evaluating threats when specific rules on a matter do not exist.
   b. Both Codes contain specific ethics and independence provisions related to public interest entities.
   c. The Codes blend the rules for members in business and public practice in one section.
   d. The Codes contain the exact same provisions for corporate accountants.

32. The SEC has historically raised questions regarding the independence of firms that derive a significant portion of their total revenues from one audit client or group of clients because the SEC staff believes this situation causes CPA firms to

   a. Profit excessively from a client or group of clients.
   b. Depend too heavily on the fees generated by the client or clients.
   c. Have a mutuality of interests with the client or group of clients.
   d. Place too heavy a burden on the client’s financial position.

33. The Yellow Book stresses five ethical principles, including all of the following except:

   a. The public interest
   b. Professional behavior
   c. The proper use of government information, resources and position
   d. The proper safeguarding of client information

34. One of the GAO’s ethical principles described in the Yellow Book stresses that

   a. Government employees may not accept gifts under any circumstances.
   b. Government information, resources, and positions should not be used for the auditor’s personal gain.
   c. Auditors may use government resources if the proper requisition forms are completed beforehand.
   d. Auditors should not discuss sensitive matters with audited entities without obtaining official clearance from the appropriate government agency.

35. Department of Labor (DOL) independence rules apply to

   a. All services provided to employee benefit plans.
   b. Audit services provided to sponsors of employee benefit plans.
   c. Audit services provided to employee benefit plans subject to ERISA requirements.
   d. All governmental audit engagements.
36. In which way do DOL independence rules differ from the AICPA rules?

a. The DOL rules on non-attest services are more comprehensive than the AICPA independence rules.
b. The DOL rules ban auditors from providing actuarial services to benefit plans that they audit.
c. The DOL defines member much more broadly than the AICPA’s covered member.
d. The DOL permits auditors to perform recordkeeping, whereas the AICPA rules would not.

37. Which of the following statements most accurately describes the Federal Deposit Insurance Corporation’s (FDIC) auditor independence requirements?

a. Regulations incorporate requirements for attorneys and actuaries.
b. Regulations closely mirror the AICPA and DOL independence rules.
c. Certain FDIC policy statements address auditor independence.
d. The FDIC has deferred adoption of regulations that incorporate SEC independence rules.

38. Tax return preparers may generally rely on a client’s representations without verification unless

a. The client lacks competence.
b. The tax matter is complex.
c. The information seems incorrect, inconsistent, or incomplete.
d. The client is new to the preparer.

39. Violating an AICPA or IRS rule may result in the following:

a. Suspension of AICPA membership or the ability to practice before the IRS.
b. Imposition of a monetary penalty by the IRS.
c. Publication of an admonishment by the AICPA.
d. All of the above.

40. Technical qualifications necessary to supervise the work of others in completing a professional assignment is a characteristic of

a. Due professional care.
b. Independence.
c. Competence.
d. Cost benefit.
41. A practitioner is engaged to prepare a client’s federal income tax return for 2012 and 2013. The practitioner files the 2012 return on the client’s behalf. After the 2013 return is prepared, the client disputes the fees for the 2013 tax engagement, terminates the relationship, and requests all tax returns and related records. The client has not yet paid for preparation of the 2013 return. Under IRS Circular No. 230, which records must the practitioner return to the client?

a. Schedules the practitioner prepared, which the client needs to file in its 2013 federal income tax return.
b. The engagement letter executed by the client for preparation of the 2013 federal income tax return.
c. An appraisal the practitioner prepared in connection with the 2012 federal income tax return.
d. Notes the practitioner took when meeting with the client about the 2012 and 2013 tax returns.

42. Sam Burke, CPA, finds a material error in his client’s tax return and advises the client on how to correct it. Which of the following actions is Sam required to do if the client does not agree to correct the error?

a. Document the consultation with the client, including the client’s rationale for not amending the return, but nothing further.
b. Make the correction without the client’s knowledge and file the return.
c. Consider whether the client’s decision not to correct the error may predict future behavior that might require termination of the client relationship.
d. Disclose the matter to the AICPA Professional Ethics division.

43. A CPA firm performs the annual audit of The Leahy Group, a private company. The client has asked the firm to perform a study to determine whether the company would qualify for certain tax credits granted by the city. The firm will receive 15 percent of any tax credits obtained by the company and no fees if the credits are denied. The firm does not believe that the results of its services would be substantively reviewed by city officials. Would performance of the service be permitted under the AICPA Code of Professional Conduct?

a. Yes, but only because the service is tax-related.
b. Yes, if the projected fees would be immaterial to the firm.
c. No, because the fee arrangement is a prohibited contingent fee.
d. No, because the service would be considered to be a management function.
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