

CHAPTER 3

Professional Ethics

Review Questions

- 3-1 An *ethical dilemma* is a situation that an individual faces involving a decision about appropriate behavior. Ethical dilemmas generally involve situations in which the welfare of one or more other individuals is affected by the results of one's decision.
- 3-2 Internal and external standards represent the two major types of constraints on decisions that involve ethical issues. Examples of internal standards are individuals' views on the importance of truthfulness, fairness, loyalty, and caring for others. External standards are those that are imposed upon individuals by society, peers, organizations, employers, or one's profession. For example, the AICPA *Code of Professional Conduct* is an external constraint on members of the AICPA.
- 3-3 The basic purpose of a professional code of ethics is to provide members of a profession with guidelines for maintaining a professional attitude and conducting themselves in a manner that will enhance the stature of their discipline.
- 3-4 The two parts of the AICPA *Code of Professional Conduct* are:
- (1) **Principles**—goal-oriented and aspirational guidelines that address members' responsibilities, the public interest, integrity and objectivity, independence, due care, and the scope and nature of services.
 - (2) **Rules**—more detailed regulations that support the principles.
- 3-5 The categories of threats to independence include (only three required):
- (1) Self-review—Using as a part of the attest engagement evidence that was obtained on a nonattest engagement.
 - (2) Advocacy—Actions that promote an attest client's interest.
 - (3) Adverse interest—Actions between the public accountant and the client that are in opposition.
 - (4) Familiarity—Having a close or longstanding relationship with client personnel or with individuals who performed nonattest services.
 - (5) Undue influence—An attest client's management coerces the accountant or exercises excessive influence over the accountant.

- (6) Financial self-interest—A potential benefit to the accountant from a financial interest in, or some other financial relationship with an attest client.
 - (7) Management participation—The accountant taking on the role of client management or otherwise performing management functions.
- 3–6 Rule 202 of the AICPA *Code of Professional Conduct* requires CPAs to adhere to appropriate professional standards in the performance of various professional services. In the case of financial statement audits those standards are the generally accepted auditing standards.
- 3–7 A CPA would have an indirect financial interest in an audit client if he or she had an investment in another entity that, in turn, had an interest in the audit client. Examples might include (1) an investment in a mutual fund which owns stock of the audit client, (2) investment in another corporation which owns securities of the audit client, and (3) ownership of shares in a bank which has extended loans to the client company.
- The *Code of Professional Conduct* only prohibits those indirect financial interests in audit clients that are material in relation to the CPA's net worth.
- 3–8 Bill Scott's father is considered a "close relative." Since a close relative only impairs a CPA's independence when that relative has a key position with the client, it is doubtful that Bill's independence is impaired. (If, however, Bill's father were in a key position, Bill's independence would be impaired and he should not participate on the attest engagement team.) Accordingly, neither Scott's nor the firm's independence is likely to be impaired. Nonetheless, it may well be a wise decision to keep Scott off of the audit.
- 3–9 The public accounting firm's independence would not be impaired as long as Greg Scott did not personally participate in the audit of this particular client. Because Scott's father is a "close relative," Scott is not independent and must not become involved with the audit. Once Scott rises to the position in which he becomes a partner of the public accounting firm, however, he must be transferred to an office that does not participate in this audit if the firm is to remain independent.
- 3–10 The signing of checks is a management function. If Kole accepted the client's request to co-sign checks, she would violate the *Code of Professional Conduct* Rule of Conduct dealing with independence. Kole would not be independent of Noyes Company for any period in which she signed checks.
- 3–11 The Public Company Accounting Oversight Board (PCAOB) has the responsibility to develop independence standards that apply to auditors of public companies. The source of the PCAOB's authority is the Sarbanes-Oxley Act of 2002, which established the board and its authority.
- 3–12 A covered member includes:
- a. An individual on the attest engagement team;
 - b. An individual in a position to influence the attest engagement;
 - c. A partner or manager who provides 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 (1) the firm signs the report on the financial statements for the fiscal year during which those services were provided, or (2) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis;
 - d. A partner in the office in which the lead attest engagement partner primarily practices in

- connection with the attest engagement;
- e. A firm, including the firm's employee benefit plans; or
- f. An entity whose operating, financial, or accounting policies can be controlled (as defined by GAAP for consolidation purposes [i.e., generally 20%] 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.

Only Part A of Interpretation 101-1 relies upon the “covered member” concept. Parts B and C include all partners or professional employees with such interests.

3–13 The Sarbanes-Oxley Act of 2002 (as interpreted by SEC regulations) prohibits CPA firms from performing bookkeeping services for a public company audit client. However, regulations of the SEC have prohibited these services for many years. The AICPA does not view such services as impairing independence. Thus, whether a CPA firm is independent of a client for which it renders accounting services depends upon whether the client falls under SEC jurisdiction (is publicly owned).

3–14 The authoritative bodies, and their standards are as follows:

<u>Technical Body</u>	<u>Authoritative Standards</u>
1. Auditing Standards Board (ASB)	<i>Statements on Auditing Standards</i>
2. Management Consulting Services Executive Committee (MCSEC)	<i>Statements on Standards for Consulting Services</i>
3. Accounting and Review Services Committee (ARSC)	<i>Statements on Standards for Accounting and Review Services</i>
4. ASB, MCSEC, and ARSC	<i>Statements on Standards for Attestation Engagements</i>
5. Financial Accounting Standards Board	<i>Statements of Financial Accounting Standards</i> and related Interpretations
6. Governmental Accounting Standards Board	<i>Statements of Governmental Accounting Standards</i> and related Interpretations

3–15 The statement is incorrect because while the CPA may provide consulting services for an attest client, the CPA should not perform consulting services that place him or her in a decision-making position. Also, only such services that will allow the CPA to maintain integrity and objectivity may be accepted. Finally, the Sarbanes-Oxley Act of 2002 and SEC regulations put additional restrictions on the types of services that may be provided by a CPA firm to a public company audit client.

3–16 A CPA may not perform professional services on a contingent fee basis in the following circumstances:

- a. The services involve the preparation or amendment of tax returns.
- b. The CPA also is engaged to perform a financial statement audit, review or certain compilations, or a prospective financial information examination for the client.

3-17 Contingent fees may be accepted from clients for whom the CPA does not also provide to the client financial statement audits, reviews or certain compilations, or prospective financial information examinations. However, it is unlikely that an expert witness would have much credibility if his or her compensation were contingent on the outcome of the case.

3-18 Because Ms. Schultz also performs financial statement audits for the client, a violation of the AICPA *Code of Professional Conduct* will result if the commission is accepted.

Note to instructor: You may wish to discuss the situation in which the CPA does not provide audits, reviews or certain compilations, or prospective financial information examinations for the client. If Ms. Schultz does not perform any of the above services for the client, and if acceptance of the commission is disclosed to the client, there is no violation of the AICPA *Code of Professional Conduct*.

3-19 Clark may only refer certain clients to his wife or to another life insurance agent who will share such a commission with his wife. Such commissions may be received only for clients for whom the CPA does not perform financial statement audits, reviews or certain compilations, or prospective financial information examinations. The acceptance of an appropriate commission and the fact that Laura Clark is his wife should be disclosed to the client.

3-20 A CPA may practice in a form of organization permitted by state law. Historically, the sole practitioner, partnership, and professional corporation forms of practice have been allowed. In 1992 the *Code of Professional Conduct* was modified to allow other forms of organization that are allowed in the various states. Currently, most states allow CPAs to practice in limited liability partnerships or corporations.

3-21 No. The concept of independence, which is essential in attestation services, is not an element of tax practice. Recall, however, that Rule 102 requires that the CPA maintain objectivity and integrity. Resolving doubt in favor of the client is not deemed, in itself, to impair integrity or objectivity.

3-22 When CPAs prepare income tax returns, they must sign the preparer's declaration, indicating that the return is "true, correct, and complete...based on all information of which the preparer has knowledge." If the information contained in the return appears to be unreasonable, the CPAs must investigate the information sufficiently to resolve their doubts. Otherwise, they cannot be associated with the return.

3-23 The International Ethics Standards Board for Accountants, established by the International Federation of Accountants, establishes international ethical standards, titled the *Code of Ethics for Professional Accountants*. While the standards between the two groups are similar, the international standards have fewer definitive prohibitions (and are somewhat more "concepts based" than are the AICPA standards).

3-24 The *Code of Ethics* of the Institute of Internal Auditors makes it clear that this statement is incorrect. For example, members have an obligation to exercise honesty, objectivity, and diligence in the performance of their duties and responsibilities.

Questions Requiring Analysis

- 3-25 *a.* If Libra Fashions, Inc. is a nonpublic client, the requirements in this situation are contained in the AICPA *Code of Professional Conduct*. Sally should notify her firm of the offer of employment. After such notification, the firm should remove Sally from the engagement until the offer is rejected. In addition, the firm should consider performing procedures to ensure that Sally's work was performed with objectivity and integrity. If Sally accepts the position, the firm should consider modifying the engagement plan due to the additional risk resulting from the fact that Sally knows the audit plan. Since Sally will be in a key position with significant interaction with the engagement team, the firm also should consider whether the current engagement team has the experience and status to deal with Sally as a client officer. Other staff members may need to be assigned to the engagement.
- b.* If Libra Fashions, Inc. is a public company the requirements are more stringent. In addition to the requirements describe in (a), the Sarbanes-Oxley Act of 2002 (as interpreted by regulations of the SEC) provides that a CPA firm is not independent if certain members of management, including the CFO, had been members of the audit team within the one-year period preceding the commencement of audit procedures. Therefore, if Sally accepts the position before a year has passed, the CPA firm would not be independent. Libra Fashions would have to engage another CPA firm.
- 3-26 Royce should attempt to evaluate whether the threat would lead a reasonable person, aware of all of the relevant facts, to conclude that an unacceptable risk of non-independence exists. The process would include:
- (1) Determine whether a Code of Conduct Rule covers the situation. If so, the Rule should be followed.
- (2) If a Rule does not cover the situation, Royce should evaluate the situation from the perspective of a reasonable person with knowledge of the threat and any related safeguards that might mitigate the threat.
- 3-27 *a.* No. A partner in another office, with no ties to the audit, is not a covered member.
- b.* Yes. An individual on the attest engagement team is a covered member.
- c.* Yes. A partner in the engagement office is a covered member.
- d.* No. Since Jepson does not work on the audit, he is not a covered member.
- e.* Yes. By serving as a consultant, Sanders is able to influence the audit.
- 3-28 Maybe. This case illustrates the threat of "undue influence," in which the attest client's management coerces the public accountant or exercises excessive influence over the accountant. Whether or not the situation impairs the firm's independence depends on the safeguards that exist. As an example, the firm might require a second opinion regarding the acceptability of the accounting principle. If appropriate safeguards exist, the threat may be mitigated.

- 3-29 Although her decision will not be popular with the audit staff, Smith should thank the client but decline the offer, both for her and for the staff. She should explain that an outsider who had knowledge of all of the relevant facts might view the free use of a condominium as a sizable "gift" to the auditors, which might influence their independent mental attitude. Thus, we believe that to maintain an appearance of independence, the auditors should not accept this offer. Note that an illustrative case in the chapter suggests that Arthur Andersen apparently disagreed with our position in that its employees are reported to have gone upon ski trips with audit client Enron's employees (although financing details are not available).
- 3-30 No. CPAs may refuse client access to their working papers for any valid business purpose. Therefore, a CPA may require that fees be paid before working papers including such adjusting entries and supporting analysis are provided to the client.
- 3-31 a. When management and the board of directors take appropriate remedial action, the CPA is not required to report the matter outside the company.
- b. If management and the board of directors fail to take appropriate remedial action, the Private Securities Reform Act of 1995 requires auditor communication outside of the entity when the failure to take appropriate remedial action is reasonably expected to warrant a departure from a standard audit report or auditor resignation. In those circumstances, the auditors must, as soon as practicable, communicate their conclusions directly to the client's board of directors. Within one day, the management of the client must send a notification to the Securities and Exchange Commission of having received such a communication from the auditors, and a copy of the notification should be sent to the auditors. If the auditors do not receive the copy within a one-day period, they have one day to directly communicate the matter to the Securities and Exchange Commission.

Objective Questions

3-32 Multiple Choice Questions

- a. (4) A partner in the national office of the firm that performs marketing services is not considered a covered member as it is unlikely that this partner will be in a position to influence the attest engagement. Individuals assigned to the attest engagement, all partners in the office, and a manager who provides tax services to the client are all included as covered members.
- b. (1) Advertising in newspapers is an acceptable practice. The other three replies are all prohibited by the *Code of Professional Conduct*.
- c. (1) A fee for audit clients that is dependent upon the results achieved by the CPA's efforts is a contingent fee and is prohibited for audit clients by Rule 302.
- d. (1) An auditor's independence would not be considered to be impaired with respect to a financial institution in which the auditor maintains a checking account that is fully insured.
- e. (1) The declaration requires the preparer to acknowledge that the return is "true, correct, and complete . . . based on all information of which the preparer has any knowledge."

- f. (3) CPAs in public practice are prohibited from disclosing confidential information without the consent of the client, except in certain specified circumstances. Answers (1), (2), and (4) are three of the circumstances in which disclosure of information is permitted.
- g. (2) Rule 505 requires that a firm practice under a firm name that is misleading. In this situation the name is misleading since it appears that Jones' firm is a partnership.
- h. (3) Rule 201-A prohibits a public accounting firm from accepting an engagement that the firm is not competent to perform. If technical competence problems develop during the engagement, the CPAs should advise the client and withdraw from the engagement.
- i. (4) Auditors may currently prepare the company's tax return. The Sarbanes-Oxley Act, as implemented by the PCAOB, prohibits internal audit outsourcing, performing tax planning for the company's officers, and performing bookkeeping services.
- j. (2) A CPA may help train client employees for an attest client. The *Code of Professional Conduct* prohibits maintaining custody of client assets, supervising client employees, and authorizing transactions.
- k. (4) There are no *Statements on Responsibilities in Assurance Services*.
- l. (3) The IIA *Code of Ethics* does not directly address the use of sampling methods.

3–33 Task-Based Simulation

- a. Not allowable (PCAOB rules prohibit)
- b. Allowable
- c. Allowable
- d. Allowable
- e. Allowable (Because no attest services are provided, the PCAOB allows this)
- f. Allowable (Because no attest services are provided, the PCAOB allows this)
- g. Allowable
- h. Not allowable (AICPA rules prohibit this when amounts are subjectively determined and material)
- i. Not allowable (Both AICPA and PCAOB rules prohibit this when amounts are subjectively determined and material)
- j. Not allowable (PCAOB rules prohibit)

- 3–34 a. No. The information provided does not indicate a violation of the AICPA *Code of Professional Conduct*. Zabish may offer to perform the service on a contingent fee basis because she does not perform financial statement audits, reviews or certain compilations or prospective financial information examinations for Westerman Corporation.
- b. No. The information provided does not indicate a violation of the AICPA *Code of Professional Conduct*. Although Zabinski performs audits for Westerman Corporation, his firm may perform such services for the \$30,000 fixed fee.

- c. Yes. Rule 302 of the AICPA *Code of Professional Conduct* prohibits the performance of such services for a contingent fee when the public accounting firm performs financial statement audits for the client. Therefore, Zabirinski cannot provide the service for a contingent fee without violating the *Code*.
- d. No. Zabirinski may still provide the service on a contingent fee basis.
- e. Yes. Since the Sarbanes-Oxley Act prohibits the provision of financial information systems design and implementation services for an audit client (independence is impaired) Zabirinski cannot provide the service, even for a fixed fee.
- 3–35 a. Both McGraw’s and the firm’s independence is impaired because part C of Interpretation 101-1 requires that an employee not be an officer in an attest client and because immediate family members (in this case her husband) ordinarily have the same requirements as the CPA. The only exceptions for immediate family members relate to the situation in which the family member is in *other than* a key position.
- b. Neither West’s nor the firm’s independence is impaired because West is unaware of the investment. Note, however, that if West becomes aware of his father’s investment, he should not participate in the engagement.
- c. Johnson’s independence is impaired because of the investment. Because he is not a covered member, firm independence is not impaired unless that investment is more than 5 percent of the client’s outstanding equity securities or other ownership interests.
- d. Independence is not normally impaired by *other relatives*. Accordingly, since uncles are not included as *close relatives*, independence is not specifically impaired. However, that independence may be impaired in circumstances that would lead a reasonable person to question the CPA’s independence. Accordingly, the Phoenix office should consider assigning Steversen to other audits.
- e. Section B of Interpretation 101-1 indicates that all members of the CPA firm can own less than 5 percent of the client’s outstanding equity. Accordingly, both Bill Adams and McGraw and West are not independent.
- 3–36 a. Yes (accounting records must be returned).
- b. No
- c. No
- d. No
- e. Yes (consolidating entries are considered accounting records and must be returned).

The overall rule here is that if the client has not been paid its fees, the firm is only be obligated to return the accounting records. These records are the client's property. The firm's work product need not be provided to the client.

Problems

3–37 SOLUTION: James Daleiden, CPA (Estimated time: 20 minutes)

- a. No violation. There is no apparent violation in this circumstance because Rule 505 allows a CPA to use a fictitious firm name.
 - b. No violation. Distribution of such a flyer is acceptable when it is not false, misleading or deceptive. While many would consider this quite unprofessional, it is nonetheless not prohibited. Daleiden must make certain, however, that the \$50 coupon truly represents a savings for the client, otherwise the advertising would be considered false, misleading, and deceptive.
 - c. Violation. Reviewing tax returns for a fee is considered equivalent to preparation, in terms of enforcement of Rule 302. Since Rule 302 does not allow contingent fees for preparation of tax returns, the proposal of basing the fee on one-third of the savings would be considered unethical.
 - d. No violation. Paying a finders fee to associates would be considered acceptable under Rule 503 as long as the client is informed of the payment of the fee and so long as the CPAs do not perform a financial statement audit, review or certain compilations, or a prospective financial information examination for the client.
 - e. No violation. As long as he intends to give the discount, this is acceptable.
- 3–38
 - a. Not definitely impaired. The facts alone lead to an independent conclusion, but the *Code of Professional Conduct* states that CPAs should consider whether personal relationships between the CPA and the client would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the CPA's independence. Being a partner in the engagement office, he is a covered member, and therefore the firm's independence would be impaired if his independence is deemed to be impaired.
 - b. Not definitely impaired. While the partner's independence is impaired, the firm's independence is not impaired if the new partner does not participate in audits related to periods for which he or she served as the controller of Trek Corporation.
 - c. Not definitely impaired. The independence of the manager is impaired because of the business position of his father. However, since he does not work on the engagement, the independence of the public accounting firm is not impaired.
 - d. Definitely impaired. Section A of Interpretation 101-1 specifically prohibits material joint ventures between directors of the client organization and covered members of the public accounting firm. Since the partner is a covered member, both his and the firm's independence is impaired.
 - e. Definitely impaired. Fees that are long overdue may create the impression that the auditors' prospects for collection depend upon the nature of the auditors' report on the current year's financial statements. Thus, independence is impaired if professional fees for services rendered in prior years are not collected prior to the issuance of the auditors' report for the current year. Of course, this independence problem can be resolved immediately by Trek Corporation paying this liability.

- 3-39 *a.* Independence is impaired. As a partner in the office of the lead auditor (Chicago), Johnson is a covered member, and is prohibited from having, among other things, a direct investment in Gillington.
- b.* Independence is not impaired. As a partner in an office other than that of the lead auditor, Gizmo's investment does not impair independence.
- c.* Independence is impaired. The restriction on financial interests of more than 5 percent of an attest client's equity securities apply to all firm personnel and, therefore, Masterson's investment would impair independence.
- d.* Independence is impaired. Schilling, as part in charge of the entire firm is a covered member, and is prohibited from having among other things, a direct or material indirect financial interest in Gillington.
- e.* Independence is impaired. Because Gorman participates in the Gillington audit and has knowledge of a close relative's material investment, independence is impaired.

3-40 *a.*

Situation Number	Service Description	Independence Impaired (Yes, No, or Indeterminate)	Additional Information Needed for "Indeterminate" Replies
1	Customize and implement a prepackaged payroll system.	Indeterminate	Whether client makes all management decisions relating to the system.
2	Manage the portion of a client's local area network system related to payroll.	Yes	
3	Using payroll time records approved by management, generate unsigned payroll checks on a continuing basis for the client; the client signs the checks.	No	
4	Prepare the payroll tax return form and sign it on behalf of management.	Yes	
5	Approve employee time cards.	Yes	
6	Accept responsibility to sign payroll checks, but only in emergency situations.	Yes	
7	Monitor employee time cards and make changes when errors are detected.	Indeterminate	Whether management approves the changes.
8	Post client-approved entries to client's trial balance.	No	
9	Provide all of the initial training and instruction to client employees	No	

	on a newly implemented payroll information and control system.		
10	Screen candidates and recommend the most highly qualified candidate to serve as treasurer for the client.	Indeterminate	Whether criteria for evaluation of candidates are client approved; one might also wish to provide a list of qualified candidates rather than only one top candidate, although this is not required.
11	Supervise client personnel in the daily operation of the payroll system.	Yes	
12	Present payroll business risk considerations to the board of directors on behalf of management.	Yes	

- b.* If the client is not an attest client, any of the services may be performed.

Problems

3–41 SOLUTION: Gary Watson (Estimated time: 15 minutes)

- a.* The parties directly affected by Gary's decision are the two employers in that they will either split the expenses or each will pay for them in total.
- b.* Yes. If the employers discover that Gary has requested reimbursement from both of them, it may provide them the impression that students at the college lack ethical values.
- c.* Yes. If the employers discover that Gary has requested reimbursement from both of them, it may provide them with the impression that the professors at the college are not instilling proper ethical values.
- d.* Obviously, the ethical course of action is to split the expenses between the two firms. If either employer found that Gary requested total reimbursement from both of them, it is highly unlikely that he would receive an offer of employment.
- e.* Again, the ethical course would be to inform the firms and obtain the proper reimbursement.

Note to instructor: This problem is loosely based on a real situation that one of the co-authors of this text became aware of when he was an undergraduate student. Another undergraduate student traveled to New York and visited with five of the international public accounting firms. He received offers from each of the firms and proceeded to bill all five for his expenses, which greatly exceeded the amounts involved in this problem. An informal discussion among two of the recruiters resulted in discovery of his scheme. Those recruiters notified the other public accounting firms and this led to the revocation of all five of his offers.

3-42 SOLUTION: Roland Company (Estimated time: 25 minutes)

- a. The auditor should inform the management of Roland Company of the underpayment for store fixtures and existing liability of \$54,000. An adjusting entry should be proposed to increase the cost of the store fixtures and to increase accounts payable to the correct amount.
- b. The unpaid portion of the liability amounting to \$54,000 is definitely a liability and the auditor has a responsibility to see that all known liabilities are included in the balance sheet. Failure to do so would render the financial statements misleading, and would constitute dishonesty and willful misrepresentation on the part of the auditor. A belief by management that it may be able, through trickery, to avoid paying its debts is no justification for omitting such debts from the balance sheet. However, it is not the responsibility of the auditor to try to force management to pay the liability. The company may include the \$54,000 amount as part of the total of accounts payable on the balance sheet without identifying the creditor or taking any steps toward paying the debt. Such action would meet the requirement of adequate disclosure in the financial statements and would permit the auditor to issue a report indicating that the statements present fairly the financial position, operating results, and cash flows.
- c. Whether the auditor would be justified in using the information gained in the audit of Roland Company to reopen an account receivable on the accounting records of Western Showcase, Inc. constitutes a puzzling question in professional ethics. To do so might be considered a violation of the professional and confidential relationship between the auditor and the client, Roland Company. Failure to take action, on the other hand, might be regarded as a breach of faith with the second client. It could be argued that the auditor has a duty to speak so that an obvious injustice may be corrected.

If the auditor had not been retained by Western Showcase, Inc., he would not have been justified in going to that concern on his own initiative and disclosing the existence of the uncollected account. However, since he has been retained to make an audit of Western Showcase, Inc.'s financial statements, he should, in the opinion of the authors, utilize all information at his command to develop an accurate determination of the company's financial position. Professional conduct would seem to call for him to review accounts receivable of Western Showcase, Inc. very carefully. In the course of doing so, he will "discover" the underbilling of Roland Company, and propose an adjustment to reinstate this receivable. Also, during this investigation of receivables, the auditor may find accounts from other customers incorrectly handled; the fact that the error in the receivable from Roland Company went undetected suggests that internal control over receivables may be weak in the Western Showcase, Inc. system. Note that this is the opinion of the authors and that the *Code of Professional Conduct* does not directly address the issue.

3-43 SOLUTION: Financial Services, Inc. (Estimated time: 25 minutes)

Acts by Gilbert that were in violation of the AICPA *Code of Professional Conduct*, and their ethical implications are as follows (only four required):

- (1) Gilbert may be in violation of Rule 102 that requires that a member be free of conflicts of interest in rendering professional services. The insurance aspects of the business might be considered incompatible if Gilbert was making recommendations concerning insurance coverage and selling insurance to the same firms. Also, the firm may be in violation of Rule 503 regarding commissions.

- (2) Gilbert's expression of an unqualified opinion on Grandtime's financial statements that did not disclose a material lien on the building asset is a violation of both Rule 202 (Compliance with Standards) and Rule 203 (Accounting Principles).

Rule 202 provides that a member shall comply with appropriate standards when performing professional services. The third standard of reporting for audits states that "informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the report." Since there was no disclosure of the business lien in the financial statements, Gilbert should have qualified his opinion.

Rule 203 requires that a member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by a body designed by Council to establish such principles. *Statement of Financial Accounting Standards No. 5*, which was published by a body designated by Council, requires disclosure of assets pledged as collateral for loans.

- (3) Having Bradley inform the insurance company of the prior lien on Grandtime's building is a violation by Gilbert of Rule 301 of the *Code*, which enjoins a member from violating the confidential relationship between himself and his client without consent of the client. The lien should have been disclosed in Gilbert's report on Grandtime's statements, but he may not disclose it independently to a third party unless the client agrees to such disclosure. However, Rule 301 should not be interpreted to preclude a CPA from correcting a previous error—in this case expressing an opinion that the financial statements were prepared in accordance with generally accepted accounting principles when, in fact, they were not. Gilbert should have first exhausted all means to persuade Grandtime to correct the error by recalling the original financial statements and reissuing them in corrected form with a new auditor's report.
- (4) Another point, not directly addressed by the text, and related to the first point above, concerns a CPA having a financial interest in a commercial corporation that performs such insurance services. Under certain circumstances this is allowed, provided such interest is not material to the corporation's stockholders' equity, and the member's interest in and relation to the corporation is solely that of an investor. Certainly Gilbert's 50-percent interest is material to Financial Services, Inc., and Gilbert's status is not that of an investor. In this respect Gilbert is in violation of Rule 505.

In-Class Team Cases

3–44 SOLUTION: Sarbanes-Oxley Act of 2002 (Estimated time: 30 minutes)

- a. The Sarbanes-Oxley Act of 2002 and related SEC regulations prohibit the auditors of public companies from performing:
- (1) Bookkeeping or other services related to the accounting records of financial statements of the audit client.
 - (2) Financial information systems design and implementation.
 - (3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports.
 - (4) Actuarial services.
 - (5) Internal audit outsourcing services.

- (6) Management functions or human resources services.
 - (7) Broker or dealer, investment adviser, or investment banking services.
 - (8) Legal services.
 - (9) Expert services unrelated to the audit.
- b.* There are a number of arguments that have been set forth for restricting nonattest services for audit clients, including:
- (1) It is not possible for the auditors to objectively evaluate their own nonattest work as it relates to the audit. Thus independence related to the audit is impaired.
 - (2) The additional fees derived from nonattest services serves as an additional threat to auditor independence.
- c.* The arguments that have been set forth for not restricting nonattest services include:
- (1) Auditors have been providing nonattest services for audit clients for years in an objective manner.
 - (2) The additional knowledge of the client obtained from performing nonattest services actually enhances the performance of the audit.
 - (3) As long as the client establishes effective oversight over the performance of the nonattest services, the auditors can perform them in an objective manner.
- d.* Responses by students may vary, including some of arguments in (b) and (c).

3–45 SOLUTION: Cases 1 and 2 (Estimated time: 45 minutes)

Case 1

- a.* Moore and Scott are not married or related; they are merely friends. They have made no special commitments to one another, and therefore the relationship is not equivalent to that of a spouse. Substantial differences exist between their relationship and that of marriage. For example, their relationship does not create community property or rights of inheritance. Hence, the joint financial interests of marriage are not created merely by the couple's living together.
- Given that the relationship is not equivalent to that of a spouse, Scott's investment cannot be considered "direct" from Moore's viewpoint. Scott, not Moore, makes the investment decisions and receives the benefits. The securities are held in Scott's name. Moore's interest, if any, must be considered only indirect. Hence, independence is not impaired as the investment is not material to the couple's combined net worth. A third party with knowledge of all of the facts would not conclude that an unacceptable risk to independence exists.
- b.* The basic issue is appearance of independence to an informed third party. Many people view living together as essentially equivalent to marriage and would view Scott as a spousal equivalent. Thus, Moore's appearance of independence is impaired. Since he is a partner, this impairs the independence of the firm.

The *Code of Professional Conduct* states that to assess the effects of such a relationship on independence, the CPA must consider both actual ability to act independently, and whether a reasonable person aware of all the facts would consider the relationship to be equivalent to that of a spouse. As Moore and Scott are romantically linked and are living together, it is reasonable to assume that Moore's concern over Scott's financial well-being might come into conflict with his objectivity with respect to the audit client in which Scott has invested.

- c. Note to instructor: Part (c) calls for a personal opinion. We offer our opinion only as a basis for discussion; it should not be used as a standard for evaluating students' responses.

The appearance of independence is a matter of judgment. We believe that many people will think that Moore participates directly in Scott's investment decisions, at least as they relate to Moore's audit clients. In addition, we think that "living together" tends to create a certain "joint financial interests," in which each partner has a vested interest in each other's solvency. Scott should be viewed as a spousal equivalent. Thus, we feel that Moore's independence has been impaired. To resolve this problem, either Scott must refrain from investing in the audit clients of Moore's firm, or the two must live separately.

Case 2

- a. Because Mary is a staff auditor, while her independence would ordinarily be impaired through such direct financial interests, the independence of the firm would not if she is not a "covered member" under section A of Interpretation 101-1.

Alternatively, if one wishes to argue that she too is independent, article IV states that "A member in public practice should be independent in fact and appearance when providing auditing and other attestation services. Independence in appearance hinges on whether a reasonable person, having knowledge of all the facts including any safeguards, would conclude that an unacceptable threat to the CPA's independence exists. In this case, a reasonable person would not conclude that the minor holdings of Reed's husband would affect her independence of mental attitude.

The actions of Reed's husband clearly are vindictive. If such a situation is assumed to impair independence, a CPA's professional career could easily be held hostage in any marital disagreement. Also, the investment is not under Mary Scott's direct control. Hence, it should be considered an indirect investment, rather than direct. Since it is not material in amount, independence is not impaired. Finally, it is reasonable to assume that the firm would have safeguards to mitigate threats to independence.

- b. Interpretation 101-1 specifically prohibits "**any** direct . . . financial interest" in an audit client by the CPA or his or her firm. Financial interests of a CPA's spouse are attributed directly to the CPA. The Code of Conduct does not recognize the degree of harmony within the marriage as relevant. Mary and her husband are married. Thus, his direct financial interest in her firm's audit clients impairs her independence. (The independence of the firm also will be impaired if she participates in the engagement.)

Also, since the investment is community property, Mary stands to benefit or lose as a direct result of fluctuations in the client's stock price. Materiality is not an issue with respect to direct financial interests.

- c. In our personal opinion, it is unlikely that a third party with knowledge of all of the facts would conclude that there is an unacceptable risk to Mary's independence.

Research and Discussion Case**3-46 SOLUTION: International Bank of Commerce (Estimated time: 45 minutes)**

This case is loosely based on the Bank of Credit and Commerce International (BCCI) case, in which the London office of Price Waterhouse directly communicated concerns about illegal acts to the Bank of England.

- a. If you reported these illegal acts directly to the SEC without first allowing management an opportunity, you would be in violation of Rule 301 of the AICPA *Code of Professional Conduct*. It might well result in successful litigation against you by your client.
- b. The appropriate course of action is to try to persuade the board of directors and senior management to disclose the problems to the appropriate regulatory agencies. If the board of directors and management do not take the appropriate action, the Private Securities Reform Act of 1995 requires auditor communication outside of the entity when the failure to take appropriate remedial action is reasonably expected to warrant a departure from a standard audit report or auditor resignation. In those circumstances, the auditors must, as soon as practicable, communicate their conclusions directly to the client's board of directors. Within one day, the management of the client must send a notification to the Securities and Exchange Commission of having received such a communication from the auditors, and a copy of the notification should be sent to the auditors. If the auditors do not receive the copy within a one-day period, they have one day to directly communicate the matter to the Securities and Exchange Commission.
- c. Arguments for requiring direct reporting of illegal acts to regulatory agencies:
 - Regulatory agencies would be more promptly notified of problems.
 - The requirement would be consistent with the auditors' role of a representative of the users of the financial statements, i.e., the watchdog role.
 - The requirement would be consistent with maintaining efficient securities markets because there would be prompt disclosure of illegal activities that could lead to financial difficulties for the country.

Arguments against requiring direct reporting of illegal acts to regulatory agencies:

- The requirement would place auditors in the role of law enforcement officers.
- The requirement would reduce communications between management and the auditors, because management would be concerned that the auditors would report the information to regulatory agencies. Such a fear might result in reduced communications even in situations in which no such illegal acts have occurred.
- The requirement would place the auditors and management in an adversarial position.