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# **ETHICS FOR TEXAS**

**By Dr. Jae Shim and  
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## Chapter 1: Ethics and Ethical Reasoning

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### LEARNING OBJECTIVES:

After studying this chapter, you will be able to:

1. Define ethics.
2. Differentiate between amoral and ethical values.
3. List and characterize two systems of ethics.
4. Differentiate between legal versus ethical codes.
5. Discuss the development of law and ethics.
6. List examples of philosophers who contributed to the development of ethics.

Ethics is the “science of morals.” A moral is an accepted rule or standard of human behavior. The understanding of “accepted” is “accepted by society,” and accepted only in so far as the behavior in question being behavior that affects others in the society, even if only indirectly. The implication of this definition is therefore that private actions that have no impact on others are a matter for personal morality, which is not of business or organizational concern.

However, the distinction between personal morality and business morality may not always be so clearly defined. This is because individuals bring personal values to their jobs and to the real or perceived problems of moral choice that confront them at work. Moral choices sometimes must be made because of tensions within individuals, between individuals, or between individuals and what they believe to be the values that drive their organizations.

Furthermore, business organizations do not operate in a social vacuum. Because of the ways business organizations can and do affect the lives and livelihoods of society at large, some would argue that business organizations are kind of “moral agents” in society. Therefore, managers and the general public alike often wrestle with defining exactly what constitutes the ethical way of doing business, and what constitutes proper constraints on individual self-interests, and by whom shall these constraints be imposed.

A further complexity results from the fact that businesses are increasingly becoming global in nature. Different countries have or seem to have vastly different customs and values. Understanding and assessing whether and how these different cultural and ethical conflicts should be taken into account is often most difficult.

## ATTITUDES TOWARD ETHICS

AMORAL:	Condone any actions that contribute to the corporate aim. Getting away with it is the key. No set of values other than greed.
LEGALISTIC:	Obey the letter of the law but not the spirit of it, especially if it conflicts with profits. Ethics ignored until it becomes a problem.
RESPONSIVE:	Take the view that there is something to gain from ethical behavior, Using ethics as a tool to attain corporate aim.
EMERGING:	Ethical values becoming part of the culture. Codes of ethics being action documents, and likely to contain statements reflecting core values.
ETHICAL:	Total ethical profile. Everything done is ethical, and the right thing is always done by everyone. The ideal.

In general, a key focus of ethics is the concept of integrity (or honesty). Integrity in broad terms will imply that no business-persons in the course of their business functions should be party to the falsification of any facts or information or make any statement which knowingly is misleading, false or deceptive.

Another major focus of ethics is professional competence and due care, which implies that business professionals should always perform their functions in accordance with the law and regulations. In other words, business transactions and professional functions should not be undertaken unless one possesses the required competence and technical skills.

A more controversial focus is the area of freedom from conflicts of interests. The preferred position of many is that one should always avoid concurrent involvement in any business, occupation or activity, which might result in the compromising of integrity, objectivity and independence of decision making.

## ETHICAL SYSTEMS

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences.
Deontology (Kantian ethics)	It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

In defining law and ethics and their relationship to each other it is necessary to distinguish between moral and legal rights and duties. Morally, a person's rights consist of claims that he can justly make to the conditions of well-being; his duties consist of what he can justly contribute to well being. Legal rights and duties – that is, claims and obligations enforceable at law - may or may not be fully in harmony with prevalent moral opinion systems in which law and ethics and religion are closely interwoven. The impact of moral opinion on law varies with the type of political structure and influence of public opinion.

In free societies, the ultimate justification of law is that it serves moral ends. But the dependence of law on moral principles must not be taken to imply that there is a set of moral principles which can be laid down for guidance. However, most free societies are coming to be more or less consistent in principles that draw the line between law and morals. The task of ethics becomes two-fold: to bring out what is involved in the notion of a principle or norm of action and to recognize the ideals that serve as agencies of guidance and control.

A number of consistent principles recognized in modern society are the individual responsibility and equity. The end of law is to secure the greatest possible general individual self-assertion. In the Judeo-Christian ethic, responsibility is a given: the best ordering of human society in which the individual may come to full manhood and satisfying existence. On the basis of equitable doctrine we can say confidently that morality is inseparable from the legal order; that right and wrong is part of the legal order.

## **HISTORICAL FOUNDATIONS OF LAW AND ETHICS**

The great religions of the world gave birth to several concepts that evolved into structural precepts for society. A commonality of precepts evolved with the passing of tribal customs and tribal belief systems and the rise of the great religions of the world.

"The monotheistic idea of God unifies and coordinates the spiritual goods of the race. The unity of GOD involves the unity of all classes of men. This is a long step toward equality. The sense of sin became part and parcel of the common consciousness. It is a leveler and equalizer," for the good of the tribal society now becomes for the good of the individual. It must come to pass that a given society, if it is to retain the right to exist, must be continually extending the experience of its best things to men who were at one time outside, the pale of the best. The principle of individuality, once established, draws after it the principle of progress." "If it amounts to this, that wherever you find man, you find the eternal goods, and therefore the highest worth. The scale of market prices for the common man is forever disarranged by the discovery in him of something that is above price."

Two of the primary maxims in ethics are the utilitarian rule "Each man is to count for one, nobody for more than one". The second is Kant's – "Always treat humanity, whether in yourself or another, as a person, and never as a thing."

"The only ground for counting every body as one, and nobody as more than one is the presence in all men of a something or other which possesses such value that existing social forms and economic accumulations cannot bid against it."

"The social question is the moral question, first, because its ultimate root is a choice between divergent ideals of the state, that, between different ways of viewing and organizing the total human life in time and space; and secondly, because, as a consequence, the question concerning the worth of the labor turns into the question concerning the worth of the laborer". The history of conscience is the history of the individual where 'conscience' means knowing along with " ... nothing can be good for one man that is not law for all men."

## SELECT DEVELOPMENT OF LAW AND ETHICS

This section will review the historical evolution of law and ethics through select excerpts of legal philosophy from Plato to Hegel.

**PLATO:** Plato maintained that all wrong doing is involuntary and arises from ignorance since right conduct is happiness, and wrong conduct is unhappiness, and no one therefore would willingly choose wrong conduct which would lead to unhappiness. Plato's resolution was to make a distinction between acts which were remediable in damages and acts which require punishment between injury and wrongdoing. If there had been a wrongdoing, the guilty person must not only pay for the injury, but must also be punished, ... the court must teach him virtue.

Plato endeavored to extend his ideas of code making from the civil to the criminal field, and to devise a penal code based upon rational principles. In the history of jurisprudence, no one has been more fully aware of the necessity of the reign of law for any state which desires to realize the ultimate values of happiness and well-being for its citizens.

**ARISTOTLE:** Aristotle assigned to jurisprudence what must always be its main task, the establishment of a rational legal order for a given society. "Every art and every inquiry and similarly every action and pursuit, is thought to aim at some good; and for this reason the good has rightly been declared to be that at which all things aim." Law may also be a means in the inculcation of established ethical ideals and the promotion of new ones. The precepts of the law are to live honorably, not to hurt another, to give each man his due." He further maintained that the state must train and educate its citizen in the spirit of the law - for there is no merit in the most valuable laws if citizens are not trained and educated early. "If a man is to lead the good life he must practice it a long time."

Aristotle left a powerful legacy on the law of property, contract, inheritance, possession, crime and punishment and tort.

**CICERO:** Cicero established a bridgehead between ancient and modern legal thought that was to be dominant in Western thinking. Justice is one; it binds all human society, and is based on one law, which is right reason applied to command and prohibition. Cicero's jurisprudence embraced a humanitarian ideal...that what people have always sought is equality of rights before the law. Laws were invented to speak to all men at all times in one and the same voice. He paved the way for identification of law and morality.

**ST. THOMAS AQUINAS:** "Law is defined by St. Thomas as an ordinance of reason for the common good, made by him who has care of the community, promulgated." His definition is an attempt to embrace all the law, the eternal, the natural as well as the human; there is an effort to include what is regarded as ethically necessary. Law is a rule or measure of

Acts whereby one is induced to act or restrained from acting. The elements of law ... insist that it is a form of reason, holds that it must be made for the common good, by the guardian of the community, and to teach men to lead the good life.

St. Thomas stated several principles that are inherent in the law: Law binds one to Act. Therefore, the first principle of human acts is the reason – modern substitutes for reasons have become utility, authority, experience. A second principle for common law asserts that choice between alternative rules of law shall rest on a deliberate balancing of possible ends and means. Third, the law must be for the common good. It rests on the ethical ideas that laws are rules of conduct which have as their final end the realization of happiness. Since, there are no limits to the good at which law aims, it is not restricted to the good of a particular person but always directed to the common good. Finally laws must be promulgated or made known to the people. Man should be informed of the laws he was expected to obey.

St. Thomas' argument for law as a necessity of human society is entirely an ethical one. The approach today attempts to show law in some sense as an essential constituent of society, generally, altogether apart from its function as an instrument in the promotion of ethical conduct. When the observance of the letter of the law is against the equality of justice and public good it is equitable to disregard it.

**FRANCIS BACON:** For Francis Bacon, there was only one end of law and that was the happiness of the citizens. He asserted that private rights were dependent ultimately for their security upon the preservation of public law extended to everything that affected the well being of the state. In Rome, private law was that part which looked to the interests of individuals.

Bacon's ultimate achievement or ideal was that certainty was the primary necessity of law. The best law leaves the least to the discretion of the judge, and this can come about only if the laws are certain. Bacon's first remedy to achieve certainty is the basis of the theory of precedents and is therefore the root of the common law system of case law.

**HOBBS:** Hobbes distinguished law and right as complete opposites to each other. Right is the liberty which the laws leave us. The laws are the restraints by which we agree mutually to abridge one another's liberty. Hobbes emphasized the idea that morality was based on instructed prudence. In thinking of law he thus took his departure from neither the ethical nor the rational – his idea culminated in the doctrine that no positive law can be unjust. He admitted of the validity of ethical rules and conceded that they were anterior to the establishment of the state. Hobbes' idea became one of the most powerful weapons for the analysis of legal phenomena ever devised.

**SPINOZA:** His views contributed to the welfare of our social existence in that they taught social cooperation and contentment. He felt the attainment of virtuous habits is something for each man to achieve for himself if he can. Morality is not the business of the state – which is concerned solely with security. The roots of law in Spinoza's system is uniformity. He stated that "the moral judgment is determined by what a man would do if he were free to do it," and hence it is only necessary that he should think himself to be free in order to justify moral responsibility. Moral responsibility rests solely on the attitude displayed in so-called "choice."

**LEIBNIZ:** His central idea was that law should be taught both as a science and as a practical discipline. He insisted upon the necessity of a liberal education for the lawyer. When we train students in the law we are instructing them in one of the most vital functions of a culture – “the maintenance and development of a dominant order of society.” For Leibniz, God is the foundation of all natural Right; God's existence serves as sufficient guarantee of the highest possible legal and moral condition in the universe. His philosophy was to exalt enlightenment, education and learning. He conceived justice as a communal virtue that is a virtue which preserves the community. Leibniz defined five types of communities: the marital community, the family community of master and servant, the community of the household, the civil community comprising the city, province and the state, and finally the community of God – the church. The aim of the community was to attain happiness. For Leibniz the end of the law emphasized two tasks – one, a proper consideration of the human being and second, the attainment of the common end as the measure of social values.

**LOCKE:** Locke believed he could, through reason, frame a set of moral rules which would be universally applicable. He took the position that human reason needed the assistance of religion in order to work out a system of ethics. At the heart of Locke's theory of civil society was the idea of the law. The great and chief end of men uniting into commonwealths, and putting themselves under government, is the preservation of their property. Law to Locke was a branch of ethics, and laws in their essence were moral rules. He did not think of law as a command but as that which is set up by authority as a rule for the measure of conduct. In Locke's system the capacity of Supreme Power is fiduciary – it establishes a pattern to which behavior should conform – which associates rewards and penalties for conformity or infractions ..... the end of law is not to abolish or restrain, but to preserve and enlarge freedom. Where there is no law, there is no freedom.

**HUME:** Hume based his studies on human nature. In his system, justice serves both an ethical and a sociological function. In ethics ... what is approved is pleasant or promotes human happiness. A legal system to be socially useful must adhere strictly to its rules even at the expense of injustice in individual cases. Hume advanced the contention that public utility is the sole origin of legal justice and the sole foundation of its merit. For example, a criminal has fewer rights than an innocent man, but he is nevertheless accorded some measure of protection by law. Hume distinguished many of the separate ideas which jurists now find in the concept "LAW". Property in the broad sense employed by Hume embraced the individual's rights to life, liberty and health. Hume's solution of why men obey law is essentially a sociological and not an ethical one. He attempted to show that morality was founded on feeling and not reason. Justice can be understood only on the basis of sympathy for the welfare of human life.

**KANT:** Kant developed his system of law on principles that originate in reason. The Kantian rule became the celebrated injunction: "Every man is free to do that which he wills provided he infringes not the equal liberty of any other man." (Herbert Spencer). Kant's conception of right became what he termed Universal Law of Right: Every action is right which in itself or in the maxim on which it proceeds, is such that it can exist along with the freedom of the will of each and all in action. Kant made a sharp distinction between ethics and law. Ethics as distinguished from law does not impose upon me the obligation to make the fulfillment of rights a maxim of my conduct. Kant assigned possession two meanings, physical possession and rational or juridical possession. He stated anyone who would assert the right to a thing as his, must be in possession of it as an object. "The property right is essentially a guarantee of the exclusion of other persons from the use of handling

the thing. To enforce this right the holder must be able to assert his right." Kant defines moveable property as everything that can be destroyed. Kant limits the right of taking possession of the soil to the extent of the capacity to defend it. Kant's important contribution is his idea that right is a thing that presupposes a collective will of all united in a relation of common possession. One of his most influential ideas is his theory of contract. Kant calls the transference of property to another its "alienation", and the act of united wills of two persons, by which what belongs to one passes to another, he terms "contract".

Kant held that four juridical acts are involved in every contract--two preparatory; an offer followed by an indication that the offer will be accepted; these two are followed by a promise and an acceptance. In civil law Kant's separation of offer and promise still prevail. By contract, Kant held, "I acquire the promise of another, as distinguished from the thing promised." His concept of the Criminal law turns on the idea of retributive justice. He defined crime as any transgression of the public law which makes him who commits it incapable of being a citizen.

**FICHTE:** For Fichte, the basis of law is the idea of the legal relation. The conception of law is the conception of a relation between human beings. He defines this relationship as the compulsion upon each individual to restrict his freedom in recognition of the possibility of the freedom of others. He calls this the "relation of legality". In no sense is jurisprudence to be connected with morality. Jurisprudence is not a branch of ethics. Law merely permits but morality commands. Fichte's law is a law of freedom.

Individuals are free to accept or reject it. The end of law is a community of free beings. All positive laws follow the principle of right. They cannot be arbitrary and they must be such as every rational being would make them. Fichte reached the conclusion that natural law, or a legal relation between men, is not possible except in a commonwealth and under positive law. He asserted to supporting propositions: "all law is purely the law of reason", and "all law is the law of the state". Man separates himself from his citizenship in order to elevate himself with absolute freedom to morality; but in order to do so he becomes a citizen.

**HEGEL:** Hegel emphasized two ideas – will and personality. "Be a person and respect others as persons." From the ideas of will and personality he developed three categories of right – possession of property, contract and wrongdoing and crime. Hegel's system is based upon a principle of knowledge, and reason, which acts universally. The ethical rules which are to guide individuals must be given a universal form.

## CONCLUSIONS

In the historical development of law there are many different points of view. It is for this reason that the law is unable to accept without modification many of the results of ethical inquiry. In modern terminology law creates a duty "... there are no properties of goodness and badness that states of affairs inherently possess, and no properties of rightness or wrongness that inhere in actions."

Value judgment in a broad sense compares contrasted ways of life; rationality, prudence and stability, (one of pleasure and happiness) versus the state of anxiety, confusion, inner turmoil and impulsive rashness. The first is a "good" way of life; the other is a "bad" way in terms of value. The best way of life involves the guidance of reason, and also the way of knowledge, of understanding, and of relative freedom from error.

Moral responsibility rests solely on the attitude displayed in so-called "choice". The act of choosing is essentially a proper and stringent expression of the ethical. Whenever in a stricter sense there is a question of an either/or, one can always be sure that the ethical is involved.

An ethic must first decide upon the kind of social effects which it desires to achieve and the kind which it desires to avoid. It must then decide, as far as our knowledge permits, what acts will promote the desired consequences; these acts it will praise, while those having a contrary tendency it will condemn. To the extent to which man has freedom, he needs a personal morality to guide his conduct. "Good and evil grow up together and are bound in an equilibrium that cannot be surrendered. The most we can do is try to tilt the equilibrium toward the good." The least we can do is be aware of our standards of conduct "... the habit of being amoral should make the immoral come to seem right."

### **Ethical Reasoning and Accountants**

The largest part of the prior research projects which have been done on ethical issues in accounting have generally avoided theoretical discussions about "right and wrong" or "good and bad" choices. Instead, they have focused on determining whether or not accountants are abiding by the rules of professional conduct. We have already discussed the many philosophical theories of ethics earlier in this chapter, but there are basically two principles used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences.
Deontology (Kantian ethics)	It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

In utilitarianism, the focus is based on the consequences of an action rather than abiding by rules. Deontology, on the other hand, focuses on just the opposite. Under Deontology principles, an accountant would be more concerned with abiding by rules of professional conduct no matter what the consequences.

For example, a study was published in 1994, to determine how accountants, specifically auditors, used ethical reasoning when confronted with issues related to client confidentiality. Rule 301, *Confidential Client Information*, of the AICPA's Code of Professional Conduct states that a member in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations

- (1) To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations
- (2) To discharge his/her professional obligations properly under Conduct Rules 202 and 203
- (3) To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization
- (4) To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

In the study, a survey consisting of three different circumstances was sent to 100 randomly selected CPAs. Each CPA was asked to respond to each circumstance described using the following guide:

- 1) To inform or not inform a third party of confidential client information, and
- 2) To indicate which response given in 1) was considered "good ethical behavior" if the Code was disregarded. Respondents were also asked to provide justification for their answers.

The following are the circumstances they were given:

“Scenario 1: James Corporation employs the regional CPA firm of Green and Cash to audit its financial statements. The firm has been asked to prepare quarterly financial statements for the first quarter of 1986. Bob Ethics, a staff accountant, was assigned to do the work. During the course of preparing the statements, Bob discovered that James Corporation materially understated net income on last year's tax return. Bob informed his supervisor about this and the client is asked to prepare an amended tax return. The client, however, refused to take corrective action.

Scenario 2: Johnson Manufacturing Corporation is a publicly owned company that manufactures equipment used by hospitals and medical laboratories. The company is audited by the national accounting firm of Adams & Pitre. One day, John, the senior in charge of the engagement overheard a conversation between two managers indicating that although they met inspection standards, they were aware of a defect in a particular piece of equipment, but they had not notified any of their customers because they felt the probability of malfunction was low. John takes this information to the controller and is told not to include it in the audit report. He then takes it to the manager on the engagement. The manager informs University Hospital, one of its clients, and also a major customer of Johnson Manufacturing Corporation, not to purchase any more equipment from Johnson. Johnson sues Adams & Pitre for violating the confidentiality rule.

Scenario 3: William Johnson, a CPA, served as a director of Last National Bank for a year. As a director, William may be held liable for damages if he fails to use care and prudence in administering bank affairs and such action causes the bank to suffer a financial loss. In the course of an audit, William discovered a seriously

weakened financial position in a client who has a large loan at Last National Bank. Disclosure of this condition to the other bank directors would minimize the bank's loss, however, since the audit has not been completed, this would represent a violation of Rule 301 of the Code.<sup>1</sup>

According to the study, the following were the results, conclusions and implications:

“Scenario 1. Given a Code, most (78%) respondents would not inform the IRS. This is in agreement with the rule of conduct. Although the variability increased, most CPAs (70%) in this situation, would make the same decision without a Code. This is consistent with the justification given that most CPAs perceived themselves to be an advocate of the client in a tax engagement. There was no perceived conflict in the rule of conduct and what most accountants perceived as good ethical behavior.

Scenario 2. Most CPAs (78%) responding in this situation would adhere to the Code and not inform one client of information discovered while auditing another client. A large percentage (52%) of respondents, however, indicated that informing would be the "best ethical behavior." In most instances, "potential safety concerns" were cited as the justification for considering informing as the "best ethical behavior." Thus, there appears to be some conflict in adhering to the Code and the moral value of some CPAs.

Scenario 3. Given a Code, a majority (78%) of CPAs would not inform, which is in agreement with the Code. A lesser percentage (53%), however, feel this is the best ethical behavior.

#### Conclusions and Implications

The findings of this study indicate that CPAs usually adhere to the Code (rule deontology) in resolving issues involving confidentiality. However, such decisions are not always in accord with what they perceive as "good ethical behavior." The broad principles of the Code indicate that ethical conduct, in the truest sense, means more than abiding by a letter of a rule. It means accepting a responsibility to do what is honorable or doing that which promotes the greatest good to the greatest number of people, even if it results in some personal sacrifice. Somehow, the profession needs to emphasize the "greatest good" criterion more strongly in applying the rules of conduct.”

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<sup>1</sup> “Ethical reasoning in confidentiality decisions,” by Barbara L. Adams, Fannie L. Malone, and Woodrow James, Jr., *The CPA Journal*, July 1994.

## **CHAPTER 1 – REVIEW QUESTIONS**

*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. In most free societies there are a number of principles that are both legally and morally consistent.
  - a) true
  - b) false
  
2. Kant developed his system of law on the principle of human nature.
  - a) true
  - b) false

## **CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES**

1. **A: True is correct.** The task of ethics is two fold: to bring out what is involved in the notion of a principle or norm of action and to recognize the ideals that serve as agencies of guidance and control.

B: False is incorrect. Modern society recognizes that individual responsibility and equity are guiding moral principles. To be effective, ethics must be expressed as a set of principles or values, and a standard of conduct by which the individual guides his/her own behavior and judges that of others.

(See page 1-3 of the course material.)

2. A: True is incorrect. Kant made a sharp distinction between ethics and law: “Ethics as distinguished from law does not impose upon me the obligation to make fulfillment of rights a maxim of my conduct.”

**B: False is correct.** Kant developed his system of law on principles that originate in reason.

(See page 1-6 of the course material.)

## Chapter 2: AICPA Ethics

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### LEARNING OBJECTIVES:

After studying this chapter, you will be able to:

1. Differentiate between rulings and principles of the AICPA's Code of Professional Conduct.
2. Briefly describe the six principles.
3. List the eleven rules.
4. Outline ethics rulings on independence.
5. List consulting services prohibited by the Sarbanes-Oxley (SOX) Act of 2002.
6. Outline the standards for tax services
7. Explain disciplinary mechanisms within the profession.
8. List the key features of corporate responsibility law (Sarbanes-Oxley Act).

This chapter covers the AICPA's *Code of Professional Conduct*, Statements on Standards for Consulting Services, and the disciplinary systems within the accounting profession. This chapter has six subunits. The first section is a condensed, but comprehensive, summary of the AICPA Code of Conduct. The second section contains summaries of AICPA Ethics Interpretations and Professional Ethics Rulings under the 11 Rules of Conduct. The third section addresses Statements on Standards for Tax Services. The fourth section lists some of the consulting services prohibited by the Sarbanes-Oxley (SOX) Act of 2002. The fifth section covers disciplinary systems within the profession. The final section outlines the key features of the SOX.

### AICPA's CODE OF PROFESSIONAL CONDUCT

It consists of two sections: Principles and Rules. The six principles, which provide the framework for the rules, are goal-oriented and aspirational but nonbinding.

#### Synopses of the Six Principles

1. *Responsibilities.* Members should exercise sensitive professional and moral judgments when carrying out their professional responsibilities. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. A distinguishing mark of a profession is acceptance of its responsibility to the public.
2. *The Public Interest.* Members should act to benefit the public interest, honor the public trust, and demonstrate commitment to professionalism. The AICPA adopted the ethical standards because a distinguishing mark of a profession is an acceptance of responsibility to the public.
3. *Integrity.* Members should perform all professional responsibilities with the highest sense of integrity to maintain public confidence.

4. *Objectivity and Independence.* A member should maintain objectivity and be free of conflicts of interest. A member in public practice should be independent in fact and appearance when providing attestation services. Objectivity is a state of mind, a quality that lends itself 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.
5. *Due Care.* A member should follow the profession's technical and ethical standards, strive for improved competence and quality services, and discharge professional responsibility to the best of the member's ability. Members must adequately plan and supervise any activity for which they are responsible.
6. *Scope and Nature of Services.* A member in public practice should follow the Principles of the *Code of Professional Conduct* in determining the nature and scope of services.

### **Synopses of the Eleven Rules**

**Rule 101** — *Independence.* A member in public practice should be independent when performing professional services as required by standards-setting bodies.

- (1) In this context, rules of the state boards of accountancy, state CPA societies, the Independence Standards Board, the SEC, the General Accounting Office, and other bodies may be relevant.
- (2) Relevant AICPA standards-setting bodies are the Auditing Standards Board (ASB), Accounting and Review Services Committee, and Management Consulting Services Executive Committee. The foregoing bodies are all authorized to promulgate attestation standards.
- (3) The ASB issues Statements on Auditing Standards. Thus, SAS 1 is consistent with the requirement for auditors to maintain an independence in mental attitude. To inspire public confidence, an auditor must not only be independent (intellectually honest) but also be recognized as independent (free of any obligation to, or interest in, the client).
- (4) The fourth general attestation standard likewise requires practitioners to maintain an independence in mental attitude when performing attest engagements.
- (5) Under Statements on Standards for Accounting and Review Services, an accountant may not report on a review of the financial statements of a nonpublic entity if (s)he is not independent.
- (6) According to the AICPA's Statements on Standards for Attestation Engagements, a practitioner must also be independent to examine or apply agreed-upon procedures to prospective financial statements (forecasts and projections).

- (7) SEC independence regulations were revised in accordance with the Sarbanes-Oxley Act of 2002.
- (a) Audit committees must preapprove the services performed by accountants (permissible nonaudit services and all audit, review, and attest engagements). Approval must be either explicit or in accordance with detailed policies and procedures. If approval is by the latter, the audit committee must be informed, and no delegation of its authority to management is allowed. However, preapproval is not needed for nonaudit services representing less than 5% of the annual amount paid to the accountant if (1) the services were not recognized as nonaudit at the time of the engagement, and (2) the audit committee approves prior to completion of the audit.
  - (b) An issuer must disclose in its proxy statement or annual filing fees paid to the accountant segregated into four categories: (1) audit, (2) audit-related, (3) tax, and (4) all other. The disclosure is for the two most recent years and must describe the services in (2)-(4).
  - (c) The lead and concurring (reviewing) audit partners must rotate every 5 years, with a 5-year time-out period. Other audit partners must rotate every 7 years, with a 2-year time-out.
  - (d) An accountant is not independent if, during the audit and the period of the professional engagement, any audit partner (excluding specialty partners such as tax partners) earns or receives compensation for selling services (excluding audit, review, or attest services) to the audit client.
  - (e) Conflicts of interest. An accounting firm is not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee accepts employment with a client if (s)he has a continuing financial interest in the firm or is in a position to influence the firm's operations or financial policies. Moreover, an accounting firm is not independent if a CEO, CFO, controller, or person in an equivalent position for an issuer was employed by that firm and participated in any capacity in the audit of that issuer during the year before the beginning of the audit.
  - (f) Communications with the audit committee by the accounting firm must include (1) all critical accounting policies and practices; (2) all material alternative accounting policies and practices within GAAP that were discussed with management; and (3) other material written communications with management, such as management representations and schedules of unadjusted audit differences. These communications must be prior to filing the audit report with the SEC.

**Rule 102 — *Integrity and Objectivity.*** A member shall maintain objectivity and integrity, be free of conflicts of interest, not knowingly misrepresent facts, and not subordinate his/her judgment to others when performing professional services.

**Rule 201** — *General Standards*. A member shall comply with the following:

- (1) Undertake only those services that the member can reasonably expect to complete with professional competence.
- (2) Exercise due professional care when performing professional services.
- (3) Adequately plan and supervise performance of professional services.
- (4) Obtain sufficient relevant data to provide a reasonable basis for conclusions in relation to any professional service.
  - (a) Proficiency. Auditors must have adequate technical training and proficiency. According to SAS 1, both education and experience, as well as proper supervision, are necessary. Objectivity and independent judgment are necessary in the preparation of the audit opinion. An auditor must have experience and seasoned judgment to accept final responsibility for an audit opinion.
  - (b) Due professional care must be exercised in the planning and performance of the audit and the preparation of the report. According to SAS 1, an auditor should have the degree of skill commonly possessed by other auditors and must exercise it with reasonable care and diligence. An auditor should also exercise professional skepticism. The exercise of due professional care allows the auditor to obtain reasonable assurance. Absolute assurance is impracticable due to characteristics of fraud such as concealment by collusion, withheld or falsified documentation, or management override of controls.

**Rule 202** — *Compliance with Standards*. A member who performs professional services must comply with promulgated standards.

**Rule 203** — *Accounting Principles*. A member shall not express an opinion or make an affirmative statement about conformity with GAAP or state that (s)he is not aware of any material modifications that should be made to achieve conformity with GAAP, given any departure from an accounting principle promulgated by bodies designated by the AICPA Council to establish such principles that has a material effect on the financial statements or data taken as a whole. However, if the member can demonstrate that, due to unusual circumstances, the financial statements or data would have been misleading without a departure from GAAP, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons compliance with the principle would be misleading.

**Rule 301** — *Confidential Client Information*. A member in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations

1. To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations.

2. To discharge his/her professional obligations properly under Conduct Rules 202 and 203.
3. To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization.
4. To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy.

**Rule 302** — *Contingent Fees*. A contingent fee is established as part of an agreement under which the amount of the fee is dependent upon the finding or result.

- (1) The receipt of contingent fees by a member is prohibited when the member performs an audit, a review, a compilation when the report will be used by third parties and the report does not disclose the CPA's lack of independence, or an examination of prospective financial information (forecasts and projections).
- (2) A contingent fee is not permitted for preparing an original or amended tax return or claim.
- (3) Fees are not deemed to be contingent if fixed by courts or other public authorities, or in tax matters, if they are based on the results of judicial proceedings or the findings of governmental agencies.

**Rule 501** — *Acts Discreditable*. A member shall not commit an act that is discreditable to the profession. Withholding as a result of nonpayment of fees for a completed engagement certain information contained in the client's books would not be considered such an act. The member's duty to return client records is absolute. However, the duty to return other information not related to the client's books and records is not absolute. Although the client's financial information may be incomplete as a result, if fees for a completed engagement have not been paid, such other information may be withheld. Thus, the duty to return is conditional upon payment of fees with respect to information such as adjusting, closing, combining, or consolidating entries and information normally found in books of original entry and general or subsidiary ledgers.

**Rule 502** — *Advertising and Other Forms of Solicitation*. A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation done in a false, misleading, or deceptive manner. Solicitation through coercion, overreaching, or harassing conduct is prohibited.

**Rule 503** — *Commissions and Referral Fees*. A member in public practice shall not accept a commission for recommending or referring to a client any product or service, or for recommending or referring any product or service to be supplied by a client, if the member performs for that client an audit, a review, a compilation when a third party will use the financial statement and the report does not disclose the CPA's lack of independence, or an examination of prospective financial information.

- (1) Permitted commissions must be disclosed to any person or entity to whom the member recommends a product or service.

- (2) A member who accepts a referral fee for recommending services of a CPA or who pays a referral fee to obtain a client must disclose the arrangement to the client. A referral fee is compensation for recommending or referring any service of a CPA to any person. Referral fees are not considered commissions.

**Rule 505** — *Form of Organization and Name.* A member may practice public accounting only in a form of organization allowed by law or regulation that conforms with resolutions of the AICPA Council.

- 1) The firm name must not be misleading.
- 2) Names of past owners may be included in the name of the successor organization.
- 3) A firm cannot designate itself as “members of the AICPA” unless all CPA owners are members.

**Definitions.** The following are summaries of selected ethics definitions.

- *Attest engagement* — One that requires independence.
- *Attest engagement team* — Participants in the engagement, including partners who perform concurring or second reviews and all employees and contractors retained by the firm, but excluding specialists.
- *Close relatives* — Parents, siblings, or nondependent children.
- *Covered member* — (1) An individual on the attest engagement team or who is able to influence the engagement, (2) a partner or manager who provides at least 10 hours of nonattest services to a client, (3) a partner in the office where the lead engagement partner primarily practices in relation to the engagement, (4) the firm (including its benefit plans), and (5) an entity that can be controlled by the foregoing parties.
- *Financial institution* — An entity that normally makes loans to the public.
- *Firm* — A form of organization permitted by law or regulation that is consistent with the resolutions of the AICPA’s Council and practices public accounting. The term “firm” includes partners except for the purposes of Rule 101.
- *Immediate family* — A covered member’s spouse, equivalent of a spouse, or dependents.
- *Individual in a position to influence the attest engagement* — One who (1) evaluates the attest engagement partner or recommends his/her compensation; (2) directly supervises or manages that partner, including all levels above such supervisor or manager; (3) consults with the engagement team about technical or industry-related issues; or (4) participates in or oversees quality control for the engagement, including all senior levels.

- *Joint closely held investment* — An investment in any entity or property by the member and (1) the client, (2) the client's officers or directors, or (3) an owner who can exercise significant influence if the investment permits such parties to control the entity or property.
- *Key position* — One in which an individual is primarily responsible for (1) significant accounting functions supporting material financial statement components, or (2) for the preparation of the statements. A key position is also one able to influence financial statement content, for example, director, CEO, CFO, general counsel, chief accountant, director of internal audit, or treasurer.
- *Normal lending procedures, terms, and requirements* — Those reasonably comparable with those for similar loans to others from the financial institution in the period when a commitment was made for a loan to a covered member.
- *Period of the professional engagement* — This period starts at the earlier of when the member signs an initial engagement letter to perform attest services or begins to perform. It continues for the entire professional relationship and does not end with the issuance of a report and start again with the next year's engagement. It ends with the later of notification by the member or client or by issuance of a report.

*Note:* Common law does not recognize privileged communication between a CPA and client. In some states and in some federal tax matters, however, the auditor may be protected by a privilege created by statute.

## **INTERPRETATIONS AND RULINGS**

Interpretations and rulings are presented for each of the eleven Rules. The Interpretations are in outline format followed by brief summaries of the Rulings.

**Rule 101** — *Independence.*

### **A. Interpretation 101-1 (Interpretation of Rule 101)**

1. Independence is impaired if, during the period of the professional engagement, a covered member
  - 1) Had a direct financial interest or a material indirect financial interest in the client.
  - 2) Was a trustee of any trust or executor of any estate that had a direct or material indirect financial interest in the client AND (1) the covered member's position conferred investment authority, (2) the trust/estate owned more than 10% of the client, or (3) the interest of the trust/estate was more than 10% of its total assets.
  - 3) Had any joint, closely held investment that was material to the covered member.
  - 4) Had a loan to or from a client, any of its officers or directors, or an individual owning at least 10% of the client. Exceptions are grandfathered loans and certain other permitted loans.

2. Independence is impaired if, during the period of the professional engagement, a firm partner or professional employee, such individual's immediate family, or a group of these individuals acting together owned more than 5% of the client.

3. Independence is impaired if, during the period covered by the financial statements or during the period of the professional engagement, a firm, or partner or professional employee of the firm, was

- 1) Also associated with the client as an officer, director, employee, promoter, underwriter, or voting trustee, or in a management capacity.
- 2) A trustee for any pension or profit-sharing trust of the client.

4. An individual may have been employed by the client or associated with the client in a capacity listed in Interpretation 101-3. Independence is impaired if (1) the employment or association overlapped the engagement, and (2) the individual participated in the engagement or was able to influence it. Independence is also impaired if the individual was otherwise a covered member relative to the client unless the individual dissociates from the client by

- 1) Ending any relationship described in Interpretation 101-3.
- 2) Disposing of any direct or material indirect financial interest in the client,
- 3) Collecting or repaying any loans to or from the client (except as permitted under the rules for grandfathered loans),
- 4) Ceasing participation in any client-sponsored employee benefit plan (unless the client is legally required to allow participation and the individual pays the full cost), and
- 5) Liquidating or transferring any vested benefits in a client plan as soon as legally permitted. This is not required if a large penalty would result.

5. A covered member's immediate family is subject to Rule 101. However, independence is not impaired solely because

- 1) An immediate family member was employed by the client in a non-key position.
- 2) As part of his or her employment, an immediate family member of one of the following participated in a benefit plan that is a client, is sponsored by a client, or invests in a client if the plan is offered to all similarly situated employees:
  - a) A partner or manager who provided at least 10 hours of nonattest services to the client
  - b) Any partner in the office where the lead engagement partner primarily practiced in relation to the engagement

6. Independence is impaired if an individual who is participating on the engagement team, who can influence the engagement, or who is a partner in the office where the lead engagement partner primarily practices, has a close relative who

- 1) Occupied a key position with the client,
- 2) Held a material financial interest in the client that was known to the individual, or

- 3) Held a financial interest that permitted significant influence over the client.

7. Because listing all situations in which an appearance of a lack of independence might arise is not feasible, members also should consider whether a relationship between the member and the client or an associate of the client might lead to a reasonable conclusion that independence is lacking.

8. Under Rule 101, materiality is determined by aggregating the interests of the covered member and his/her immediate family.

### **B. Interpretation 101-2 (Employment or association with attest clients)**

A former partner or professional employee (POPE) of the firm who is employed by or associated with an attest client in a key position impairs the firm's independence unless

- (1) Amounts due to the former POPE are not material to the firm, and the payment formula is fixed during the payout period. Retirement benefits may also be adjusted for inflation, and interest may be paid.
- (2) The former POPE cannot influence the firm's operations or financial policies.
- (3) Once employed or associated with the client, the former POPE does not participate or appear to participate in, and is not associated with, the firm, regardless of compensation, for example, by consulting, use of an office, or inclusion in membership lists.
- (4) The engagement team considers the risk that the POPE's knowledge of the audit plan will reduce audit effectiveness.
- (5) The firm assesses when team members can effectively deal with the POPE.
- (6) The engagement is reviewed to determine whether team members maintained professional skepticism in dealings with the POPE.

A team member's consideration of employment or association with the client impairs independence absent prompt reporting to the firm and removal from the team.

### **C. Interpretation 101-3 (Performance of nonattest services)**

- 1) Before a member and his or her firm performs nonattest services (such as tax or consulting services) for an attest client, (s)he must comply with Interpretation 101-3 to avoid impairment of independence. If the applicable independence rules of an authoritative body (e.g., the SEC or a state board of accountancy) are more restrictive, the member must comply with them.

- 2) General Requirements. Performing management functions or making management decisions impairs independence, but providing advice, research, and recommendations does not.
  - a) The member should be satisfied that the client will make an informed judgment about the results of nonattest services and be able to designate a competent employee (preferably a senior manager) to oversee the services; evaluate their adequacy and results; make management decisions and perform management functions; accept responsibility for results; and establish and maintain internal controls.
  - b) The member and client should agree about the objectives and limitations of the engagement, the services to be performed, and mutual responsibilities. The understanding should be documented in writing. This requirement does not apply to routine services, those provided before the client became an attest client, and those performed before 2005.
- 3) General activities that impair independence include
  - a) Exercise or possession of authority over transactions on a client's behalf
  - b) Preparing source documents evidencing transactions
  - c) Custody of client assets
  - d) Supervision of client employees in normal activities
  - e) Determining member recommendations to be implemented
  - f) Reporting to the board on behalf of management
  - g) Service as a stock transfer or escrow agent, registrar, or general counsel
- 4) Examples of nonattest services that may not impair independence if the general requirements are met include bookkeeping, disbursement, benefit plan administration (e.g., preparing participant account valuations and statements), investment advisory, finance, executive search, business risk consulting, and IT (but designing a system or operating a network impairs independence).
- 5) An appraisal, valuation, or actuarial service impairs independence if the results are material to the financial statements and significant subjectivity is involved. For example, a valuation for a business combination, but not an actuarial valuation for a pension liability, usually involves significant subjectivity. Furthermore, appraisal, valuation, and actuarial services not performed for financial statement purposes do not impair independence if the other requirements of Interpretation 101-3 are satisfied.
- 6) Internal audit assistance services impair independence unless the member ensures that the client understands its responsibility for internal control and managing the internal audit function. Accordingly, the member must ensure that the client designates a competent individual to oversee internal audit; determines the scope, risk, and frequency of its activities; evaluates its findings; and evaluates the adequacy of its procedures.

- a) The member should be satisfied that the client's governing body is informed about his/her role so that it can develop proper guidelines.
  - b) The member may assist in preliminary risk assessment, preparation of the audit plan, and recommendation of priorities.
  - c) Independence is impaired if the member, among other things, performs an ongoing monitoring or control function, determines which control recommendations are adopted, reports to the board on behalf of management, approves or is responsible for the overall audit work plan, or is a client employee or manager (or the equivalent).
  - d) Services that are normal extensions of the external audit scope (e.g., confirming receivables or analyzing balances) and engagements under the attestation standards do not impair independence.
- 7) SEC regulations promulgated under the Sarbanes-Oxley Act of 2002 prohibit auditors of public companies from performing certain nonaudit services:
- a) Appraisal and other valuation services.
  - b) Designing and implementing financial information systems.
  - c) Internal auditing or actuarial functions unless the firm reasonably concludes it will not examine such work during the financial statement audit.
  - d) Management services.
  - e) Human resource services.
  - f) Bookkeeping if the firm also conducts an audit.
  - g) Expert services not pertaining to the audit.
  - h) Investment banking or advisory services.
  - i) Broker-dealer services.

**D. Interpretation 101-4 (Honorary directorships and trusteeships of not-for-profit organizations)**

A member in an honorary position will not impair independence if (s)he is associated with the financial statements of a not-for-profit organization that (s)he allows to use his/her name on letterheads and circulated materials to lend prestige to the organization. However, the member should not be able to vote or participate in board or management decisions and should be identified as an honorary director or trustee.

**E. Interpretation 101-5 (Loans from financial institution clients)**

- 1) Grandfathered loans. Independence is not impaired by (a) unsecured loans that are not material to the covered member's net worth or (b) secured loans (including home mortgages) provided that the loans were obtained from a financial institution under its normal lending procedures, terms, and requirements. However, loans are grandfathered only if

- a) They were kept fully current at all times after the borrower became a covered member, and the terms did not change in a way not allowed in the original agreement.
  - b) They were obtained
    - i) From a financial institution before it became a client requiring independence;
    - ii) From a client not requiring independence and were sold to one requiring independence;
    - iii) Prior to February 5, 2001 and satisfied the requirements of the Interpretation then effective;
    - iv) During the period from February 5, 2001 through May 31, 2002, and the covered member complied with SEC regulations then effective; or
    - v) After May 31, 2002 from a client requiring independence before the borrower became a covered member relative to the client.
- 2) The date a grandfathered loan is obtained is the date a loan commitment or line of credit was granted.
  - 3) The collateral for a secured grandfathered loan must equal or exceed the remaining balance of the loan during its term. If the loan exceeds the value of collateral, this excess must not be material to the covered member's net worth.
  - 4) In the case of a limited partnership in which covered members have a combined interest exceeding 50% or a general partnership in which covered members control the partnership, the loan is ascribed to each covered member based on his/her legal liability as a limited or general partner. Even if this amount is zero, renegotiating the loan or entering into a new loan that is not an "other permitted loan" is deemed to impair independence.
  - 5) Other permitted loans. The following loans are permitted even if the client is one for which independence is required, provided that they are obtained under normal lending procedures, terms, and requirements and are always kept current:
    - a) Automobile loans and leases collateralized by the automobile
    - b) Loans fully collateralized by the cash surrender value of insurance
    - c) Loans fully collateralized by cash deposits
    - d) Credit cards and overdraft reserve accounts with an aggregate outstanding balance of \$10,000 or less on a current basis by the payment due date

**F. Interpretation 101-6 (Effect of actual or threatened litigation)**

- 1) Litigation between client and member
  - a) Independence is impaired when litigation is begun by
    - i) The present management alleging deficiencies in audit work
    - ii) The member alleging management fraud or deceit

- b) An expressed intention by the management to litigate against the member for alleged deficiencies in audit work will impair independence if it is probable that the claim will be filed.
- c) Independence is not impaired when the threatened or actual litigation is not related to the audit and the amount is not material. Examples include disputes over billings for services and results of tax advice.

2) Litigation by security holders (primary litigation)

- a) Shareholders may bring a class action against the client company or its management without impairing independence. Often the member and the client are both defendants, but if cross-claims are filed, adverse interests may arise and independence may be impaired.
- b) Cross-claims filed by the client to protect a right to legal redress in the event of a future adverse decision do not impair independence in the absence of a significant risk of a material settlement.
- c) Cross-claims against the member by an underwriter do not impair independence if no similar claims are made by the client.
- d) Cross-claims filed against the member by persons who are also officers or directors of other clients do not usually impair independence with respect to the other clients.

3) Other third-party litigation

- a) Litigation may be commenced against the member by a creditor or insurer that alleges reliance on financial statements of the client. This litigation does not affect independence if the client is not the plaintiff or is a nominal plaintiff. Independence may be impaired if the third party (e.g., an insurance company) is also a client of the member and there is a significant risk of a material settlement.

- 4) If a reasonable person would conclude that litigation poses an unacceptable risk of impairment of independence, the member should disengage or disclaim an opinion for lack of independence.

**G. Interpretation 101-8 (Financial interests in nonclients having investor or investee relationships with the client)**

1) Independence is impaired when

- a) A member has a direct or material indirect financial interest in the nonclient if the investee is material to the investor.
- b) A member has a material interest in a nonclient who is an immaterial investee of the client investor.
- c) A member can exercise significant influence over a nonclient investor who has an immaterial interest in the client investee.

- 2) Independence is not impaired if a member did not know about the financial interests described above.

## **H. Interpretation 101-10 (Effect on independence of relationships with entities included in governmental financial statements)**

- 1) A financial reporting entity's basic financial statements (BFS) issued in accordance with U.S. GAAP include the government-wide statements (reporting governmental activities, business-type activities, and discretely presented component units), fund financial statements (reporting major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds), and other entities disclosed in the notes of the BFS. Disclosures should be made in the notes to the BFS about related organizations, joint ventures, jointly governed organizations, etc.
- 2) An auditor of the BFS of the entity must be independent of it. Nevertheless, a primary auditor need not be independent with respect to any fund, component unit, or disclosed entity if (s)he explicitly relies on reports by other auditors on such fund, etc. Moreover, (s)he need not be independent of a disclosed entity if the reporting entity is not financially accountable for it and the required disclosure does not include financial information.
  - a) Neither the covered member nor a member of his/her immediate family should occupy a key position with a fund, component unit, or disclosed entity.
- 3) An auditor of the statements of a fund, component unit, or disclosed entity who is not auditing the primary government must be independent only of the statements reported on. Nevertheless, the covered member or a member of his/her immediate family may not occupy a key position with the primary government.

## **I. Interpretation 101-11 (Independence and attest engagements)**

- 1) This interpretation applies only to engagements, other than examinations and reviews, covered by SSAEs when the use of the report is restricted.
- 2) The following covered members and their immediate families must be independent in relation to the responsible party:
  - a) An individual on the attest engagement team.
  - b) An individual who directly supervises or manages the attest engagement partner.
  - c) Individuals who consult with the attest engagement team about technical or industry-related matters specific to the engagement.

- 3) Independence is impaired if the firm had a material relationship with the responsible party prohibited under Rule 101.
- 4) A firm may provide nonattest services to the responsible party that are prohibited due to an association as an employer, director, officer, promoter, voting trustee, or pension trustee. However, if they do not relate directly to the subject matter of the attest engagement, independence is not impaired.
- 5) When the party that engages the firm is not the responsible party or associated therewith, individuals on the attest engagement need not be independent of the party that engaged the firm. However, they should consider their responsibilities regarding conflicts of interest.

#### **J. Interpretation 101-12 (Independence and cooperative arrangements with clients)**

- 1) Independence is impaired if, during the engagement or at the time of expressing an opinion, a member's firm had any material cooperative arrangement with the client.
  - a) A cooperative arrangement means joint participation in a business activity.

#### **K. Interpretation 101-14 (Effect of APSs on independence rules)**

- 1) The independence rules for an alternative practice structure (APS) apply to all structures in which "the 'traditional firm' engaged in attest services is closely aligned with another organization, public or private, that performs other professional services." For example, a CPA firm may be sold to another entity having subsidiaries or divisions such as a bank, an insurance company, a broker-dealer, and entities providing nonattest services (tax, management consulting, etc.). The owners and employees of the CPA firm become employees of one of the parent's subsidiaries or divisions and may offer nonattest services. Moreover, the original owners of the acquired CPA firm create a new CPA firm to offer attest services. The majority ownership of the new firm must be held by CPAs, but it leases employees, offices, and equipment from the parent, which may also provide advertising and perform back office functions. The owners of the new CPA firm pay a negotiated amount for such services.
- 2) In the example above, the term "member or a member's firm" includes the new CPA firm (the firm) and any leased or employed person or entity.
- 3) When two or more new CPA firms are "closely aligned" with another organization, issues arise as to whether owners of one perform services or have significant economic interests in another. Thus, if an owner of one performs services for another, (s)he is deemed to be an owner of both. Similar issues arise regarding managers (leased or otherwise).

- 4) In an APS, persons and entities included in “member or a member’s firm” are closely aligned with other persons and entities. The latter include direct superiors who can directly control the activities of an owner or manager. A direct superior is an immediate superior who can direct the activities of an owner or manager so as to be able to directly or indirectly derive a benefit. Direct superiors are subject to the same independence rules as persons included in “member or a member’s firm.”
- 5) An indirect superior (defined to include a spouse, cohabitant, or dependents of an indirect superior) is one or more levels above a direct superior and does not have a direct reporting relationship with the new CPA firm’s owners and managers. Less restrictive standards apply to indirect superiors and to other entities in the consolidated group.
  - a) These parties may not have a relationship involving a direct financial interest or an indirect material financial interest with an attest client of the new CPA firm that is material.
  - b) These parties also should not exercise significant influence over the attest client.
  - c) Other entities in the consolidated group and their employees may not be promoters, underwriters, directors, officers, or voting trustees of an attest client. However, with the foregoing exceptions, indirect superiors and other consolidated entities may provide services to an attest client that a member could not without impairing independence.
- 6) The new CPA firm may not perform a service requiring independence for any entity in the consolidated group.
- 7) Independence is impaired with regard to an attest client who exercises significant influence over, or has a material investment in, the parent.
- 8) Referrals within the consolidated group are subject to the provisions regarding conflicts of interest.

## **Ethics Rulings on Independence — Rule 101.**

### **Independence Not Impaired**

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1. Membership in a client trade association provided the member is not an officer or a director, or in a position equivalent to management.
  2. The member provides advisory services for a client.
  3. A member is designated to serve as an executor of an individual’s estate that owns the majority of the stock of a corporation. Independence with respect to the corporation is not impaired unless the member serves as executor.

4. A CPA is a director of a federated fund-raising organization, e.g., United Way, and audits local charities receiving funds. Independence with respect to the charities is not impaired unless the organization exercises managerial control over them.
5. A CPA has a pro rata share of securities in a social club, unless (s)he is on the governing board or takes part in management.
6. A member serves on a citizens' committee advising a county and on another committee advising the state where the county is located.
7. A CPA's ownership of shares in a mutual fund that holds some of a client's shares. Independence becomes impaired if the indirect interest becomes material or the CPA has significant influence over the mutual fund.
8. A member and a client bank serve in a co-fiduciary capacity with respect to an estate, provided the estate assets are not material.
9. A client financial services company has custody of a covered member's assets (not in depository accounts); services are provided under its normal procedures, terms, and requirements; and any assets subject to risk of loss are immaterial to the member's net worth.
10. Independence is not impaired if a member audits an employee benefit plan unless a partner or professional employee of the firm had significant influence over the employer(s); was in a key position with the employer; or was associated with the employer as a promoter, underwriter, or voting trustee.
11. The mere servicing of a member's loan by a client financial institution.
12. When a covered member has a checking or savings account, certificate of deposit, or money market account in a client financial institution, provided the amounts are fully insured. Uninsured amounts do not impair independence if they are immaterial or if they are reduced to an immaterial balance within 30 days. A firm's independence is not impaired if the probability is remote that the depository institution will have financial difficulty.
13. Membership in a client credit union if all the following are met:
  1. Each member qualifies to join the credit union without regard to the professional services.
  2. The member's vote must not have significant influence over policies.
  3. Loans must be limited to grandfathered and other permitted loans made under normal procedures, terms, and requirements.
  4. Any deposits with the credit union must meet the conditions in number 12.
14. A member's service as treasurer of a mayoral campaign organization. Independence is impaired with respect to the organization itself, but not the political party of the candidate or the city.

15. If a member leases property to or from a client under an operating lease with terms comparable to those of similar leases, and all amounts are paid in accordance with the lease. If, however, the lease is a capital lease, independence would be impaired unless the lease is tantamount to a permitted loan.
16. Inclusion of a clause in an engagement letter providing for member indemnification by the client.
17. A predispute agreement with a client to use alternative dispute resolution (ADR) techniques.
18. Commencement of an ADR proceeding. However, Interpretation 101-6 applies, and independence may be impaired if the proceeding is sufficiently similar to litigation because the parties have material adverse interests, e.g., in binding arbitration.
19. Performing extended audit services regarding reporting on internal control if management assumes responsibility for control, and management does not rely on the member's work as the primary basis for its assertion.

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### **Independence Impaired**

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1. Acceptance of more than a token gift from a client.
2. The member signs or cosigns checks or purchase orders or exercises general supervision to ensure compliance as a representative of a creditors' committee in control of a debtor corporation.
3. The member serves as an elected legislator in a municipal body at the same time as (s)he is performing an audit of that body.
4. With respect to a foundation and an estate if the member is a trustee of the foundation that is the beneficiary of the estate.
5. A CPA serves on the board of directors of a client nonprofit social club.
6. A CPA is on a client's committee that administers the deferred compensation program.
7. A CPA is a director of a company and an auditor of the profit sharing and retirement trust.
8. A CPA owns an immaterial amount of bonds in a municipal authority (considered a loan).
9. With respect to a common interest realty association (CIRA) as a result of owning or leasing realty. But no impairment occurs if the CIRA has governmental functions, the CPA's annual assessment is immaterial, sale of the CIRA or common assets does not result in a distribution to the member, CIRA creditors have no recourse to the member, and the CPA is not a manager or employee of the CIRA.

10. A CPA owns an investment club that holds a client's shares (a direct financial interest).
11. A member of a university's faculty audits the student senate fund (the member will audit functions performed by the university, which is his/her employer).
12. If billed or unbilled fees, or a note arising from the fees, for client services rendered more than 1 year before the current year's report date remain unpaid. Not applicable if the client is in bankruptcy.
13. When a CPA is on the board of directors of a fund-raising organization; unless the position is honorary.
14. If a member's retirement or savings plan has a direct or material indirect financial interest in a client.
15. A direct financial interest in a client whether or not the interest is placed in a blind trust.
16. For both partnerships, when two limited partnerships have the same general partner and a member has a material interest in one of the partnerships.
17. The use of partners, shareholders, and professional employees from another firm that is not independent of the client. Their work can be used in the same manner as that of internal auditors.
18. A CPA's service on a client's advisory board unless it
  - a. Is in fact advisory,
  - b. Has no authority to make management decisions, and
  - c. Is distinct from the board of directors with few common members.
19. A CPA who is not independent may not express an audit opinion or issue a review report, but (s)he may issue a compilation report disclosing the lack of independence.
20. A member who is a general partner in a partnership that invests in a client. If the member is a limited partner, independence would not be impaired unless the interest in the client is material.
21. If a member is a limited partner in a limited partnership (LP) and the client is a general partner, the member lacks independence with respect to the LP, the client if the client has a material interest in the LP, and a subsidiary of the LP if the member's interest is material.
22. A member's joint interest in a vacation home with a principal shareholder of a client will be considered a "joint closely held business investment" (even if it is only intended for personal use) if the interest is material.

23. Unless a loan from a nonclient subsidiary of a client parent is “grandfathered” or “permitted” under Interpretation 101-5, it impairs independence with respect to the parent. However, a loan from a nonclient parent does not impair independence with respect to a client subsidiary if the subsidiary is not material to the parent.
  24. If a report was issued when a member was independent, (s)he may reissue it or consent to its use when his/her independence is impaired provided (s)he did not do any post-audit work (not including reading subsequent statements or inquiries of subsequent auditors) while not independent.
  25. Agreeing to indemnify a client for losses arising from lawsuits, etc., that relate directly or indirectly to client acts impairs independence.
  26. When a member has significant influence over an entity with significant influence over a client.
  27. Independence is impaired with respect to the client and the plan if a member participates in a client’s health and welfare plan. But, if participation arises from permitted employment of the immediate family of the covered member, no impairment occurs provided the plan is offered to all employees in equivalent positions.
  28. When investment contributions by a member are invested or managed by a nonclient firm that offers financial services products (FSPs) that allow the member to direct his/her investment, independence is impaired if the FSP is invested in that client, whether or not the member directs the investment (a direct interest). If the member does not have authority to direct the investment, and the FSP invests in the client, an indirect interest results. If it is material to the member, independence is impaired. If the FSP invests only in the member’s clients, the interest is direct, and independence is impaired.
  29. A member’s performing investment management or custodial services for an employee benefit plan sponsored by a client impairs independence regarding the plan. Independence is also impaired regarding the client-sponsor of a defined benefit plan if the assets involved are material to the plan or sponsor. Independence is not impaired regarding a client-sponsor of a defined contribution plan if the member performs no management functions and does not have custody of the assets.
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**Rule 102— *Integrity and Objectivity.***

- a. Interpretation 102-1. Knowing misrepresentations of facts include knowingly making materially false and misleading entries in financial statements or records, failing to make corrections in materially false or misleading statements or records when the member has such authority, or signing a document with materially false and misleading information.

- b. Interpretation 102-2. If a conflict of interest arises that could impair objectivity. When a member performs a professional service, Rule 102 will not prohibit the service if disclosure is made to and permission is obtained from the appropriate parties. However, an independence objection cannot be overcome by disclosure and consent. The following are examples of situations in which objectivity may be impaired:
- 1) Performing litigation services for the plaintiff when the defendant is a client
  - 2) Providing tax or personal financial planning (PFP) services to both parties to a divorce
  - 3) Suggesting that a PFP client invest in a business in which the member has an interest
  - 4) Providing tax or PFP services to family members with conflicting interests
  - 5) Performing consulting services for a client that is a major competitor of a company in which the member has a significant financial interest, occupies a management position, or exercises influence
  - 6) Serving on a board of tax appeals that hears matters involving clients
  - 7) Providing services in connection with a real estate purchase from a client
  - 8) Referring a tax or PFP client to a service provider that refers clients to the member under an exclusive arrangement
  - 9) Referring a client to a service bureau in which the member or a partner in the member's firm has a material interest
- c. Interpretation 102-3. In dealings with an employer's external accountant, a member must be candid and not knowingly misrepresent facts or fail to disclose material facts.
- d. Interpretation 102-4. If a member and his/her supervisor have a dispute about statement preparation or recording of transactions, the member should do nothing if the supervisor's position is an acceptable alternative and does not materially misrepresent the facts.
- 1) If the member concludes that a material misstatement would result, (s)he should consult the appropriate higher level(s) of management and should consider documenting relevant matters.

- 2) If, after such discussions, the member concludes that action was not taken, (s)he should consider the continuing relationship with the employer, the obligation to communicate with third parties, and the desirability of consulting legal counsel.
- e. Interpretation 102-5. Educational services, e.g., teaching and research, are professional services subject to Rule 102.
- f. Interpretation 102-6. Professional services involving client advocacy are governed by the Code, e.g., Rules 201, 202, 203, and 102. If independence is required for a service, Rule 101 also applies.
  - 1) If the service stretches the bounds of performance standards, exceeds sound and reasonable professional practice, or compromises credibility, and therefore poses an unacceptable risk of injury to the member's or the firm's reputation, the propriety of accepting the engagement should be considered.

### **Ethics Rulings on Integrity and Objectivity — Rule 102.**

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1. A member in public practice should not ordinarily serve as a director of a bank if it engages in significant transactions with his/her clients. The rules on confidential client information and conflict of interest may be violated.
2. The use of the CPA designation by a member not in public practice if it implies the member is independent of his/her employer is an intentional misrepresentation. The member should clearly indicate the employment title in any transmittal in which (s)he uses the CPA designation. If the member states that a financial statement conforms with GAAP, Rule 203 applies.
3. A member is a director of a federated fund-raising organization from which local charities that are clients (with significant relationships with the member) receive funds. If the significant relationship is disclosed and consent is received from the appropriate parties, performance of services not requiring independence is allowed.
4. A company approaches a member to provide PFP or tax services for its executives, who consent to the arrangement and are aware of any relationship the member has with the company. The result of the services could be recommendations adverse to company interests. Rule 102 and Rule 301 do not prohibit acceptance of the engagement if the member believes (s)he can perform objectively. The member should consider informing all parties of possible results. The member should also consider responsibilities to the company and to the executives under Rule 301.
5. Service as an expert witness does not constitute client advocacy.

6. If a member is an officer, director, or principal shareholder of an entity having a loan to or from a client, independence is impaired with respect to that client if the member controls the entity, unless the loan is specifically permitted. If the member does not control the entity, the guidance in the interpretations should be considered. Disclosure and consent may therefore overcome the conflict-of-interest objection and permit the performance of the professional service for the client, provided the member believes it can be done with objectivity.
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**Rule 201 — *General Standards.***

- a. Interpretation 201-1. A member should have the competence to complete professional services according to professional standards and with reasonable care and diligence.
- 1) Competence involves technical qualifications and the ability to supervise and evaluate the work. It relates to knowledge of standards, techniques, and technical subject matter and to the ability to exercise sound judgment.
  - 2) In some cases, additional research and consultation is a normal part of performing services. However, if a member cannot gain sufficient competence, (s)he should suggest the engagement of someone competent.

**Rule 202 — *Compliance with Standards. No interpretations.***

**Rule 203 — *Accounting Principles.***

- a. Interpretation 203-1. Professional judgment should be used in determining what constitutes unusual circumstances requiring a departure from established principles to prevent the financial statements or data from being misleading. Events that may justify such departures are new legislation or evolution of a new form of business transaction. An unusual degree of materiality or conflicting industry practices ordinarily do not justify departures.
- b. Interpretation 203-2. The body designated to establish accounting principles for nongovernmental entities is the FASB. Unsuperseded SFASs, ARBs, and APB Opinions are accounting principles within the meaning of Rule 203. The GASB, with respect to Statements of Governmental Accounting Standards, is the designated body for state and local governments. The Federal Accounting Standards Advisory Board (FASAB), with respect to its Statements of Federal Accounting Standards adopted and issued beginning in March 1993, is the designated body for federal governmental entities.

- c. Interpretation 203-4. Rule 203 applies to all members regarding any affirmative statement about GAAP conformity.
  - 1) Thus, Rule 203 applies to members who sign client reports to regulatory agencies, creditors, or auditors that contain such representations.

### **Ethics Rulings on General and Technical Standards — Rules 201, 202, 203.**

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1. The member has a responsibility to make sure that a subcontractor (s)he has selected has the professional qualifications and skills needed.
  2. A member is not required to be able to perform all the services of a newly hired systems analyst. But the member must be qualified to supervise and evaluate the specialist's work.
  3. If a member submits financial statements in his/her capacity as an officer, shareholder, partner, director, or employee to a third party, the member's relationship to the entity should be clearly communicated. No implication of independence should be made. Rule 203 applies if the communication states that the financial statements conform with GAAP. If the member acts as a public practitioner or submits the statements on his/her public practitioner's letterhead, (s)he should comply with applicable standards, including disclosure of lack of independence.
  4. Rule 203 applies to members who perform litigation support services.
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### **Rule 301 — Confidential Client Information**

- a. Interpretation 301-3. The rule against disclosure of confidential information does not prohibit the review of a member's professional practice pursuant to a purchase, sale, or merger of the practice. However, appropriate precautions (e.g., a written confidentiality agreement) should be taken so that the prospective buyer does not disclose any confidential client information.

### **Rule 302 — Contingent Fees.**

- a. Interpretation 302-1. An example of circumstances in which a contingent fee is not allowed is the preparation of an amended income tax return for a client claiming a refund of taxes because of an inadvertent omission of a proper deduction.
  - 1) Examples of circumstances in which a contingent fee is allowed include
    - a) Representation of a client in an examination by a revenue agent

- b) Representation of a client who is obtaining a private letter ruling
- c) Filing an amended tax return claiming a refund based on a tax issue that is the subject of a test case involving a different taxpayer

### **Ethics Rulings on Responsibilities to Clients — Rules 301 and 302.**

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1. A member may use an outside service to process tax returns provided (s)he takes all necessary precautions to prevent the release of confidential information.
2. A member may give a client's profit and loss percentages to a trade association provided the member has permission from the client.
3. A member who withdrew from an engagement because of fraud on a client's tax return should suggest that the successor obtain permission from the client to reveal the reasons for leaving.
4. A member may use a records-retention agency to store client records, but the responsibility for confidentiality still lies with the member.
5. A member may work for a municipality in verifying that proper amounts of taxes have been paid by the area businesses. Members are prohibited from releasing any confidential information obtained in their professional capacity.
6. A member may reveal a client's name without permission unless disclosure would constitute release of confidential information.
7. A member performing a consulting service must maintain the confidentiality of nonclient outside sources. If the client does not agree to this arrangement, the member should withdraw.
8. Knowledge and expertise obtained from a prior engagement may be used on behalf of a current client provided that the details of the other engagement are not revealed without permission.
9. A member who prepares a joint tax return should consider both spouses to be clients. After the spouses have divorced, the member will not violate Rule 301 if (s)he releases information to either spouse. But the legal implications should be discussed with an attorney.
10. A contingent fee or commission is considered to be received when the performance of related services is complete and the fee or commission is determined.
11. Rule 301 does not prohibit a member from releasing confidential client information to the member's liability insurance carrier solely to assist the defense against a claim against the member.
12. A member may make disclosures necessary to initiate, pursue, or defend legal or alternative dispute resolution proceedings. Rule 301 does not prohibit compliance with laws or regulations.

13. A member who provides investment advisory services for an attest client for a percentage of the investment portfolio violates Rule 302 unless the fee is a specified percentage of the portfolio, the dollar amount of the portfolio is determined at the beginning of each quarterly (or longer) period and is adjusted only for the client's additions or withdrawals, and the fee arrangement is not renewed more often than quarterly.
  14. Providing investment advisory services to the owners, officers, or employees of an attest client or to a nonattest client employee benefit plan sponsored by an attest client for a contingent fee does not violate Rule 302. Referring for commission the products or services of a nonclient or a nonattest client to the foregoing parties does not violate Rule 503 if the commission is disclosed to them. However, the member should consider the possible conflict of interest and also Rule 301.
  15. See Ethics Ruling 25 under Rule 503.
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### **Rule 501 — Acts Discreditable**

- a. Interpretation 501-1. Client records must be returned after a client demands them even if fees have not been paid. This ethical standard applies even if the state in which the member practices grants a lien on certain records in his/her possession.
  - 1) Client records are defined as “any accounting or other records belonging to the client that were provided to the member by or on behalf of the client.”
  - 2) However, “a member’s workpapers — including, but not limited to, analyses and schedules prepared by the client at the request of the member — are the member’s property, not client records, and need not be made available.”
  - 3) Moreover, the duty to return is not absolute regarding certain other information. Examples include adjusting, closing, combining, and consolidating entries; information usually found in the journals and ledgers; and tax and depreciation carryforward information. When the engagement is complete, this information should be made available upon request in the medium in which it is requested if it exists in that medium. But information need not be converted from a nonelectronic format to an electronic one. Furthermore, the information need not be provided if all fees due the member have not been paid.
- b. Interpretation 501-2. When a court or administrative agency has made a final determination that a member has violated an antidiscrimination law, (s)he is deemed to have committed an act discreditable.

- c. Interpretation 501-3. In a governmental audit, failure to adhere to applicable audit standards, guides, procedures, statutes, rules, and regulations is an act discreditable to the profession unless the report discloses the failure and the reasons therefore.
- d. Interpretation 501-4. Negligently making, or permitting or directing another to make, materially false and misleading entries in the financial statements or records; negligently failing to correct materially false and misleading statements when the member has such authority; or negligently signing, or permitting or directing another to sign, a document with materially false and misleading information is an act discreditable.
- e. Interpretation 501-5. A member must follow GAAP and the requirements of governing bodies, commissions, or regulatory agencies when preparing financial statements or related information or in performing attest services for entities subject to their jurisdiction. A material departure from the requirements is an act discreditable unless the member discloses the reasons.
- f. Interpretation 501-6. Solicitation or knowing disclosure of May 1996 or later CPA examination questions or answers is an act discreditable.
- g. Interpretation 501-7. Failing to comply with laws regarding timely filing of personal or firm tax returns or timely remittance of taxes collected for others is an act discreditable.

**Rule 502 — Advertising and Other Forms of Solicitation.**

- a. Interpretation 502-2. False, misleading, or deceptive acts are prohibited because they are against public interest. These prohibited activities include
  - 1) Creating false expectations of favorable results
  - 2) Implying the ability to influence any court, regulatory agency, or similar body
  - 3) Representing that specific services will be performed for a stated fee when it is likely at the time of the representation that the fees will be substantially increased and the client is not advised of the possibility
  - 4) Other representations that would cause a reasonable person to misunderstand or be deceived
- b. Interpretation 502-5. Members are permitted to render services to clients of third parties. If the third party obtained its clients through advertising, the members must ascertain that all promotional efforts were within the Rules of Conduct. Members must not do through others what they are prohibited from doing themselves.

**Rule 503 — Commissions and Referral Fees. No interpretations.**

**Rule 505 — Form of Organization and Name.**

- a. According to the relevant AICPA Council Resolution, a member may practice public accounting only in a firm or organization with certain characteristics.
  - 1) If such an entity performs any audit under the SASs, a review under the SSARs, or an examination of prospective information (forecasts and projections) under the SSAEs or holds itself out as a firm of CPAs, an entity must have the following attributes:
    - a) CPAs must own a majority of the firm in terms of financial interests and voting rights.
    - b) A non-CPA owner, including an investor or commercial enterprise, must be actively engaged in providing services to clients as his/her/its principal occupation.
    - c) A CPA must have ultimate responsibility for all services provided.
    - d) A non-CPA owner must have a baccalaureate degree.
    - e) Non-CPA owners cannot hold themselves out to be CPAs, must abide by the Code, must complete the work-related CPE requirements, and are ineligible for AICPA membership.
    - f) Owners must own their equity in their own right.
    - g) Ownership must be transferred to the firm or to other qualified owners within a reasonable time if the owner ceases to be actively engaged in the firm.
  - 2) The characteristics of all other entities are considered to be whatever is legally permissible except as indicated in 3) below.
  - 3) If a firm or organization not meeting the foregoing requirements performs compilations under SSARs, a CPA must have ultimate responsibility for any such services and for each business unit performing such services. Moreover, any compilation report must be signed individually by a CPA.
- b. Interpretation 505-2. A member in the practice of public accounting may own an interest in a separate business that performs the services for which standards are established. If the member, individually or with his/her firm or members of the firm, controls the separate business (as defined by U.S. GAAP), the entity and all its owners and employees must comply with the Code. Absent such control, the member, but not

the separate business, its other owners, and its employees, would be subject to the Code.

- c. Interpretation 505-3. The overriding focus of the Council Resolution, the Code, and other AICPA requirements is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. However, in the context of alternative practice structures (APSs), CPAs may own the majority of financial interests in the attest firm, but substantially all revenues may be paid to another entity in return for services and the lease of employees, equipment, etc. Nevertheless, given the previously mentioned safeguards, if the CPA-owners of the attest firm remain financially responsible under state law, they are deemed to be in compliance with the financial-interests requirement of the Resolution.

### **Ethics Rulings on Other Responsibilities and Practices — Rules 501-503, and 505.**

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1. A firm may arrange with a bank to collect notes issued by a client in payment of fees.
2. A CPA employed by a firm with one or more non-CPA practitioners must obey the Rules of Conduct. If the CPA becomes a partner, (s)he is responsible for compliance with the Rules of Conduct by all associated practitioners.
3. A CPA who teaches a course is responsible for determining that promotional efforts are within Rule 502.
4. A member not in public practice who is controller of a bank may use the CPA title on bank stationery and in paid advertisements.
5. A member who is an attorney and a CPA may use a letterhead with both titles on it.
6. A member interviewed by the press should observe the Rules of Conduct and not provide information that the member could not publish.
7. A member may serve as a director of a consumer credit company if (s)he does not audit the company and avoids conflicts of interest.
8. Although members may share an office, have the same employees, etc., they should not use a letterhead with both their names unless a partnership exists.
9. CPA firms that wish to form an association are not allowed to use the title of an association (e.g., Smith, Jones & Associates) because the public may believe a true partnership exists instead of an association. Each firm should use its own letterhead indicating the others as correspondents.
10. A CPA and a non-CPA who dissolve their partnership should sign an audit report, after dissolution, in a way not implying a partnership.
11. The title “nonproprietary partner” should not be used by someone who is not a partner because it is misleading.

12. A member may have his/her own CPA practice and be a partner of a public accounting firm all other members of which are noncertified.
13. A partnership may continue to practice using the managing partner's name as the firm name after (s)he withdraws. "And Company" should be added to the partnership name.
14. If a CPA forms a partnership with a non-CPA, the CPA is responsible for the non-CPA's violation of the Code.
15. A firm may use an established firm name in different states even though the roster of partners differs.
16. When two partnerships merge, they may retain a title that includes a retired or former partner's name.
17. A newsletter, tax booklet, etc., not prepared by the member or member's firm (member) may be attributed to the member if the member has a reasonable basis to believe the information attributed to the member is not false, misleading, or deceptive.
18. If a CPA in public practice forms a separate business that centralizes billing services for physicians, the CPA must comply with the Rules of Conduct because this service is of a type performed by public accountants.
19. CPA firms that are associated for joint advertising and other purposes should practice under their own names and indicate the association in other ways.
20. A CPA is not required to give the client a prepared tax return if the engagement to prepare the return is terminated prior to completion. Only the records originally provided by the client must be returned.
21. The designation "Personal Financial Specialists" may only be used on a letterhead when all partners or shareholders have the AICPA-awarded designation. However, the individual members holding the designation may use it after their names.
22. A member is permitted to purchase a product and resell it to a client. Any profits collected are not considered a commission because the member had title to the product and assumed the risks of ownership.
23. A member may contract with a computer hardware maintenance servicer to support a client's computer operations and charge a higher fee to the client than the servicer charges the member.
24. A member's spouse may provide services to the member's attest client for a contingent fee or refer products or services for a commission to or from the member's attest client, provided the spouse's activities are separate from the member's practice and the member is not significantly involved. However, a conflict of interest issue may arise.

25. A CPA may not refer for commissions products to clients through distributors and agents when the CPA is performing any of the services described in Rule 503. If the services are not being provided by the CPA, (s)he may refer the products provided (s)he discloses the commissions to the clients.
26. Individuals associated with a client may be involved in an internal dispute, and each may request client records and other information. The CPA is under an obligation to supply certain information specified by Interpretation 501-1. This obligation is satisfied by turning over any required information to the designated client representative.
27. A CPA in partnership with non-CPAs may sign the firm name to a report and below it affix his/her name with the CPA designation. However, it must be clear that the partnership does not consist entirely of CPAs.
28. Unless permitted by contract, if the relationship of a member who is not an owner of a firm is terminated, (s)he may not take or retain originals or copies from the firm's client files or proprietary information without permission.
29. See Ethics Ruling 14 under Rule 302.
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## **CONSULTING SERVICES PROHIBITED BY SARBANES-OXLEY ACT OF 2002**

Title II of the Sarbanes-Oxley Act of 2002 prohibits most "consulting" services outside the scope of practice of auditors.

- (a) These services are prohibited even if pre-approved by the issuer's audit committee.
- (b) Prohibited services include:
- Bookkeeping and related services,
  - Design and implementation of financial information systems,
  - Appraisal or valuation services (including fairness opinions and contribution-in-kind reports), (*Note:* The valuations relate to financial statement items and not valuations per se.)
  - Actuarial services,
  - Internal audit outsourcing, (*Note:* "Operational" internal audits are allowed.)
  - Services that provide any management or human resources,
  - Investment or broker/dealer services,
  - Legal and "expert services unrelated to the audit," and
  - Any other service that the board determines, by regulation, is impermissible.

(c) Services Not Prohibited. Firms, however, may provide tax services (including tax planning and tax compliance) or others that are not listed, provided the firm receives pre-approval from the board. However, certain tax planning products, like tax avoidance services, may be considered prohibited nonaudit services.

## STANDARDS FOR TAX SERVICES

The AICPA has issued eight Statements on Standards for Tax Services. The statements are enforceable under the AICPA's *Code of Professional Conduct*.

### **SSTS No. 1 — Tax Return Positions**

- a. An AICPA member should not recommend a position unless (s)he has a good faith belief that the position has a realistic possibility of being sustained if challenged. A member may reach such a position on the basis of well-reasoned articles or treatises or pronouncements of the taxing authority.
- b. A member should not prepare or sign a return if (s)he knows it takes a position that cannot be recommended as stated in a. above.
- c. Despite a. and b., a member may recommend a position that is not frivolous (knowingly advanced in bad faith and improper) if (s)he advises disclosures. The member may prepare or sign a return containing such a position if the position is properly disclosed.
- d. A member should advise the taxpayer of possible penalties associated with the recommended tax return position.
- e. A member should not recommend a position that
  - 1) Exploits the taxing authority's audit selection process, or
  - 2) Is advanced solely to obtain leverage in the bargaining process.
- f. A member has the right and responsibility to be an advocate for the taxpayer. A taxpayer has no obligation to pay more taxes than legally owed.

### **SSTS No. 2— Answers to Questions on Returns**

- a. A member should make a reasonable effort to obtain appropriate answers to all questions on a tax return before signing as preparer.
- b. Examples of reasonable grounds for omitting an answer
  - 1) Information is not readily available, and the answer is insignificant with respect to taxable income or loss or the tax liability.
  - 2) Genuine uncertainty exists as to the meaning of the question in relation to the particular return.
  - 3) The answer to the question is voluminous, and the return states that the data will be supplied upon examination.
- c. A taxpayer is not required to explain on the return the omission of an answer when reasonable grounds exist for the omission. The member should consider whether the omission causes the return to be incomplete.

### **SSTS No. 3— *Certain Procedural Aspects of Preparing Returns***

- a. A member may rely without verification on information provided by the taxpayer or third parties. Reasonable inquiries should be made if information appears to be incorrect, incomplete, or inconsistent on its face or on the basis of other facts known. Prior returns should be consulted if feasible.
- b. Inquiries should be made to determine whether the taxpayer has met requirements to maintain books, records, or documentation to support deductions.
- c. A member who prepares a return should consider information known from another taxpayer's return if it is relevant, its consideration is necessary, and its use does not violate any law or rule of confidentiality.

### **SSTS No. 4— *Use of Estimates***

- a. A member may use the taxpayer's estimates if it is impracticable to obtain exact data, and the estimates are reasonable under the facts.
- b. Estimates should be presented so as not to imply greater accuracy than exists.
- c. The taxpayer is responsible for providing the estimated data.
- d. Appraisals and valuations are not considered estimates.

### **SSTS No. 5— *Departure from a Position Previously Conducted in an Administrative Proceeding or Court Decision***

- a. The treatment of an item as determined in an administrative proceeding or a court decision does not restrict the recommendation of a different tax treatment in later years, unless the taxpayer is bound to a specified treatment in the later year.

### **SSTS No. 6— *Knowledge of Error: Return Preparation***

- a. The member should inform the taxpayer upon becoming aware of an error in a previously filed return or that the taxpayer did not file a required form.
- b. The member should recommend measures to take.
- c. The member is not obligated to inform the taxing authority and may not do so without the taxpayer's permission, unless required by law.
- d. If the member is requested to prepare a return when the taxpayer has not corrected a previous year's error, the member should consider whether to continue a professional relationship with the taxpayer or withdraw.
- e. If the member prepares the current return, the member should take reasonable steps to ensure that the error is not repeated.

### **SSTS No. 7— Knowledge of Error: Administrative Proceedings**

- a. The responsibilities are the same as stated in SSTS No. 6 except that they relate to representation of a taxpayer in an administrative proceeding.
- b. The taxpayer's agreement must be obtained to disclose the error to the taxing authority.
- c. Errors include a position on a return that no longer meets these standards (SSTS No. 1) because of retroactive legislation, judicial decisions, or administrative pronouncements. An error does not include an item with an insignificant effect.

### **SSTS No. 8— Form and Content of Advice to Clients**

- a. When providing tax advice to a taxpayer, a member should use judgment to ensure that the advice reflects professional competence and meets the taxpayer's needs.
- b. When advising or consulting on tax matters, the member should follow SSTS No. 1.
- c. A member is not obligated to communicate with the taxpayer when subsequent developments affect previous advice. However, (s)he is obligated to do so when helping to implement the plans associated with the advice or when undertaking the obligation by specific agreement.
- d. Tax advice can be in any form. However, important, unusual, or complicated transactions should be in writing.

*Note:* Members may use a trade name as long as it is not deceptive or misleading. "Pay Less" may be construed as misleading for a tax service.

## **DISCIPLINARY SYSTEMS WITHIN THE PROFESSION**

1. The AICPA's disciplinary mechanisms include the Professional Ethics Division and a joint trial board.
  - a. The Professional Ethics Division investigates ethics violations. It imposes sanctions in less serious cases. For example, it may require an AICPA member to take additional CPE courses as a remedial measure.
  - b. More serious infractions come before a joint trial board panel, which can acquit, admonish (censure), suspend, or expel a member. It may also take such other disciplinary, remedial, or corrective action as it deems to be appropriate. The *CPA Letter* publishes information about suspensions and expulsions.

- 1) A decision of a trial board panel may be appealed to the full trial board. The determination of this body is conclusive.
- 2) Upon the member's exhaustion of legal appeals, automatic expulsion without a hearing results when a member has been convicted of, or has received an adverse judgment for,
  - a) Committing a felony
  - b) Willfully failing to file a tax return
  - c) Filing a fraudulent tax return on the member's or a client's behalf
  - d) Aiding in preparing a fraudulent tax return for a client
- 3) Automatic expulsion also occurs when a member's CPA certificate is revoked by action of any governmental agency, e.g., a state board of accountancy.
- 4) Expulsion from the AICPA or a state society does not bar the individual from the practice of public accounting.
  - a) A valid state-issued license is required to practice.
  - b) Thus, violation of a state code of conduct promulgated by a board of accountancy is more serious than expulsion from the AICPA because it may result in revocation of the CPA certificate.

c. Joint Ethics Enforcement Program (JEEP)

- 1) The AICPA and most state societies have agreements that permit referral of an ethics complaint either to the AICPA or to a state society.
- 2) The AICPA handles matters of national concern, those involving two or more states, and those in litigation.
  - a) JEEP also promotes formal cooperation between the ethics committees of the AICPA and of the state societies.

2. The SEC, IRS, and PCAOB may also discipline accountants.

- a. The SEC may seek an injunction from a court to prohibit future violations of the securities laws. Moreover, under its Rule of Practice 2(e), the SEC may conduct administrative proceedings that are quasi-judicial.
  - 1) Pursuant to such proceedings, it may suspend or permanently revoke the right to practice before the SEC, including the right to sign any document filed by an SEC registrant, if the accountant

- a) Does not have the qualifications to represent others
  - b) Lacks character or integrity
  - c) Has engaged in unethical or unprofessional conduct
  - d) Has willfully violated, or willfully aided and abetted the violation of, the federal securities laws or their rules and regulations
- 2) Suspension by the SEC may also result from
- a) Conviction of a felony, or a misdemeanor involving moral turpitude
  - b) Revocation or suspension of a license to practice
  - c) Being permanently enjoined from violation of the federal securities acts
- 3) Some Rule 2(e) proceedings have prohibited not only individuals but also accounting firms from accepting SEC clients.
- 4) Under the Securities Law Enforcement Act of 1990, the SEC may impose civil penalties in administrative proceedings of up to \$100,000 for a natural person and \$500,000 for any other person. Furthermore, the SEC may order a violator to account for and surrender any profits from wrongdoing and may issue cease-and-desist orders for violations.
- b. The IRS may prohibit an accountant from practicing before the IRS if the person is incompetent or disreputable or does not comply with tax rules and regulations.
- 1) The IRS may also impose fines.
- c. The PCAOB was established by the Sarbanes-Oxley Act of 2002.
- 1) A firm's registration application must contain information about a firm's quality control and a description of all actions pending against it. This information may have a great effect on enforcement actions and potential punishments. Moreover, the firm must give consent to cooperate with PCAOB investigations.
  - 2) The PCAOB has rule-making authority regarding quality control, ethics and auditing standards. These rules, especially those governing quality control, will have great relevance to enforcement actions.
  - 3) The PCAOB will inspect large firms annually and report violations to the SEC and state authorities. All attestation engagements, notably those in litigation, may be reviewed. The inspection also involves a quality control assessment. Furthermore, the inspection report must include the firm's response. The firm then has twelve months to correct the reported weaknesses.

- 4) The PCAOB has substantially the same investigatory scope with respect to accountants as the SEC. The PCAOB may request that the SEC issue subpoenas to third parties, and it may deregister any uncooperative firm.
  - 5) The PCAOB has no injunctive power, but it may institute administrative proceedings. It may seek disassociation of a person from a registered firm, suspension (temporary or permanent) of the firm's registration, or a penalty of up to \$15 million. The extreme cases in which the harshest penalties may be imposed include repeated instances of negligent misconduct. By contrast, the SEC may impose the severest punishments when the firm has engaged in just one instance of highly unreasonable conduct.
3. State boards of accountancy and state CPA societies also have codes of ethics and/or rules of conduct.
- a. State boards are governmental agencies that license CPAs to use the designation "Certified Public Accountant" and prohibit non-CPAs from performing the attest function. They can suspend or revoke licensure through administrative process.
    - 1) Like the AICPA, state boards have trial boards to conduct administrative hearings.
  - b. State societies are voluntary, private organizations that can admonish, suspend, or expel members.

*Note:* A CPA may not claim to be endorsed by the Institute. A member may, however, state that (s)he is a member.

### **CORPORATE RESPONSIBILITY LAW (SARBANES-OXLEY ACT)** **([www.whitehouse.gov/infocus/corporateresponsibility/](http://www.whitehouse.gov/infocus/corporateresponsibility/))**

President George W. Bush signed the Sarbanes-Oxley Act of 2002 (Public Law 107-204) on Tuesday, July 30, 2002. Congress presented the act to the president on July 26, 2002, after passage in the Senate by a 99-0 vote and in the House by a 423-3 margin.

As enacted, the law will directly impact the following groups:

1. CPAs and CPA firms auditing public companies;
2. Publicly traded companies, their employees, officers, and owners—including holders of more than 10 percent of the outstanding common shares. This category would include CPAs employed by publicly traded companies as chief financial officers (CFOs) or in the finance department;
3. Attorneys who work for or have as clients publicly traded companies; and
4. Brokers, dealers, investment bankers and financial analysts who work for these companies.

The Act changes how publicly traded companies are audited, and reshapes the financial reporting system. This Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensures justice for wrongdoers, and protects the interests of workers and shareholders.

This law improves the quality and transparency of financial reporting, independent audits, and accounting services for public companies. It also:

- Creates a Public Company Accounting Oversight Board ([www.pcaobus.org](http://www.pcaobus.org)) to enforce professional standards, ethics, and competence for the accounting profession;
- Strengthens the independence of firms that audit public companies;
- Increases corporate responsibility and the usefulness of corporate financial disclosure;
- Increases penalties for corporate wrongdoing;
- Protects the objectivity and independence of securities analysts; and
- Increases Securities and Exchange Commission resources.

Under this law, CEOs and chief financial officers must personally vouch for the truth and fairness of their company's disclosures. And those financial disclosures will be broader and better than ever before.

Corporate officials will play by the same rules as their employees. In the periods when workers are prevented from buying and selling company stock in their pensions or 401(k)s, corporate officials will also be banned from any buying or selling.

Corporate misdeeds will be found and punished. This law authorizes new funding for investigators and technology at the SEC to uncover wrongdoing. The SEC will now have the administrative authority to bar dishonest directors and officers from ever again serving in positions of corporate responsibility. The penalties for obstructing justice and shredding documents are greatly increased.

## **Specifics**

### New Public Company Accounting Oversight Board (PCAOB)

- The law establishes a five-member accounting oversight board that is subject to Securities and Exchange Commission (SEC) oversight.
- Though the board oversees accounting firms, only two members of the board may be CPAs.
- The SEC will appoint the board.
- Duties of the board include registering public accounting firms that prepare audit reports; and establishing or adopting auditing, quality control, ethics and independence standards.

- The board also inspects, investigates and disciplines public accounting firms and enforces compliance with the act.
- **Registration with the Board Is Mandatory.** For public accounting firms, foreign or domestic, that participate in the preparation or issuance of any audit report with respect to a public company. Registration and annual fees collected from each registered CPA firm will go towards the costs of processing and reviewing applications and annual reports.
- **Seven-Year Record Retention Requirement.** PCAOB must adopt a rule to require registered CPA firms to prepare and maintain audit work papers and other information related to an audit for at least seven years in sufficient detail to support the conclusions reached in the audit report. (A separate criminal provision requires retention of all audit and review workpapers for five years from the end of the fiscal year in which the audit or review was completed.)
- **Cooperation with CPA Groups.** The board will cooperate with professional accountant groups and advisory groups to increase the effectiveness of the standards setting process. (The PCAOB may cooperate, but authority to set standards rests with the PCAOB, subject to SEC review.)
- **Annual Inspections.** Inspection of registered public accounting firms shall occur annually for every registered public accounting firm that regularly provides audit reports for more than 100 issuers (at least once every three years for registered firms that audit fewer than 100 issuers).
- **Investigations.** The board may investigate any act, omission or practice by a registered firm or an individual associated with a registered firm for any possible violation of the act, the board's rules, professional standards, or provisions of the securities laws relating to the preparation and issuance of audit reports.
  - (a) The board may require testimony or documents and information (including audit work papers) from a registered firm or individual associated with a registered firm or in the possession of any other person.
- Sanctions for violations that the board finds may include:
  - (a) Suspension or revocation of a registration;
  - (b) Suspension or bar of a person from further associating with any registered public accounting firm;
  - (c) Limitations on the activities of a firm or person associated with the firm; and
  - (d) Penalize the firm up to \$2 million per violation, up to a maximum of \$15 million.
  - (e) Individuals employed or associated with a registered firm who violate the act can face penalties that range from required additional continuing professional education (CPE) or training, disbarment of the individual from further association with any registered public accounting firm, or even a fine up to \$100,000 for each violation, up to a maximum of \$750,000.
    - (1) A portion of the penalties collected will go to accounting scholarships.

- **Funding.** The law also provides independent funding for the Financial Accounting Standards Board (FASB). While the SEC and American Institute of CPAs (AICPA) both have recognized FASB as the standard setting body for accounting principles, federal authority to issue auditing, quality control, ethics and independence standards may seriously impact the AICPAs' role in official pronouncements.
  - (a) **Source.** The budget for the board and FASB will be payable from "annual accounting support fees" set by the board and approved by the Commission. The fees will be collected from publicly traded companies and will be determined by dividing the average monthly equity market capitalization of the company for the preceding fiscal year by the average monthly equity market capitalization of all such companies for that year.

#### Other Requirements for CPA Firms

- **Audit Reports Require Concurring Partner Review.** Requires a concurring or second partner's review and approval of all audit reports and their issuance.
- **"Revolving Door" Employment of CPAs with Audit Clients Is Banned.** A registered CPA firm is prohibited from auditing any SEC registered client whose chief executive, CFO, controller or equivalent was on the audit team of the firm within the past year.
- **Audit Partner Rotation Required.** Audit partners who either have performed audit services or been responsible for reviewing the audit of a particular client must be rotated every five consecutive years. CPAs should read carefully the requirements for rotation of both the partner-in-charge and the concurring review partner for certain organizational constraints.
  - (a) **No Firm Rotation Requirement.** Firm rotation is not required. However, the U.S. Comptroller General will study and review the potential effects of mandatory rotation and will report its findings to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.
- **CPA Firms Are Required to Report Directly to the Audit Committee.**
- **CPA Firm Consolidations to Be Studied.** The U.S. Comptroller General will conduct a study analyzing the impact of the merger of CPA firms to determine if consolidation leads to higher costs, lower quality of services, impairment of auditor independence, or lack of choice.
- **Corporate and Criminal Fraud Accountability.** Changes to the securities laws can penalize anyone found to have destroyed, altered, hid or falsified records or documents to impede, obstruct or influence an investigation conducted by any federal agency, or in bankruptcy, with fines or up to 20 years imprisonment, or both.
- **Current Requirements for Audit Firms.** Accountants are required to maintain all audit or review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded.

- **Additional Rules.** The law requires the SEC to promulgate rules and regulations on the retention of any and all materials related to an audit, including communications, correspondence and other documents created, sent or received in connection with an audit or review.
  - (a) **Penalties.** For violating the requirement or the rules that will be developed will result in a fine, or up to 10 years imprisonment, or both.

#### Internal Control Report.

Under Section 404 of the act, management must establish and document internal control procedures and include in the annual report a report on the company's **internal control over financial reporting**. This report is to include

1. A statement of management's responsibility for internal control;
2. Management's assessment of the effectiveness of internal control as of the end of the most recent fiscal year;
3. Identification of the framework used to evaluate the effectiveness of internal control (such as the report of the Committee of Sponsoring Organizations);
4. A statement about whether significant changes in controls were made after their evaluation, including any corrective actions; and
5. A statement that the external auditor has issued an attestation report on management's assessment.

Because of Section 404, two audit opinions are expressed: one on **internal control** and one on the **financial statements**. The auditor must attest to and report on management's assessment.

The auditor must evaluate whether the structure and procedures

- Include records accurately and fairly reflecting the firm's transactions.
- Provide reasonable assurance that transactions are recorded so as to permit statements to be prepared in accordance with GAAP.

The auditor's report also must describe any material weaknesses in the controls. The evaluation is not to be the subject of a separate engagement but be in conjunction with the audit of the financial statements.

#### Of Note to Industry Members—Requirements for Corporations, Their Officers and Board Members

- **No Lying to the Auditor.** The act makes unlawful for an officer or director or anyone acting for a principal to take any action to fraudulently influence, coerce, manipulate or mislead the auditing CPA firm.
- **Code of Ethics for Financial Officers.** The SEC is mandated to issue rules adopting a code of ethics for senior financial officers.
- **Financial Expert Requirement.** The SEC is required to issue rules requiring a publicly traded company's audit committee to be comprised of at least one member who is a financial expert.

- **Audit Committee Responsible for Public Accounting Firm.** The Act vests the audit committee of a publicly traded company with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.
- **Audit Committee Independence.** Requires audit committee members to be members of the board of directors of the company, and to otherwise be independent.
- **CEOs & CFOs Required to Affirm Financials.** Chief executive officers (CEOs) and CFOs must certify in every annual report that they have reviewed the report and that it does not contain untrue statements or omissions of material facts. (a) **Penalty for Violation.** If material noncompliance causes the company to restate its financials, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials.
- **CEOs & CFOs Must Enact Internal Controls.** CEOs and CFOs will be responsible for establishing and maintaining internal controls to ensure they are notified of material information.
- **Penalties for Fraud.** The Act also has stiffened penalties for corporate and criminal fraud by company insiders. The law makes it a crime to destroy, alter or falsify records in a federal investigation or if a company declares bankruptcy. The penalty for those found guilty includes fines, or up to 20 years imprisonment, or both.
- **Companies Affected by the Act.** Publicly traded companies affected by the Act are those defined as an “issuer” under Section 3 of the Securities Exchange Act of 1934, whose securities are registered under Section 12 of the 1934 Act. An issuer also is considered a company that is required to file reports under Section 15(d) of the Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933.
- **Debts Not Dischargeable in Bankruptcy.** Amends federal bankruptcy law to make non-dischargeable in bankruptcy certain debts that result from a violation relating to federal or state securities law, or of common law fraud pertaining to securities sales or purchases.
- **Expanded Statute of Limitations for Securities Fraud.** For a civil action brought by a non-government entity or individual, an action involving a claim of securities fraud, deceit or manipulation may be brought not later than the earlier of two years after discovery or five years after the violation.
- **No Listing on National Exchanges for Violators.** The SEC will direct national securities exchanges and associations to prohibit the listing of securities of a noncompliant company.
- **No Insider Trading.** No insider trading is permitted during pension fund blackout periods. The insider must forfeit any profit during this period to the company.

- **SEC Rules on Enhanced Financial Disclosures.**
  - (a) Off-Balance Sheet Transactions: All quarterly and annual financial reports filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities. Disclosure must be made on significant aspects relating to financial condition, liquidity, capital expenditures, resources, and components of revenue and expenses.
  - (b) Pro Forma Figures: Pro forma financial information in any report filed with the SEC or in any public release cannot contain false or misleading statements or omit material facts necessary to make the financial information not misleading.
- **No Personal Loans.** No personal loans or extensions of credit to company executives either directly or through a subsidiary, except for certain extensions of credit under an open-ended credit plan or charge card, home improvement and manufactured home loans, or extensions of credit by a broker or dealer to its employee to buy, trade or carry securities.
  - (a) The terms of permitted loans cannot be more favorable than those offered to the general public.

#### Criminal Penalties Enhanced\*

BEHAVIOR	SENTENCE
The alteration, destruction, or concealment of any records with the intent of obstructing a federal investigation.	Fine and/or up to 10 years imprisonment.
Failure to maintain audit or review "workpapers" for at least five years.	Fine and/or up to 5 years imprisonment.
Anyone who "knowingly executes, or attempts to execute, a scheme" to defraud a purchaser of securities.	Fine and/or up to 10 years imprisonment.
Any CEO or CFO who "recklessly" violates his or her certification of the company's financial statements.	Fine of up to \$1,000,000 and/or up to 10 years imprisonment.
If violation is willful.	Fine of up to \$5 million and/or up to 20 years imprisonment.
Two or more persons who conspire to commit any offense against or to defraud the U.S. or its agencies.	Fine and/or up to 10 years imprisonment.
Any person who "corruptly" alters, destroys, conceals, etc., any records or documents with the intent of impairing the integrity of the record or document for use in an official proceeding.	Fine and/or up to 20 years imprisonment.
Mail and wire fraud.	Increase from 5 to 20 years imprisonment.
Violating applicable Employee Retirement Income Security Act (ERISA) provisions.	Various lengths depending on violation.

\* Source: Sarbanes-Oxley Act of 2002 and New York City Office of the Comptroller.

## **CHAPTER 2 – REVIEW QUESTIONS**

*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance:
  - a) a distinguishing mark of a profession is its acceptance of responsibility to the public
  - b) a requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues
  - c) ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character
  - d) vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts
  
2. The AICPA Code of Professional Conduct states, in part, that a CPA should maintain integrity and objectivity. Objectivity in the Code refers to a CPA's ability:
  - a) to maintain an impartial attitude on all matters that come under the CPA's review
  - b) to independently distinguish between accounting practices that are acceptable and those that are not
  - c) to be unyielding in all matters dealing with auditing procedures
  - d) to independently choose between alternate accounting principles and auditing standards
  
3. A CPA serving as a bank director should not be concerned with:
  - a) a possible conflict of interest between the bank and the CPA's clients
  - b) the compatibility of serving as a bank director and the possibility of soliciting clients
  - c) the CPA's independence with respect to a client's receiving a large loan from the bank
  - d) disclosure of confidential client information to the bank
  
4. The appearance of independence of a CPA is most likely to be impaired if the CPA:
  - a) provides appraisal, valuation, or actuarial services for an attest client
  - b) joins a trade association, which is an attest client, and serves in a nonmanagement capacity
  - c) accepts a token gift from an attest client
  - d) serves as an executor and trustee of the estate of an individual who owned the majority of the stock of a closely held client corporation

5. A violation of the profession's ethical standards would most likely have occurred when a CPA:
  - a) made arrangements with a bank to collect notes issued by a client in payment of fees due
  - b) joined an accounting firm made up of three non-CPA practitioners
  - c) expressed an unqualified opinion on the year 2 financial statements when fees for the year 1 audit were unpaid
  - d) purchased a bookkeeping firm's practice of monthly write-ups for a percentage of fees received over a 3-year period
  
6. AICPA Conduct Rule 301, Confidential Client Information, is violated when a member in public practice:
  - a) provides client profit and loss percentages to a trade association without the client's consent
  - b) uses outside computer services to process tax returns
  - c) performs consulting services for similar clients
  - d) advises potential consulting services clients about previous problems on similar engagements
  
7. A CPA's retention of client records as a means of enforcing payment of an overdue audit fee is an action that is:
  - a) not addressed by the AICPA Code of Professional Conduct
  - b) acceptable if sanctioned by state law
  - c) prohibited under the AICPA Code of Professional Conduct
  - d) a violation of GAAS
  
8. According to Conduct Rule 502, advertising or other forms of solicitation that are false, misleading, or deceptive are not in the public interest, and AICPA members in public practice shall not seek to obtain clients in such a manner. Such activities include all the following except those that:
  - a) indicate the CPA's educational and professional attainments
  - b) imply the ability to influence a court
  - c) claim to be able to save the taxpayer 20% of a determined tax liability
  - d) create unjustified expectations of favorable results

## **CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES**

1. **A: Correct.** According to Article II of the Principles section of the AICPA Code of Professional Conduct, "Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism." According to the accompanying explanation, "A distinguishing mark of a profession is acceptance of its responsibility to the public."

B: Incorrect. The responsibility of CPAs is to a public that is not limited to clients and colleagues, but includes all those who rely on their objectivity and integrity.

C: Incorrect. Excellence in performance is but one of the effects of accepting responsibility to the public.

D: Incorrect. Vigorous enforcement is significant but secondary to the creation of an environment in the profession that fosters voluntary adherence to ethical principles.

(See page 2-1 of the course material.)

2. **A: Correct.** According to the Principles, "Objectivity is a state of mind, a quality that lends itself 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."

B: Incorrect. The CPA uses both judgment and GAAP to evaluate whether a client's accounting practices are acceptable.

C: Incorrect. The CPA is expected to use professional judgment, which may include flexibility, in applying audit procedures.

D: Incorrect. Auditing standards are concerned with the quality of the auditor's performance, whereas adherence to accounting principles by management is a prerequisite for fairly stated financial statements.

(See page 2-2 of the course material.)

3. A: Incorrect. The conflict between the bank's and the clients' interests may not be avoidable. As a result, the CPA's objectivity may be questioned.

**B: Correct.** The Code of Professional Conduct does not prohibit solicitation of clients. Solicitation is permitted as long as it is not false, misleading, or deceptive.

C: Incorrect. If the CPA's client receives a material loan from the bank, the CPA's independence may be impaired with respect to that client.

D: Incorrect. The CPA's responsibility to the client precludes the disclosure of confidential client information, but failure to disclose may cause a breach of the fiduciary duty owed to the bank.

(See page 2-5 of the course material.)

4. A: Incorrect. Independence is not necessarily impaired if the CPA does not perform management functions or make management decisions, if all significant matters of judgment are determined or approved by the client, and the client is in a position to make an informed judgment.

B: Incorrect. Independence is not impaired, provided the CPA does not participate in management.

C: Incorrect. A token gift will not impair independence. However, a CPA who accepts more than a token gift, even with the knowledge of the member's firm, will appear to lack independence.

**D: Correct.** According to an Interpretation of Conduct Rule 101, independence is impaired if, during the period of the professional engagement, "a covered member was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client." An Ethics Ruling states that mere designation as trustee or executor does not impair independence in the foregoing circumstances but that actual service does.

(See page 2-7 of the course material.)

5. A: Incorrect. The AICPA has ruled that this practice does not violate the Code.

B: Incorrect. The Code does not prohibit this arrangement. However, according to Conduct Rule 505, such a firm could not designate itself as "Members of the AICPA" unless all CPA-owners are AICPA members.

**C: Correct.** The AICPA has ruled that audit fees that are long past due take on the characteristics of a loan under Conduct Rule 101. An Ethics Ruling considers independence to be impaired if billed or unbilled fees for client services rendered more than 1 year prior to the report date remain unpaid when the current year's report is issued. This amount is viewed as a loan to the client and thus impairs independence (certain loans from financial institution clients do not). Thus, independence is impaired and an opinion cannot be expressed if fees for all prior years (year 1) are not collected before issuance of the current (year 2) report. However, long overdue fees would not preclude the CPA from performing services not requiring independence. The Ruling does not apply if the client is in bankruptcy.

D: Incorrect. No Code provision prohibits purchase of a bookkeeping firm for a percentage of fees over a given period.

(See page 2-19 of the course material.)

6. **A: Correct.** An Ethics Ruling states that, prior to disclosing confidential client profit and loss percentages to a trade association, the CPA must have specific client consent.

B: Incorrect. According to an Ethics Ruling, using outside computer services to process tax returns is permissible as long as client confidentiality is maintained.

C: Incorrect. Most CPAs perform consulting services for clients in the same or related industries.

D: Incorrect. According to an Ethics Ruling, CPAs must make full disclosure about any reservations concerning the usefulness of potential consulting services, especially those based on past experience with similar engagements. However, client confidentiality must be preserved or waived.

(See page 2-25 of the course material.)

7. A: Incorrect. Conduct Rule 501 (as authoritatively interpreted) prohibits retention of client records as a means of enforcing payment of an overdue audit fee.

B: Incorrect. The profession may require CPAs to adhere to standards beyond the legal minimum.

**C: Correct.** An Interpretation of Conduct Rule 501, *Acts Discreditable*, defines client records as "any accounting or other records belonging to the client that were provided to the member by or on behalf of the client." This Interpretation prohibits the retention (after a demand is made for them) of client records to enforce payment or for any other purpose. Such an act is deemed to be discreditable to the profession.

D: Incorrect. Retention of client records as a means of enforcing payment of an overdue audit fee is prohibited by the Code of Professional Conduct, not by GAAS.

(See page 2-26 of the course material.)

8. **A: Correct.** Advertising and solicitation are acceptable as long as they do not involve falsehood or deception.

B: Incorrect. Advertisement of influence over courts, tribunals, regulatory agencies, or a similar body or official is deceptive.

C: Incorrect. A correct amount of tax liability exists, and a claim to save a taxpayer part of that amount is deceptive.

D: Incorrect. It is misleading to create false and unjustified expectations of favorable results.

(See page 2-27 of the course material.)

## **Chapter 3: Standards of Ethical Conduct for Practitioners of Management Accounting and Financial Management for Certified Managerial Accountants (CMA) and the Certified In Financial Management (CFM)**

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### **LEARNING OBJECTIVES:**

After studying this chapter, you will be able to:

1. Describe the level of competence required by certified managerial accountants (CMAs) and certified financial managers (CFMs).
2. Distinguish between the concepts of confidentiality and integrity.
3. Outline and clarify a method of resolution of ethical conflict.

Practitioners of management accounting and financial management have an obligation to the public, their profession, the organizations they serve, and themselves, to maintain the highest standards of ethical conduct. In recognition of this obligation, the Institute of Management Accountants (IMA) has promulgated the following standards of ethical conduct for practitioners of management accounting and financial management. Adherence to these standards, both domestically and internationally, is integral to achieving the *Objectives of Management Accounting*. Practitioners of management accounting and financial management shall not commit acts contrary to these standards nor shall they condone the commission of such acts by others within their organizations.

### **Competence**

Practitioners of management accounting and financial management have a responsibility to:

- Maintain an appropriate level of professional competence by ongoing development of their knowledge and skills.
- Perform their professional duties in accordance with relevant laws, regulations, and technical standards.
- Prepare complete and clear reports and recommendations after appropriate analyses of relevant and reliable information.

### **Confidentiality**

Practitioners of management accounting and financial management have a responsibility to:

- Refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to do so.
- Inform subordinates as appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality.
- Refrain from using or appearing to use confidential information acquired in the course of their work for unethical or illegal advantage, either personally or through third parties.

## **Integrity**

Practitioners of management accounting and financial management have a responsibility to:

- Avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict.
- Refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically.
- Refuse any gift, favor, or hospitality that would influence or would appear to influence their actions.
- Refrain from either actively or passively subverting the attainment of the organization's legitimate and ethical objectives.
- Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.
- Communicate unfavorable as well as favorable information and professional judgments or opinions.
- Refrain from engaging in or supporting any activity that would discredit the profession.

## **Objectivity**

Practitioners of management accounting and financial management have a responsibility to:

- Communicate information fairly and objectively.
- Disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

## **Resolution of Ethical Conflict**

In applying the standards of ethical conduct, practitioners of management accounting and financial management may encounter problems in identifying unethical behavior or in resolving an ethical conflict. When faced with significant ethical issues, practitioners of management accounting and financial management should follow the established policies of the organization bearing on the resolution of such conflict. If these policies do not resolve the ethical conflict, such practitioners should consider the following courses of action:

- Discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level. If the immediate superior is the chief executive officer, or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with the superior's knowledge, assuming the superior is not involved. Except where legally prescribed, communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate.

- Clarify relevant ethical issues by confidential discussion with an objective advisor (e.g., IMA Ethics Counseling Service) to obtain a better understanding of possible courses of action.
- Consult your own attorney as to legal obligations and rights concerning the ethical conflict.
- If the ethical conflict still exists after exhausting all levels of internal review, there may be no other recourse on significant matters than to resign from the organization and to submit an informative memorandum to an appropriate representative of the organization. After resignation, depending on the nature of the ethical conflict, it may also be appropriate to notify other parties.

(Source: Statement on Management Accounting 1C (Revised), Objectives: Standards of Ethical Conduct for Practitioners of Management Accounting and Financial Management, April 1997, pp. 69-70).

### **CHAPTER 3 – REVIEW QUESTIONS**

*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. In which situation is a financial manager/management accountant permitted to communicate confidential information to individuals or authorities outside the firm:
  - a) there is an ethical conflict and the board has refused to take action
  - b) such communication is legally prescribed
  - c) the financial manager/management accountant knowingly communicates the information indirectly through a subordinate
  - d) an officer at the financial manager/management accountant's bank has requested information on a transaction that could influence the firm's stock price
  
2. The IMA Code of Ethics requires a financial manager/management accountant to follow the established policies of the organization when faced with an ethical conflict. If these policies do not resolve the conflict, the financial manager/management accountant should:
  - a) consult the board of directors immediately
  - b) discuss the problem with the immediate superior if (s)he is involved in the conflict
  - c) communicate the problem to authorities outside the organization
  - d) contact the next higher managerial level if initial presentation to the immediate superior does not resolve the conflict
  
3. A financial manager/management accountant discovers a problem that could mislead users of the firm's financial data and has informed his/her immediate superior. (S)he should report the circumstances to the audit committee and/or the board of directors only if:
  - a) the immediate superior, who reports to the chief executive officer, knows about the situation but refuses to correct it
  - b) the immediate superior assures the financial manager/management accountant that the problem will be resolved
  - c) the immediate superior reports the situation to his/her superior
  - d) the immediate superior, the firm's chief executive officer, knows about the situation but refuses to correct it

### **CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES**

1. A: Incorrect. There is an ethical conflict if a board takes problems to authorities or individuals not employed or engaged by the organization and prior to adhering to the established due process practices established by the company's policy.

**B: Correct.** According to the IMA Code of Ethics, financial managers/management accountants are responsible for observing the standard of confidentiality. Thus, the financial manager/management accountant should "refrain from disclosing confidential information acquired in the course of his/her work except when authorized, unless legally obligated to do so."

C: Incorrect. The financial manager/management accountant should "inform subordinates as to what is appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality."

D: Incorrect. The financial manager/management accountant is required to "refrain from using or appearing to use confidential information acquired in the course of his/her work for unethical or illegal advantage either personally or through third parties."

(See page 3-1 of the course material.)

2. A: Incorrect. This course of action would be appropriate only for the chief executive officer or for his/her immediate subordinate when the CEO is involved in the conflict.

B: Incorrect. The proper action would be to present the matter to the next higher managerial level.

C: Incorrect. Such action is inappropriate unless legally prescribed.

**D: Correct.** In these circumstances, the problem should be discussed with the immediate superior unless (s)he is involved. In that case, initial presentation should be to the next higher managerial level. If the problem is not satisfactorily resolved after initial presentation, the question should be submitted to the next higher level.

(See page 3-2 of the course material.)

3. A: Incorrect. In this situation, the chief executive officer is the next higher managerial level.

B: Incorrect. The immediate superior has promised or taken action toward satisfactory resolution.

C: Incorrect. The immediate superior has promised or taken action toward satisfactory resolution.

**D: Correct.** According to the IMA Code of Ethics, the financial manager/management accountant should "discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level. If the immediate superior is the chief executive officer, or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners."

(See page 3-2 of the course material.)

## Chapter 4: Texas Ethics

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### LEARNING OBJECTIVES:

After studying this chapter, you will be able to:

1. Outline the professional ethics and conduct for Texas CPAs.
2. Summarize the ethical concepts promulgated in the Code of Professional Conduct.

### CHAPTER 501 TEXAS RULES OF PROFESSIONAL CONDUCT – SUBCHAPTER A GENERAL PROVISIONS

#### **RULE §501.51 Preamble and General Principles**

(a) These rules of professional conduct were promulgated under the Public Accountancy Act, which directs the Texas State Board of Public Accountancy to promulgate rules of professional conduct "in order to establish and maintain high standards of competence and integrity in the practice of public accountancy and to insure that the conduct and competitive practices of licensees serve the purposes of the Act and the best interest of the public."

(b) The services usually and customarily performed by those in the public, industry, or government practice of accountancy involve a high degree of skill, education, trust, and experience which are professional in scope and nature. The use of professional designations carries an implication of possession of the competence associated with a profession. The public, in general, and the business community, in particular, rely on this professional competence by placing confidence in reports and other services of accountants. The public's reliance, in turn, imposes obligations on persons utilizing professional designations, both to their clients and to the public in general. These obligations include maintaining independence of thought and action, continuously improving professional skills, observing generally accepted accounting principles and generally accepted auditing standards, promoting sound and informative financial reporting, holding the affairs of clients in confidence, upholding the standards of the public accountancy profession, and maintaining high standards of personal and professional conduct in all matters.

(c) The board has an underlying duty to the public to insure that these obligations are met in order to achieve and maintain a vigorous profession capable of attracting the bright minds essential to serving adequately the public interest.

(d) These rules recognize the First Amendment rights of the general public as well as licensees and do not restrict the availability of accounting services. However, public accountancy, like other professional services, cannot be commercially exploited without the public being harmed. While information as to the availability of accounting services and qualifications of licensees is desirable, such information should not be transmitted to the public in a misleading fashion.

(e) The rules are intended to have application to all kinds of professional services performed in the practice of public accountancy, including services relating to:

- (1) accounting, auditing and other assurance services,
- (2) taxation,

- (3) financial advisory services,
- (4) litigation support,
- (5) internal auditing,
- (6) forensic accounting, and
- (7) management advice and consultation.

(f) Finally, these rules also recognize the duty of certified public accountants to refrain from committing acts discreditable to the profession. These acts, whether or not related to the accountant's practice, impact negatively upon the public's trust in the profession.

(g) In the interpretation and enforcement of these rules, the board may consider relevant interpretations, rulings, and opinions issued by the boards of other jurisdictions and appropriate committees of professional organizations, but will not be bound thereby.

(h) Interpretive Comment: Outsourced internal audit services are considered engagements in the client practice of public accountancy as defined in §501.52(9) of this title (relating to Definitions).

### **RULE §501.52 Definitions**

The following words and terms, when used in title 22, part 22 of the Texas Administrative Code relating to the Texas State Board of Public Accountancy, shall have the following meanings, unless the context clearly indicates otherwise. The masculine shall be construed to include the feminine or neuter and vice versa, and the singular shall be construed to include the plural and vice versa.

(1) "Act" means the Public Accountancy Act, Chapter 901, Occupations Code;

(2) "Advertisement" means a message which is transmitted to persons by, or at the direction of, a certificate or registration holder and which has reference to the availability of the certificate or registration holder to perform Professional Services;

(3) "Affiliated entity" means an entity controlling or being controlled by or under common control with another entity, directly or indirectly, through one or more intermediaries;

(4) "Attest Service" means:

(A) an audit or other engagement required by the board to be performed in accordance with the auditing standards adopted by the American Institute of Certified Public Accountants or another national accountancy organization recognized by the board;

(B) a review, compilation or other engagement required by the board to be performed in accordance with standards for accounting and review services adopted by the American Institute of Certified Public Accountants or another national accountancy organization recognized by the board;

(C) an engagement required by the board to be performed in accordance with standards for attestation engagements adopted by the American Institute of Certified Public Accountants or another national accountancy organization recognized by the board; or

(D) any other assurance service required by the board to be performed in accordance with professional standards adopted by the American Institute of Certified Public Accountants or another national accountancy organization recognized by the board;

(5) "Board" means the Texas State Board of Public Accountancy;

(6) "Certificate or registration holder" the holders of all currently valid:

(A) certificates issued to individuals who have been awarded the designation certified public accountant by the board pursuant to the Act, or pursuant to corresponding provisions of a prior Act;

(B) registrations with the board under §901.355 of the Act; and

(C) firm licenses or registrations;

(7) "Charitable Organization" means an organization which has been granted tax-exempt status under the Internal Revenue Code of 1986, §501(c), as amended;

(8) "Client" means a person who enters into an agreement with a license holder or a license holder's employer to receive a professional accounting service;

(9) "Client Practice of Public Accountancy" is the offer to perform or the performance by a certificate or registration holder for a client or a potential client of a service involving the use of accounting, attesting, or auditing skills. The phrase "service involving the use of accounting, attesting, or auditing skills" includes:

(A) the issuance of reports on, or the preparation of, financial statements, including historical or prospective financial statements or any element thereof;

(B) the furnishing of management or financial advisory or consulting services;

(C) the preparation of tax returns or the furnishing of advice or consultation on tax matters;

(D) the advice or recommendations in connection with the sale or offer for sale of products (including the design and implementation of computer software), when the advice or recommendations routinely require or imply the possession of accounting or auditing skills or expert knowledge in auditing or accounting; and/or

(E) the performance of litigation support services;

(10) "Commission" means compensation for recommending or referring any product or service to be supplied by another person;

(11) "Contingent fee" means a fee for any service where no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service. However, a certificate or registration holder's non-contingent fees may vary depending, for example, on the complexity of the services rendered. Fees are not contingent if they are fixed by courts or governmental entities acting in a judicial or regulatory capacity, or in tax matters if

determined based on the results of judicial proceedings or the findings of governmental agencies acting in a judicial or regulatory capacity, or if there is a reasonable expectation of substantive review by a taxing authority;

(12) "Financial Statements" means a presentation of financial data, including accompanying notes, derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time, or the changes therein for a period of time, in accordance with generally accepted accounting principles. Incidental financial data to support recommendations to a client or in documents for which the reporting is governed by Statements or Standards for Attestation Engagements and tax returns and supporting schedules do not constitute financial statements for the purposes of this definition;

(13) "Firm" means a proprietorship, partnership, limited liability partnership, limited liability company, or professional or other corporation, or other business engaged in the practice of public accountancy;

(14) "Good standing" means compliance by a certificate with the board's licensing rules, including the mandatory continuing education requirements and payment of the annual license fee, and any penalties and other costs attached thereto. In the case of board-imposed disciplinary or administrative sanctions, the certificate or registration holder must be in compliance with all the provisions of the board order to be considered in good standing;

(15) "Licensee" means the holder of a license issued by the board to a certificate or registration holder pursuant to the Act, or pursuant to provisions of a prior Act;

(16) "Peer review" or "Quality Review" means the study, appraisal, or review of the professional accounting work of a public accountancy firm that performs attest services by a certificate holder who is not affiliated with the firm;

(17) "Person" means an individual, partnership, corporation, registered limited liability partnership, or limited liability company;

(18) "Practice unit" means an office of a firm required to be licensed with the board for the purpose of practicing public accountancy;

(19) "Professional services" or "professional accounting work" means services or work that requires the specialized knowledge or skills associated with certified public accountants, including:

- (A) issuing reports on financial statements;
- (B) providing management or financial advisory or consulting services;
- (C) preparing tax returns; and
- (D) providing advice in tax matters;

(20) "Report" means, when used with reference to financial statements, either an engagement performed through the application of procedures under the Statement on Standards for Accounting and Review Services or any opinion, report, or other form of language that states or implies assurance as to the reliability of any financial statements and/or includes or is accompanied by any statement or implication that the person or firm issuing it has special knowledge or competence in accounting or auditing. Such a statement or implication of special knowledge or competence may arise from use by the issuer of the report of names or titles indicating that he or it is an accountant or auditor or from the language of the report itself. The term "report" includes any form of language which disclaims an opinion when such form of language is conventionally understood to imply any assurance as to the reliability of the financial statements to which reference is made. It also includes any form of language conventionally used with respect to a compilation or review of financial statements, and any other form of language that implies such special knowledge or competence;

(21) Interpretive Comment: The practice of public accountancy is defined in §901.003 of the Act (relating to the Practice of Public Accountancy).

#### **RULE §501.53 Applicability of Rules of Professional Conduct**

(a) All of the rules of professional conduct shall apply to and must be observed by a certificate or registration holder engaged in the client practice of public accountancy.

(b) No certificate or registration holder shall issue, or otherwise be associated with, financial statements that do not conform to the accounting principles described in Section 501.61 of this title (relating to Accounting Principles).

(c) The following rules of professional conduct shall apply to and be required to be observed by certificate or registration holders when not employed in the client practice of public accountancy:

- (1) Section 501.73 of this title (relating to Integrity and Objectivity);
- (2) Section 501.74 of this title (relating to Competence);
- (3) Section 501.77 of this title (relating to Acting through Others);
- (4) Section 501.78 of this title (relating to Withdrawal or Resignation);
- (5) Section 501.90 of this title (relating to Discreditable Acts);
- (6) Section 501.91 of this title (relating to Reportable Events);
- (7) Section 501.92 of this title (relating to Frivolous Complaints);
- (8) Section 501.93 of this title (relating to Responses); and
- (9) Section 501.94 of this title (relating to Mandatory Continuing Education Reporting).

#### **RULE §501.54 Savings and Provisions and Disposition Table**

(a) Repeal or amendment of Chapter 501 shall not abate any pending claims, liabilities or prosecutions.

(b) The following table shows the disposition of board rules in Chapter 501:

#### **RULE §501.55 Definition of Acronyms**

The following acronyms, when used in Title 22, Part 22 of the Texas Administrative Code relating to the Texas State Board of Public Accountancy, shall have the following meanings:

- (1) "AICPA" means the American Institute of Certified Public Accountants;
- (2) "CPA" means Certified Public Accountant;
- (3) "CPE" means continuing professional education;
- (4) "NASBA" means the National Association of State Boards of Accountancy;

- (5) "PCAOB" means the Public Company Accounting Oversight Board;
- (6) "SEC" means the United States Securities and Exchange Commission.

#### **RULE §501.60 Auditing Standards**

A certificate or registration holder shall not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an auditor with respect to such financial statements, unless he has complied with applicable generally accepted auditing standards. Statements on auditing standards issued by the American Institute of Certified Public Accountants, auditing standards included in Standards for Audit of Government Organizations, Programs, Activities and Functions issued by the United States General Accounting Office, and in other pronouncements having similar generally recognized authority, are considered to be interpretations of generally accepted auditing standards, and departures from such pronouncements must be justified.

#### **RULE §501.61 Accounting Principles**

A certificate or registration holder shall not issue a report asserting that financial statements are presented in conformity with generally accepted accounting principles if such financial statements contain any departure from such accounting principles which has a material effect on the financial statements taken as a whole, unless the certificate or registration holder can demonstrate that by reason of unusual circumstances the financial statements would otherwise have been misleading. In such a case, the certificate or registration holder's report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the generally accepted accounting principles would result in a misleading statement. For purposes of this section, generally accepted accounting principles are considered to be defined by pronouncements issued by the Financial Accounting Standards Board and its predecessor entities and similar pronouncements issued by other entities having similar generally recognized authority.

#### **RULE §501.62 Other Professional Standards**

A certificate or registration holder in the performance of consulting services, accounting and review services, any other attest service, or tax services shall conform to the professional standards applicable to such services. For purposes of this section, such professional standards are considered to be interpreted by:

- (1) Statements on Standards on Consulting Services (SSCS) issued by the American Institute of Certified Public Accountants;
- (2) Statements on Standards for Accounting and Review Services (SSARS) issued by the American Institute of Certified Public Accountants;
- (3) Statements on Standards for Attestation Engagements (SSAE) issued by the American Institute of Certified Public Accountants;
- (4) Statements on Standards for Tax Services issued by the American Institute of Certified Public Accountants; or
- (5) similar pronouncements by other entities having similar generally recognized authority.

### **RULE §501.70 Independence**

A certificate or registration holder in the performance of professional services, including those who are not members of the AICPA, shall conform in fact and in appearance to the independence standards established by the AICPA and the board, and, where applicable, the U.S. Securities and Exchange Commission, the General Accounting Office and other regulatory or professional standard setting bodies.

### **RULE §501.71 Receipt of Commissions and Other Compensation**

(a) A certificate or registration holder shall not for a commission recommend or refer to a client any product or service or refer any product or service to be supplied to a client, or receive a commission, when the licensee or the licensee's firm also performs services for that client requiring independence under §501.70 of this chapter (relating to Independence).

(b) This prohibition applies during the period in which the certificate or registration holder is engaged to perform any of the services requiring independence and during the period covered by any of the historical financial statements involved in such services requiring independence.

(c) A certificate or registration holder who receives or agrees to receive other compensation with respect to services or products recommended, referred, or sold by him to another person shall, no later than the making of such recommendation, referral, or sale, make the following disclosures in writing to such other persons:

(1) if the other person is a client, the nature, source, and amount of all such other compensation; or

(2) if the other person is not a client, the nature and source of any such other compensation.

(d) The disclosure shall be made regardless of the amount of other compensation involved.

(e) This section does not apply to payments received from the sale of all, or a material part, of an accounting practice, or to retirement payments to persons formerly engaged in the practice of public accountancy.

(f) Interpretive Comment: Reference should be made to §501.73(d) of this title (relating to Integrity and Objectivity) for issues relating to the payment of fees by a certificate or registration holder to any person to obtain clients for the certificate or registration holder.

### **RULE §501.72 Contingency Fees**

(a) A certificate or registration holder shall not perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the certificate or registration holder performs services requiring independence under §501.70 of this chapter (relating to Independence).

(b) A certificate or registration holder shall not prepare an original or amended federal, state, local or other jurisdiction tax return for a contingent fee for any client during the period in which the licensee or the licensee's firm is engaged to perform any of the services referenced by subsection (a) of this section and the period covered by any historical or prospective financial statements involved in any of the referenced services. Fees are not contingent if they are fixed by courts or governmental entities acting in a judicial or regulatory capacity, or in tax matters if determined based on the results of judicial proceedings or the findings of governmental agencies acting in a judicial or regulatory capacity, or if there is a reasonable expectation of substantive review by a taxing authority.

(c) A certificate or registration holder shall not perform an engagement as a testifying accounting expert for a contingent fee. A testifying accounting expert is one that at any

time during the preceding becomes subject to disclosure and discovery under the procedural rules of the forum where the matter for which his services were engaged is pending.

(d) The prohibitions outlined in subsections (a) and (b) of this section apply during any period in which the certificate or registration holder is engaged to perform any of the services referenced by subsections (a) and (b) of this section, and the period covered by any historical or prospective financial statements involved in any of the referenced services.

(e) A certificate or registration holder shall otherwise comply with the provisions of §501.70 of this chapter (relating to Independence).

(f) Interpretive Comment: A consulting accounting expert may become a testifying accounting expert when the client for whom he is working makes his work available to a testifying expert. A consulting accounting expert who is working on a contingent fee basis should work closely with his client to insure that he does not inadvertently become a testifying expert through the actions of his client. An accounting expert may not accept a contingent fee for part of an engagement and a set fee for part of the same engagement. A consulting accounting expert who becomes a testifying expert may not accept a contingent fee for the part of his work done as a consultant, but must be compensated on a set fee basis for all of the work performed on the same engagement. A consulting accounting expert who enters into a contingent fee engagement should reach an agreement, preferably in writing, with the client as to how he will be compensated should he become a testifying expert prior to beginning the engagement.

#### **RULE §501.73 Integrity and Objectivity**

(a) A certificate or registration holder in the performance of professional services shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a certificate or registration holder may resolve doubt in favor of his client as long as there is reasonable support for the position.

(b) A conflict of interest may occur if a certificate or registration holder performs a professional service for a client or employer and the certificate or registration holder has a relationship with another person, entity, product, or service that could, in the certificate or registration holder's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the certificate or registration holder's objectivity. If the certificate or registration holder believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, then this rule shall not operate to prohibit the performance of the professional service because of a conflict of interest.

(c) Certain professional engagements, such as audits, reviews, and other services, require independence. Independence impairments under §501.70 (relating to Independence), its interpretations and rulings cannot be eliminated by disclosure and consent.

(d) A certificate or registration holder shall not pay a commission to a third party to obtain a client unless, prior to being engaged by such client, the certificate or registration holder discloses to the client in writing the fact and the fixed or variable amount of such commission. This section does not apply to payments made to a certificate or registration holder for the purchase of all, or a material part, of an accounting practice, or to retirement payments to persons formerly engaged in the practice of public accountancy.

(e) A certificate or registration holder shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs

independence or objectivity in rendering professional services, or which is conducted so as to augment or benefit the accounting practice unless these rules are observed in the conduct thereof.

(f) Interpretive Comment: Reference should be made to §501.62(4) and (5) of this title (relating to Other Professional Standards) where applicable.

#### **RULE §501.74 Competence**

(a) A certificate or registration holder shall not undertake any engagement for the performance of professional services which he cannot reasonably expect to complete with due professional competence, including compliance, where applicable, with §501.60 of this title (relating to Auditing Standards), §501.61 of this title (relating to Accounting Principles), and §501.62 of this title (relating to Other Professional Standards).

(1) Competence to perform professional services involves both the technical qualifications of the certificate or registration holder and the certificate or registration holder's staff and the ability to supervise and evaluate the quality of the work being performed.

(2) The certificate or registration holder may have the knowledge required to complete the professional services with competence prior to performance. In some cases, however, additional research or consultation with others may be necessary during the performance of the professional services. If a certificate or registration holder is unable to gain sufficient competence through these means, the certificate or registration holder shall suggest to the client the engagement of someone competent to perform the needed professional service, either independently or as an associate.

(b) A certificate or registration holder shall exercise due professional care in the performance of professional services.

(c) A certificate or registration holder shall adequately plan and supervise the performance of professional services.

(d) A certificate or registration holder shall obtain sufficient data to afford a reasonable basis for conclusions and recommendations in relation to any professional services performed.

#### **RULE §501.75 Confidential Client Communications**

Except by permission of the client or the authorized representatives of the client, a certificate or registration holder or any partner, officer, shareholder, or employee of a certificate or registration holder shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional services rendered to the client by the certificate or registration holder. Such information shall be deemed confidential. However, nothing herein shall be construed as prohibiting the disclosure of information required to be disclosed by the standards of the public accounting profession in reporting on the examination of financial statements or as prohibiting disclosures pursuant to a subpoena or other compulsory process, in investigations or proceedings under the Act, in ethical investigations conducted by private professional organizations, or in the course of peer reviews.

#### **RULE §501.76 Records and Work Papers**

(a) Upon request, regardless of the status of the client or former client's account, a certificate or registration holder shall provide to the client or former client any accounting or other records, whether in the form of hard copy or computer readable format, belonging to, or obtained from or on behalf of, the client that the certificate or registration holder removed from the client's premises or received on behalf of the client. The certificate or registration holder may make and retain copies of such records when they

form the basis of work done by him. For a reasonable charge for personnel time and photocopying, a certificate or registration holder shall furnish to his client or former client, upon request made within a reasonable time after original issuance of the document in question:

(1) a copy of the client's tax return;

(2) a copy of any report or other document previously issued by the certificate or registration holder to or for such client provided that furnishing such reports to or for a client or former client would not cause the certificate or registration holder to be in violation of the portions of Section 501.60 of this title (relating to Auditing Standards) concerning subsequent events;

(3) a copy of the certificate or registration holder's working papers, to the extent that such working papers include records which would ordinarily constitute part of the client's books and records and are not otherwise available to the client.

(b) A certificate or registration holder, when performing an engagement that is terminated prior to the completion of the engagement, is required to return or furnish the originals of only those records originally obtained by the certificate or registration holder from the client.

(c) Working papers developed by a certificate or registration holder during the course of a professional engagement as a basis for, and in support of, an accounting, audit, consulting, tax, or other professional report prepared by the certificate or registration holder for a client, shall be and remain the property of the certificate or registration holder who developed the working papers.

(1) Working papers, whether in the form of hard copy or computer readable format, are those papers developed by the certificate or registration holder incident to the performance of his engagement which do not result in changes to the client's records or are in part of the records ordinarily maintained by the client.

(2) Analyses of inventory or other accounts as part of the certificate or registration holder's selective audit procedures, even when prepared by client personnel at the request of the certificate or registration holder, are the certificate or registration holder's working papers.

(3) If the analyses described in paragraph (2) of this subsection result in changes to the client's records, the certificate or registration holder is required to furnish the details from his working papers in support of the journal entries recording such changes unless the journal entries themselves contain all necessary details.

(d) Working papers include, but are not limited to:

(1) letters of confirmation and representation;

(2) excerpts of company documents;

(3) audit programs;

(4) internal memoranda;

(5) schedules;

(6) flowcharts; and

(7) narratives.

(e) Working papers which constitute client records include, but are not limited to:

(1) worksheets in lieu of books of original entry such as listings and distributions of cash receipts or cash disbursements;

(2) worksheets in lieu of general ledger or subsidiary ledgers, such as accounts receivable, job cost and equipment ledgers, or similar depreciation records;

(3) all adjusting and closing journal entries and supporting details when the supporting details are not fully set forth in the explanation of the journal entry; and

(4) consolidating or combining journal entries and worksheets and supporting detail in arriving at final figures incorporated in an end product such as financial statements or tax returns.

(f) Documentation or working papers required by professional standards for attest services shall be maintained in paper or electronic format by a certificate or registration holder for a period of not less than five years from the date of any report issued in connection with the attest service, unless otherwise required by another regulatory body. Failure to maintain such documentation or working papers constitutes a violation of this section and may be deemed an admission that they do not comply with professional standards.

(g) Interpretive Comment: It is recommended that a certificate or registration holder obtain a receipt or other written documentation of the delivery of records to a client.

#### **RULE §501.77 Acting through Others**

(a) A certificate or registration holder shall not permit others including non-CPA owners and employees, to carry out on his behalf, either with or without compensation, acts, which, if carried out by the certificate or registration holder, would place him in violation of these rules of professional conduct.

(b) The board shall consider that the conduct of any non-CPA owner or employee in connection with the business of a licensed firm is the conduct of that licensed firm for the purposes of the rules of professional conduct.

#### **RULE §501.78 Withdrawal or Resignation**

(a) If a certificate or registration holder cannot complete an engagement or employment assignment in a manner that complies with the requirements of this chapter, the certificate or registration holder shall withdraw from the engagement or resign from the employment assignment.

(b) If a certificate or registration holder withdraws from an engagement or resigns from an employment assignment pursuant to this section, the certificate or registration holder shall inform the client or employer of the withdrawal or resignation.

(c) Interpretive Comment: Any withdrawal or resignation shall preferably be in writing. A certificate or registration holder shall comply with the requirements of §501.75 of this title (relating to Confidential Client Communications) and §501.90(17) of this title (relating to Discreditable Acts) regarding confidential information of clients and employers during and after a withdrawal or resignation executed pursuant to this section. For purposes of this section, an engagement commences once an engagement letter is signed by the client, time is charged to the engagement, or compensation is received by a certificate or registration holder in connection with an engagement or employment assignment.

#### **RULE §501.80 Practice of Public Accountancy**

(a) A certificate or registration holder may not engage in the practice of public accountancy unless he holds a valid license issued by the board. A certificate or registration holder may not use the title or designation "certified public accountant", the abbreviation "CPA", or any other title, designation, word, letter, abbreviation, sign, card, or device tending to indicate that the person is a certified public accountant unless he holds a valid license issued by the board. A license is not valid for any date or for any period prior to the date it is issued by the board and it automatically expires and is no longer valid after the end of the period for which it is issued.

(b) Any licensee of this board in good standing as a certified public accountant or public accountant may use such designation whether or not the licensee is in the client, industry, or government practice of public accountancy. However, a licensee who is not in the client

practice of public accountancy may not in any manner, through use of the CPA designation or otherwise, claim or imply independence from his employer or that the licensee is in the client practice of public accountancy.

(c) Interpretive Comment: This section incorporates the definitions of the practice of public accountancy and professional services and accounting work found in §501.52(9) and §501.52(19) of this title (relating to Definitions) as well as §901.003 of the Act (relating to Practice of Public Accountancy).

#### **RULE §501.81 Firm License Requirements**

(a) A Firm, including a sole proprietorship, may not provide attest services or use the title "CPA," "CPAs," "CPA Firm," "Certified Public Accountants," "Certified Public Accounting Firm," or "Auditing Firm" or any variation of those titles unless the firm holds a firm license.

(b) An individual may not provide attest services unless:

(1) the individual has a license or registration issued under the Act; and

(2) the individual offers the attest services through an entity holding a firm license.

(c) Each advertisement or written promotional statement that refers to a CPA's designation and his or her association with an unlicensed entity in the client practice of public accountancy must include the disclaimer: "This firm is not a CPA firm." The disclaimer must be included in conspicuous proximity to the name of the unlicensed entity and be printed in type not less bold than that contained in the body of the advertisement or written statement. If the advertisement is in audio format only, the disclaimer shall be clearly declared at the conclusion of each such presentation.

(d) The requirements of subsection (c) of this section do not apply with regard to a certificate or registration holder performing services:

(1) as a licensed attorney at law of this state while in the practice of law or as an employee of a licensed attorney when acting within the scope of the attorney's practice of law; or

(2) as an employee, officer, or director of a federally-insured depository institution, when lawfully acting within the scope of the legally permitted activities of the institution's trust department.

(e) On the third determination by the board that a certificate holder has practiced without a license or through an unregistered entity in violation of subsection (c) of this section, the individual's certificate shall be subject to revocation and may not be reinstated for at least 12 months from the date of the revocation.

(f) Interpretive Comment: A certificate or registration holder who is employed by an unlicensed firm that offers services that fall within the definitions of the client practice of public accountancy as defined in §501.2(9) and §501.2(19) of this title (relating to Definitions) and §901.003 of the Act (relating to Practice of Public Accountancy) must comply with the disclaimer requirement found in subsection (c) of this section.

#### **RULE §501.82 Advertising**

(a) A certificate or registration holder shall not use or participate in the use of:

(1) any written, oral, or electronic communication having reference to the certificate or registration holder's professional services that contains a false, fraudulent, misleading or deceptive statement or claim; nor

(2) any written, oral or electronic communication that refers to the certificate or registration holder's professional services that is accomplished or accompanied by coercion, duress, compulsion, intimidation, threats, overreaching, or vexatious or harassing conduct.

(b) Definitions:

(1) A "false, fraudulent, misleading, or deceptive statement or claim" includes, but is not limited to, a statement or claim which:

- (A) contains a misrepresentation of fact;
  - (B) is likely to mislead or deceive because it fails to make full disclosure of relevant facts;
  - (C) is intended or likely to create false or unjustified expectations of favorable results;
  - (D) implies educational or professional attainments or licensing recognition not supported in fact;
  - (E) represents that professional services can or will be completely performed for a stated fee when this is not the case, or makes representations with respect to fees for professional services that do not disclose all variables that may reasonably be expected to affect the fees that will in fact be charged;
  - (F) contains other representations or implications that in reasonable probability will cause a reasonably prudent person to misunderstand or be deceived;
  - (G) implies the ability to improperly influence any court, tribunal, regulatory agency or similar body or official due to some special relations;
  - (H) consists of self-laudatory statements that are not based on verifiable facts;
  - (I) makes untrue comparisons with other accountants; or
  - (J) contains testimonials or endorsements that are not based upon verifiable facts.
- (2) Broadcast -- Any transmission over the airwaves or over a cable, wireline, Internet, or e-mail system.
- (3) Coercion – Compelling by force so that one is constrained to do what his free will would otherwise refuse.
- (4) Compulsion -- Driving or urging by force or by physical or mental constraint to perform or forbear from performing an act.
- (5) Direct personal communication – Either a face-to-face meeting or a conversation by telephone.
- (6) Duress – Any conduct which overpowers the will of another.
- (7) Harassing -- Any word, gesture, or action which tends to annoy, alarm, and verbally abuse another person.
- (8) Intimidation – Willfully to take, or attempt to take, by putting in fear of bodily harm.
- (9) Overreaching – Tricking, outwitting, or cheating a person into doing an act which he would not otherwise do.
- (10) Threats – Any menace of such a nature and extent as to unsettle the mind of the person on whom it operates, and to take away from his acts that free and voluntary action which alone constitutes consent.
- (11) Vexatious – Irritating or annoying.
- (c) It is a violation of these rules for a certificate or registration holder to persist in contacting a prospective client when the prospective client has made known to the certificate or registration holder, or the certificate or registration holder should have known the prospective client's desire not to be contacted by the certificate or registration holder.
- (d) In the case of direct mail communication, the certificate or registration holder shall retain a copy of the actual mailing along with a list or other description of persons to whom the communication was mailed or otherwise distributed. Such copy shall be retained by the certificate or registration holder for a period of at least 36 months from the date of the last transmission or use.
- (e) Subsection (d) of this section does not apply to persons when:
- (1) the communication is made to a person who is at that time a client of the certificate or registration holder;
  - (2) the communication is invited by the person to whom it was made; or
  - (3) the communication is made to a person seeking to secure the performance of professional services, which are currently not being provided by another certificate or registration holder.

(f) In the case of radio and television broadcasting, the broadcast shall be recorded and the certificate or registration holder shall retain a recording of the actual transmission for at least 36 months.

#### **RULE §501.83 Firm Names**

(a) A firm name may not include descriptive words relating to the quality of services offered or that is misleading about the legal form of the firm, or about the persons who are partners, officers, or shareholders of the firm, or about any other matter. However, names of one or more former partners or shareholders may be included in the name of a firm or its successor.

(b) A firm name is misleading if:

(1) it is not the lawful and registered name of the firm;

(2) the name contains a misrepresentation of facts;

(3) the name indicates character or grade of service which is not based upon verifiable facts;

(4) the name is likely to mislead or deceive because it fails to make full disclosure of relevant facts; the following are examples, but are not inclusive:

(A) the name indicates a geographic area of service which is not based on verifiable facts; or

(B) the firm name includes a non-owner firm employee or a non-CPA.

(5) the name is intended or likely to create false or unjustified expectations of favorable results;

(6) the name implies special expertise;

(7) the name implies educational or professional attainment or licensing recognition of the firm and/or of its owners, partners, or shareholders which are not supported in fact;

(8) the name of the firm that is incorporated does not include the words "corporation," "incorporated," "professional corporation," or "company," or an abbreviation thereof as a part of the firm name; the words "professional corporation," or "PC" are not included with the firm name each time it is used; and the name of a firm organized under the limited liability partnership statute does not include the words "limited liability company" or "limited liability partnership" as appropriate, or an abbreviation thereof as part of the firm name unless the entity was organized prior to September 1, 1993;

(9) the name includes the designation "and company," "company," "group," "associates" or "and associates" or abbreviations thereof or similar names implying more than one employed licensee in the firm unless there are at least two licensees involved full time in the practice;

(10) the name of a firm that is a partnership or professional corporation fails to contain the personal name or names of one or more individuals presently or previously a partner, officer, or shareholder thereof; except that an acronym may be used for a firm name if the acronym is composed exclusively of the first letters of the surnames of current or past partners or shareholders of the firm;

(11) the name of a firm that is a sole proprietorship fails to contain the name of the sole proprietor; or

(12) the name contains other representations or implications that in reasonable probability will cause a reasonably prudent person to misunderstand or be deceived.

(c) A partner surviving the death or withdrawal of all other partners may continue to practice under a partnership name for up to two years after becoming a sole practitioner.

(d) The name of any former partner or former shareholder may not be used in a registered firm name during the period when the former partner or former shareholder has been prohibited from practicing public accountancy or prohibited from using the title "CPA" or "PA."

**RULE §501.84 Form of Practice**

A certificate or registration holder may practice public accountancy only in a proprietorship, a partnership, a limited liability company, a registered limited liability partnership, a professional public accounting corporation, or business corporation organized under the laws of the State of Texas or an equivalent law of another state, territory, or foreign country, or as an employee of one of these entities.

**RULE §501.85 Complaint Notice**

When a firm receives a complaint that an alleged violation of the Act or Rules of Professional Conduct has occurred, a certificate or registration holder shall provide to the complainant a statement that: Complaints concerning Certified Public Accountants may be addressed in writing to the Texas State Board of Public Accountancy at 333 Guadalupe, Tower 3, Suite 900, Austin, Texas 78701-3900, telephone (512) 305-7800, email to [enforcement@tsbpa.state.tx.us](mailto:enforcement@tsbpa.state.tx.us), or fax (512) 305-7854.

**RULE §501.90 Discreditable Acts**

A certificate or registration holder shall not commit any act that reflects adversely on his fitness to engage in the practice of public accountancy. A discreditable act includes but is not limited to:

(1) fraud or deceit in obtaining a certificate as a certified public accountant or in obtaining registration under the Act or in obtaining a license to practice public accounting;

(2) dishonesty, fraud or gross negligence in the practice of public accountancy;

(3) violation of any of the provisions of Subchapter J or §901.458 of the Act applicable to a person certified or registered by the board;

(4) final conviction of a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States;

(5) final conviction of any crime or imposition of deferred adjudication or community supervision in connection with a criminal prosecution, an element of which is dishonesty or fraud under the laws of any state or the United States, or a criminal prosecution for a crime of moral turpitude, or a criminal prosecution involving alcohol abuse or controlled substances;

(6) cancellation, revocation, suspension or refusal to renew authority to practice as a certified public accountant or a public accountant by any other state for any cause other than failure to pay the appropriate registration fee in such other state;

(7) suspension or revocation of or a voluntary consent decree concerning the right to practice before any state or federal agency for a cause which in the opinion of the board warrants its action;

(8) knowingly participating in the preparation of a false or misleading financial statement or tax return;

(9) fiscal dishonesty or breach of fiduciary responsibility of any type;

(10) failure to comply with a final order of any state or federal court;

(11) repeated failure to respond to a client's inquiry within a reasonable time without good cause;

(12) misrepresenting facts or making a misleading or deceitful statement to a client;

(13) false swearing or perjury in any communication to the board or any other federal or state regulatory or licensing authority;

(14) threats of bodily harm or retribution to a client;

(15) public allegations of a lack of mental capacity of a client which cannot be supported in fact;

- (16) causing a breach in the security of the CPA examination;
- (17) voluntarily disclosing information communicated to the certificate holder by an employer, past or present, or through the certificate holder's employment in connection with accounting services rendered to the employer, except:
  - (A) by permission of the employer;
  - (B) pursuant to the Government Code, Chapter 554 (commonly referred to as the "Whistle Blowers Act");
  - (C) pursuant to a subpoena or other compulsory process;
  - (D) in an investigation or proceeding by the board under the Public Accountancy Act; or
  - (E) in an ethical investigation conducted by a professional organization of certified public accountants; and
- (18) breaching the terms of an agreed consent order entered by the Board or violating any Board Order.
- (19) Interpretive Comment: The board has found in §519.16 of this title (relating to Misdemeanors that Subject a Certificate or Registration Holder to Discipline by the Board) and §525.1 of this title (relating to Applications for the Uniform CPA Examination, Issuance of the CPA Certificate, a License, or Renewal of a License for Individuals with Criminal Backgrounds) that any crime of moral turpitude directly relates to the practice of public accountancy. A crime of moral turpitude is defined in this chapter as a crime involving grave infringement of the moral sentiment of the community. The board has found in §519.16 of this title that any crime involving alcohol abuse or controlled substances directly relates to the practice of public accountancy.

#### **RULE §501.91 Reportable Events**

- (a) A licensee shall report in writing to the board the occurrence of any of the following events within 30 days of the date the licensee has knowledge of these events:
  - (1) the conviction or imposition of deferred adjudication of the licensee of any of the following:
    - (A) a felony;
    - (B) a crime of moral turpitude;
    - (C) any crime of which fraud or dishonesty is an element or that involves alcohol abuse or controlled substances; and
    - (D) any crime related to the qualifications, functions, or duties of a public accountant or certified public accountant, or to acts or activities in the course and scope of the practice of public accountancy or as a fiduciary.
  - (2) the cancellation, revocation, or suspension of a certificate, other authority to practice or refusal to renew a certificate or other authority to practice as a certified public accountant or a public accountant, by any state, foreign country or other jurisdiction; or
  - (3) the cancellation, revocation, or suspension of the right to practice as a certified public accountant or a public accountant before any governmental body or agency or other licensing agency.
- (b) The report required by subsection (a) of this section shall be signed by the licensee and shall set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.
- (c) Nothing in this section imposes a duty upon any licensee to report to the board the occurrence of any of the events set forth in subsection (a) of this section either by or against any other licensee.

(d) As used in this section, a conviction includes the initial plea, verdict, or finding of guilt, plea of no contest, or pronouncement of sentence by a trial court even though that conviction may not be final or sentence may not be actually imposed until all appeals are exhausted.

(e) Interpretive Comment: A crime of moral turpitude is defined in this chapter as a crime involving grave infringement of the moral sentiment of the community.

#### **RULE §501.92 Frivolous Complaints**

A certificate or registration holder who, in writing to the board, accuses another certificate holder of violating the rules of the board shall assist the board in any investigation and/or prosecution resulting from the written accusation. Failure to do so, such as not appearing to testify at a hearing or to produce requested documents necessary to the investigation or prosecution, without good cause is a violation of this rule.

#### **RULE §501.93 Responses**

(a) An applicant, certificate or registration holder shall substantively respond in writing to any communication from the board requesting a response, within 30 days. The board may specify a shorter time for response in the communication when circumstances so require. The time to respond shall commence on the date the communication was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number, or e-mail address furnished to the board by the applicant, certificate or registration holder.

(b) An applicant, certificate or registration holder shall provide copies of documentation and/or working papers in response to the board's request at no expense to the board within 30 days. The board may specify a shorter time for response in the communication when circumstances so require. The time to respond shall commence on the date the request was mailed, delivered to a courier or delivery service, faxed or e-mailed to the last address, facsimile number or e-mail address furnished to the board by the applicant, certificate or registration holder. An applicant, certificate or registration holder may comply with this subsection by providing the board with original records for the board to duplicate. In such a circumstance, upon request the board will provide an affidavit from the custodian of records documenting custody and control of the records.

(c) Failure to timely respond substantively to written board communications, or failure to furnish requested documentation and/or working papers, constitutes conduct indicating lack of fitness to serve the public as a professional accountant.

(d) Each applicant, certificate holder and each person required to be registered with the board under the Act shall notify the board, in writing, of any and all changes in either such person's mailing address or telephone number and the effective date thereof within 30 days before or after such effective date.

(e) Interpretive Comment. This section should be read in conjunction with §519.6 of this title (relating to Subpoenas).

#### **RULE §501.94 Mandatory Continuing Professional Education**

Each certificate or registration holder shall comply with the mandatory continuing professional education reporting and the mandatory continuing professional education attendance requirements of Chapter 523 of this title (relating to Mandatory Continuing Professional Education Program). Once an individual's license has been suspended a third time by the board for failing to complete the 120 hours of continuing professional education required by §523.63 of this title (relating to Mandatory CPE Attendance), the individual's certificate shall be subject to revocation and may not be reinstated for at least 12 months from the date of the revocation.

## **CHAPTER 4 – REVIEW QUESTIONS**

*The following questions are designed to ensure that you have a complete understanding of the information presented in the chapter. They do not need to be submitted in order to receive CPE credit. They are included as an additional tool to enhance your learning experience.*

*We recommend that you answer each review question and then compare your response to the suggested solution before answering the final exam questions related to this chapter.*

1. The rules of professional services performed in the practice of public accounting are intended to apply to all kinds of professionals but do not include services performed by public accountants or certified public accountants in:
  - a) taxation and internal auditing
  - b) litigation support
  - c) non-financial advisory services outside the scope of public accounting
  - d) forensic accounting
  
2. A contingency fee means:
  - a) compliance by certificate with the board's licensing rules, including mandatory continuing education, payment of annual fees, and any penalties or other costs
  - b) a presentation of financial data including accompanying notes derived from accounting records and intended to communicate an entity's economic resources or obligations at a point in time
  - c) a fee for any service where no fee will be charged unless there is a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of the service provided
  - d) compensation for recommending any product or service to be supplied by another person
  
3. Rules of professional conduct for those engaged in the practice of public accounting do not relate to:
  - a) discreditable acts and frivolous complaints
  - b) dissolution of corporations
  - c) competency and reportable events
  - d) acting through others and responses
  
4. Professional services other than accounting principles that conform to GAAP include the performance of consulting services, accounting and review services, attest services and tax services. The professional standards issued by AICPA for attest services are considered to be interpreted by:
  - a) Statement on Standards Consulting Services (SSCS)
  - b) Statements on Standards for Accounting and Review Services (SSARS)
  - c) Statements on Standards for Attestation Engagements (SSAE)
  - d) Statements on Standards for Tax Services (SSTS)

5. An accountant may not knowingly misrepresent the facts or subordinate his or her judgment to others in matters relating to professional accounting decisions. This is known as:
  - a) independence
  - b) integrity and objectivity
  - c) competence
  - d) confidentiality
  
6. A certificate or registration holder shall not use or participate in the use of any type of media advertising or references that contain any of the following except:
  - a) professional attainments or licensing
  - b) false claims
  - c) fraudulent statements
  - d) misleading or deceptive statements
  
7. A firm may not include descriptive words relating to the quality of services offered such as all of the following except:
  - a) the use of a name that is misleading and not lawfully registered with the board
  - b) include a misrepresentation in the firm's registered name
  - c) register a name implying professional attainment supported by fact
  - d) include a name that indicates character or grade of service

## **CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES**

1. A: Incorrect. Public accounting services include services related to taxation and internal auditing.

B: Incorrect. The practice of public accounting includes services related to litigation support.

**C: Correct.** Non-financial advisory services outside the scope of public accounting such as office design and interior decorating are not considered financial advisory services or public accounting services.

D: Incorrect. Professional services performed in the practice of public accounting include forensic accounting.

(See pages 4-1 to 4-2 of the course material.)

2. A: Incorrect. Good standing is defined as compliance by certificate and adherence to the board's rules and regulations.

B: Incorrect. A financial statement is defined as financial data presented in accordance with generally accepted accounting principles and accompanying notes derived from records.

**C: Correct.** Contingency fee is a fee for any service where no fee will be charged unless a specified finding or result is obtained.

D: Incorrect. A commission is compensation for recommending or referring any product or service to be supplied by another person.

(See page 4-3 of the course material.)

3. A: Incorrect. Rules of professional conduct shall apply to and require to be observed by certificate or registration holders when not employed in the client practice of public accounting including those related to discreditable acts and frivolous complaints.

**B: Correct.** Dissolution of a corporation is filed through a state government agency such as the state corporation commission.

C: Incorrect. Rules of professional conduct shall apply to and require to be observed by certificate or registration holders when not employed in the client practice of public accounting including those related to competency and reportable events.

D: Incorrect. Rules of professional conduct shall apply to and require to be observed by certificate or registration holders when not employed in the client practice of public accounting including those related to acting through others and responses.

(See page 4-5 of the course material.)

4. A: Incorrect. SSCS interprets performance of consulting services.

B: Incorrect. SSARS interprets accounting and review services.

**C: Correct.** SSAE interprets attest services.

D: Incorrect. SSTs interprets tax services.

(See page 4-6 of the course material.)

5. A: Incorrect. Independence of an accountant or firm is not knowingly in fact or action or appearance subordinating his or her judgment to others and conforming to the independent standards established by the AICPA and the board relating to professional accounting decisions.

**B: Correct.** Integrity and objectivity is being free of conflicts of interest and not knowingly misrepresenting facts nor subordinating his or her judgment to others.

C: Incorrect. Competence is described as any engagement in which the accountant or firm may undertake an engagement and can reasonably expect to complete the engagement to the best of his or her ability and best effort.

D: Incorrect. Confidential relations, unless required by law or court order, may not be violated by an accountant while engaged by a client without the client's permission. A confidence is violated when information gained through a professional relationship is disclosed to another without the client's consent.

(See page 4-8 of the course material.)

6. **A: Correct.** Educational or professional attainments or licensing recognition supported in fact are legal to use in any media venue.

B: Incorrect. The use of false claims or statements is misleading and deceptive and a violation of the professional codes issued by the board.

C: Incorrect. Fraudulent statements are likely to be misleading or deceptive because they fail to make full disclosure of relevant facts, which is a violation of the professional codes issued by the board.

D: Incorrect. Misleading or deceptive statements are intended or likely to create false or unjustified expectations of favorable results and are considered violations of the professional codes issued by the board.

(See page 4-12 of the course material.)

7. A: Incorrect. A firm name is misleading and not lawful if it is not legally registered with the board.

B: Incorrect. A firm name is misleading even if lawfully registered but contains a misrepresentation of facts.

**C: Correct.** A name that is legally registered and includes professional attainments or licensing supported by fact is a legal use of a registered name.

D: Incorrect. A firm name that indicates character or grade of service that is not based on verifiable facts is misleading and a violation of the professional code.

(See page 4-14 of the course material.)

## Glossary

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**ETHICS:** standards of professional conduct and business practices adhered to by professionals in order to enhance their profession and maximize idealism, justice and fairness when dealing with the public, clients and other members of their profession.

**LAWS:** bodies of rules governing members of a community, state, organization, professional, etc. enforced by authority or compelling legislation.

**MORAL:** an accepted rule or standard of human behavior.

**PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB):**

([www.pcaobus.com](http://www.pcaobus.com)) established in 2002 as a result of the Sarbanes-Oxley Act, a private sector, non-profit corporation set up to oversee the audits of public companies and ensure that accountancy firms should no longer derive non-audit revenue streams, such as consultancy, from their audit clients.

**SARBANES-OXLEY (SOX) ACT:** wide-ranging U.S. corporate reform legislation, coauthored by the Democrat in charge of the Senate Banking Committee, Paul Sarbanes, and Republican Congressman Michael Oxley. The Act, which became law in July 2002, lays down stringent procedures regarding the accuracy and reliability of corporate disclosures, places restrictions on auditors providing non-audit services and obliges top executives to verify their accounts personally. Section 409 is especially tough and requires that companies must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

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