Ethics and Professional Conduct for Missouri CPAs

Course #4425H

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**Glossary**

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Chapter 1: The Code of Professional Conduct

Objectives: After completing this chapter, you will be able to:

- List the six guiding principles in the AICPA Code of Professional Conduct.
- Explain the difference between the principles and the rules.
- Discuss how to apply the rules to specific actions common to the CPA community.

The Code of Professional Conduct provides guidelines for accounting practitioners in the conduct of their professional affairs. A member of the AICPA must observe all the Rules of Conduct unless an exception applies. The need to observe the Rules of Conduct also extends to individuals who carry out tasks on behalf of an AICPA member. A member may be held responsible for a violation of the rules committed by fellow partners, shareholders, or any other person associated with him who is engaged in the practice of public accounting. The bylaws of the AICPA provide the basis for determining whether a member has violated the Rules of Conduct. If a member is found guilty of a violation, he or she may be admonished, suspended or expelled.

A member of the AICPA also must be aware of Interpretations of the AICPA Rules of Conduct. After public exposure, Interpretations of the AICPA Rules of Conduct are published by the Executive Committee of the Professional Ethics Division. Interpretations are not intended to limit the scope or application of the Rules of Conduct. A member of the AICPA who departs from the guidelines provided in the Interpretations has the burden of justifying such departure.

Question: Why do I care about the AICPA rules if I am not a member of the AICPA?

Answer: Most states pattern their rules after the AICPA. In addition, when courts look at professional negligence, they will look to national standards such as the AICPA Code of Professional Conduct.

Observation: In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the Public Company Accounting Oversight Board (PCAOB), and the U.S. Securities and Exchange Commission (SEC) if the member’s report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member’s report will be filed with the DOL, the Government Accountability Office (GAO) if law, regulation, agreement, policy or contract requires the member’s report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member’s engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.
A) Principles
The six principles of the Code of Professional Conduct provide the conceptual framework for the code. They are the cornerstone of ethical behavior.

B) Rules
The rules of the Code of Professional Conduct are more specific than the six principles. Members must observe the rules.

C) Interpretations
Interpretations are issued by the AICPA to better explain the Code of Professional Conduct. Only the principles and rules are considered part of the Code of Professional Conduct. Interpretations explain the code but are not part of it.

D) Rulings
The rulings apply the rules of conduct and interpretations to particular circumstances. AICPA members who depart from such rulings must justify their departures.

E) Your Behavior
The code, interpretations and rulings are meaningless if they do not impact your behavior. For this reason, your behavior is at the top of the pyramid.

PRINCIPLES

The Principles of the Code of Professional Conduct:

I. Responsibilities

In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgments in all their activities.
II. The Public Interest

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

III. Integrity

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

IV. Objectivity and Independence

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

V. Due Care

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

VI. Scope and Nature of Services

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

These principles establish the basis for characterizing the responsibilities the CPA has to clients, colleagues and the public at large. The fundamental theme of the six principles is to be committed to honorable behavior, even at the sacrifice of personal advantage.

RULES

The following definitions are used in the Rules of the Code of Professional Conduct:

**Practice of public accounting** - The practice of accounting consists of the performance for a client, by a member or a member’s firm, while holding out as CPA(s), of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council.

However, a member or a member’s firm, while holding out as CPA(s), is not considered to be in the practice of public accounting if the member or the member’s firm does not perform, for any client, any of the professional services described in the preceding paragraph.

**Professional services** - Professional services include all services performed by a member while holding out as a CPA.
Below is a listing of the applicable rules followed by a discussion of each rule:

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**Rule 101 - Independence**

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

*Independence* is a highly subjective term because it concerns an individual’s ability to act with integrity and objectivity. Integrity relates to an auditor’s honesty, while objectivity is the ability to be neutral during the conduct of the engagement and the preparation of the auditor’s report. Two facets of independence are independence in fact and independence in appearance. The second general standard of generally accepted auditing standards requires that an auditor be independent in mental attitude in all matters relating to the engagement. In essence, the second standard embraces the concept of independence in fact. However, independence in fact is impossible to measure, since it is a mental attitude; the Code of Professional Conduct takes a more pragmatic approach to the concept of independence.

Rule 101 is applicable to all professional services provided by a CPA that require independence.

**Observation:** A CPA may conduct a compilation engagement when he or she is not independent, but the compilation report must be modified to disclose the lack of independence.

**Rule 102 - Integrity and Objectivity**

In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.
Rule 102 is very broad on purpose. The Code of Professional Conduct could not possibly proscribe every action that is to be avoided. Thus, Rule 102 could cover a variety of misconduct.

**Rule 201 - General Standards**

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

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

**B. Due Professional Care.** Exercise due professional care in the performance of professional services.

**C. Planning and Supervision.** Adequately plan and supervise the performance of professional services.

**D. Sufficient Relevant Data.** Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

In general, these standards are applicable to all professional services rendered by an accounting firm. For example, an accountant who performs a consulting services engagement must properly plan and supervise the job (ET 201.01).

Rule 201 requires that a firm have a certain level of expertise before an audit, tax, or consulting engagement is accepted. This does not suggest that an accounting firm must have complete knowledge in an area before the engagement is accepted -- a lack of competence is not apparent just because an accounting firm accepts a client knowing that additional research may be necessary to complete the job.

**Rule 202 - Compliance with Standards**

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

Rule 202 requires members to observe technical standards promulgated by bodies designated by the AICPA Council. To date, the bodies designated by the Council are the Auditing Standards Board (ASB), Accounting and Review Services Committee (ARSC), Management Consulting Services Executive Committee (MCSEC), and Tax Executive Committee.

**OBSERVATION:** The Code of Professional Conduct does not refer to Audit and Accounting Guides that may be issued by a committee or task force established by the AICPA. Although each Audit Guide contains a preamble that states that a Guide does not have the authority of a pronouncement by the ASB, it does note that a member may be called upon to justify departures from the Guide if the member’s work is challenged.
Rule 203 - Accounting Principles

A member shall not: (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles, or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that have a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances, the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.

**OBSERVATION:** The AICPA Council has designated the FASB, GASB, IASB, PCAOB, and FASAB as bodies to promulgate accounting principles. In addition, several AICPA committees have been designated to promulgate standards in their respective subject areas.

Rule 203 also provides flexibility in the application of accounting principles.

When the auditor concludes that a written accounting rule should not be followed, the auditor's standard report must be expanded to include an explanatory paragraph. The explanatory paragraph would describe the nature of the departure; however, the opinion expressed would be an unqualified opinion and no reference to the explanatory paragraph would be made in the opinion paragraph.

Rule 301 - Confidential Client Information

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

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

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.
NOTE: An auditor should have access to a variety of information held by the client if the engagement is to be successful. The client will grant the auditor access to sensitive files and reports only if it can expect the auditor to hold the information in confidence. The purpose of Rule 301 is to encourage a free flow of information from the client to the CPA; however, the rule makes it clear that the principle of confidentiality is not absolute. The confidentiality concept does not allow the client to omit information that is required by generally accepted accounting principles.

Rule 301 recognizes the confidentiality of client information, but makes it clear that the information does not constitute privileged communication. In most states, and most federal courts, the CPA can be forced to testify in a case involving the client. Thus, the rule recognizes that an auditor must respond to a subpoena or summons.

In recent years, the concept of peer review has been accepted by the profession. Rule 301 allows a peer or quality review of a CPA’s professional practice as part of an AICPA or state society of CPAs program.

Finally, Rule 301 states that it is not a violation of confidentiality when a member initiates a complaint with or responds to inquiries from a recognized investigative or disciplinary body such as the AICPA’s Professional Ethics Division or Trial Board.


The theft of laptop computers and the sensitive data they contain is a growing problem for CPAs – in one week, three CPAs contacted the Board regarding the theft of laptops from their firms.

There are three major aspects to laptop security – physical security, data protection, and tracking/recovery.

One of the first things to do after purchasing a laptop is to make a copy of the purchase receipt, serial number, and description of the laptop and keep that information in a location separate from the laptop. This information will be invaluable if the laptop is lost or stolen.

In addition, asset tag or engrave the laptop. Engraving your firm name and phone number or address may increase the likelihood of getting the laptop returned if it is stolen and recovered. Tamper-proof asset tags may serve as a deterrent to a thief who must choose between stealing an unmarked laptop or a marked laptop. Why? Asset tags are difficult to remove and may hamper the thief’s ability to sell the laptop on the open market.

Industry experts estimate that one in eight laptops is at risk of theft. With such a daunting statistic, laptop users may feel resigned to being the victim of theft. However, one of the cheapest and most cost-effective solutions to deter the theft of a laptop is to attach a security cable (similar to the locks used on bicycles) to the laptop.
With cable locks, a steel clip provided by the manufacturer is installed in a security slot on the back or side of the laptop and a steel cable is threaded through the clip and wrapped around a heavy object such as a desk leg or support pole. The two ends of the cable are then secured with a locking device. If the laptop does not contain a security slot or if the desk does not provide a location for suitable anchorage, special adhesive pads containing an anchorage slot are available. Although cable locks are not infallible, they will at least make the thief work a little harder to get the laptop.

Another effective method of protecting a laptop is to use a laptop safe. An advantage of a laptop safe is that when the laptop is locked in a safe, the PC cards and peripherals are secure, a protection that is not available with cable locks.

The two main types of safes available are portable safes that can safely attach to most work surfaces and car safes which are designed to protect valuables while they are stored in the trunk of a vehicle. (NOTE: Never leave a laptop in plain sight in a vehicle; doing so is inviting a thief to break in the vehicle and take the laptop.)

Whereas cable locks and safes are designed to stop (or at least slow down) an opportunistic thief, alarms and motion detectors are intended to make the potential robber so conspicuous that he or she aborts the crime.

Products range from simple motion detectors to sensors that detect the unplugging of cables. Some products are designed to lock down the laptop if it is moved out of a designated range. Other products rely on nothing more than movement of the object to which it is attached; if the laptop to which the sensor is attached is moved, an alarm will sound.

Let’s assume that, despite taking the appropriate physical security measures, your laptop has been stolen. How worried would you be about the security of the data on the machine?

Safeguarding data when it is in unauthorized hands is a matter of controlling access and encrypting data. If the first thing a thief sees when turning on a laptop is, “please enter boot password,” he or she knows that it will take some effort to access the information on the machine.

Many machines allow the owner to set a boot password and a user will be prompted three times to enter the correct password. If there are three password failures, the machine will refuse to boot. However, if the machine is restarted, the user will have three more chances to enter the right password.

Removing a password-protected BIOS (basic input output system) and boot sequence typically involves physically opening the computer and removing the CMOS (complementary metal oxide semiconductor) battery (which may clear the BIOS information) or shorting some jumpers to reset the BIOS to a default state.

If you are running an operating system that supports proper logins (Windows NT/2000/XP or Linux), setting a password is not only a good idea, it is required. To successfully login to the computer, the user must provide a login name and password. If the information entered is incorrect, the operating system will refuse to allow the user to become an active user.
When creating a password, make sure you create a strong password. For a password to be considered strong, it must be eight or more characters (14 characters or longer is ideal); it must combine letters, numbers, and symbols; it must use a mix of uppercase letters and lowercase letters; and it should use words and phrases that are easy for you to remember, but difficult for others to guess. (NOTE: Avoid using your login name, your name, your birthday, anniversary, social security number, telephone number, etc., as part of your password.) Don’t forget to change your passwords on a regular basis.

Although applying strong passwords to your laptop will make it more difficult for a casual thief to log in as “you,” and therefore gain access to the information on your machine, passwords should not be relied upon as the sole piece of security on a laptop.

Even if an unauthorized user gains access to your laptop, encryption will protect the information stored on your machine. When you encrypt a file or folder, you are converting it to a format that can’t be read by another user. When a file or folder is encrypted, an encryption key is added to the files or folder that you selected to encrypt and the key is needed to read the file.

Although Microsoft provides a form of encryption through Windows Encrypted File Service (EFS), that encryption is keyed to your user login. If the intruder is able to login as “you,” he or she has access to your data even if it is encrypted with EFS.

Therefore, most firms who go this route will seek a third-party product which relies on encryption techniques above and beyond the Windows operating system.

CPAs using encryption technology need assurances that application databases such as tax, audit automation, and time and billing will operate correctly from encrypted disks or folders. The major software vendors test their products under a variety of scenarios and will be able to advise their customers of encryption solutions which are fully compatible with their products.

While encryption will protect the sensitive information on your laptop, it does nothing to retrieve the data on a lost or stolen machine. To do that, you must back up your files and store them in a secure location. Ideally, files should be backed up on a network server, but if that is not possible, there are other options.

External drives, flash drives, zip drives, and CDs are excellent choices for backing up your files. You can even use your digital music player to back up your data; these players don’t just copy music files, they can copy any data. Players are easily hooked up to a laptop through the USB port and have up to 20-gigabyte hard drives.

While encryption strategies will help safeguard the data on a lost or stolen notebook computer, they do nothing to help recover the missing machine – the FBI estimates that just 3% of stolen or lost laptops are recovered.

Until recently, luck was the determining factor in recovering a lost or stolen machine, but new technology is providing users with the ability to track stolen or lost laptops.
With tracking programs, once a computer is reported lost or stolen, the tracking company will wait for the laptop to send a location signal (sent whenever the machine is connected to the Internet). When a signal is retrieved, the program will be instructed to broadcast as much information as it can about the current connection (originating phone number, IP address, service provider, etc.). When enough information has been collected, the tracking company will notify the appropriate law enforcement agency which may be able to recover the machine.

Other programs provide the user with the ability to execute commands remotely to the missing machine (if connected to the Internet), theoretically allowing the user to delete all of the important information on the hard drive.

If you haven’t yet experienced the loss of a computer full of sensitive and confidential data, you are living on borrowed time. Plan ahead now to minimize the risk, reduce your exposure, and enhance your chances of recovery. Manage your risks through proactive strategies. Develop a security policy and implement it.

This is not an issue you can address once and have solved forever. Threats will change, risks will change, and requirements will change. Be sure your plans, your people, and your processes change along with them. Conduct periodic training updates, ensure software is kept up to date with the latest versions, and keep your emergency reaction checklists current.
Practitioner Pointer:
The Ethics of Outsourcing Client Tax Returns

Business process outsourcing – contracting business processes to outside service vendors – is not a new concept, and the accounting industry has long taken advantage of the benefits of outsourcing. However, a growing trend among CPA firms is causing concern among regulators.

A number of CPA firms, both multi-state and local, have begun using the burgeoning outsourcing and technology markets in India to process client tax returns. Although the AICPA Code and Rules do not expressly prohibit the practice of outsourcing the preparation of client tax returns, there are several rules a CPA must consider when outsourcing services.

One prime concern is maintaining the confidentiality of client records. Pursuant to Rule 301, a CPA shall not disclose any confidential information except with the consent of the client.

To process the tax return, the preparer must have sensitive client information such as the client’s Social Security Number, date of birth, bank and brokerage statements, credit card information, salary, etc. In short, much of the information can be used to perpetrate identity theft.

If your CPA firm has professional liability insurance coverage, you should check with your insurance carrier to see if your policy covers the firm when using an outsource center.

The accuracy of the tax return remains the ultimate responsibility of the CPA firm, and all returns prepared by an outsource center must be reviewed by the CPA firm and the signing CPA.

If your CPA firm is considering outsourcing the preparation of client tax returns, remember that a CPA is responsible for ensuring that any partner, shareholder, officer, director, unlicensed principal, proprietor, employee or agent, including outsource personnel, comply with the AICPAs rules on Professional Ethics and Conduct. In 2004, the AICPA adopted revised ethics rulings to address these concerns.

In addition, the IRS and most states impose criminal and civil penalties for the unauthorized disclosure of tax return data.
Rule 302 - Contingent Fees

A member in public practice shall not:

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

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

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

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

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

**NOTE:** For example, charging a new client $500 for completing a tax return when a similar continuing client is charged only $300 for a similar tax return is permitted, since a first year engagement is more difficult than a repeat engagement.

The accounting profession has had a long-standing tradition that a contingent fee would infringe on the CPA’s ability to be independent. A contingent fee is based on an arrangement whereby the client is not required to pay the CPA unless a specified finding or result is attained. For example, a contingent fee arrangement would exist if the auditor’s fee is dependent on the net proceeds of a public stock offering. Engagement fees should be determined by such factors as the number of hours required to perform the engagement, the type of personnel needed for the engagement, and the complexity of the engagement.

Fees are not considered to be contingent if they are determined (1) by courts or other public authorities or (2) by judicial proceedings or governmental agencies in the case of tax matters.
Before 1991, Rule 302 prohibited contingent fees for all professional engagements (with the exception of certain fees fixed by the judicial or quasi-judicial process). In 1985, The Federal Trade Commission (FTC) challenged the position of the profession concerning contingent fees on the basis of restraint of trade. After prolonged negotiations between the AICPA and the FTC, Rule 301 (as reproduced above) was issued to modify the prior prohibition against contingent fees.

Rule 302 prohibits contingent fees for all additional professional services when the CPA has performed an attestation engagement, which includes audits, reviews, and examinations of prospective financial information. Also, the CPA may not perform any services for a client on a contingent fee basis when the CPA has performed a compilation engagement if the compilation report is expected to be used by a third party and does not disclose that the CPA is not independent with respect to the client.

The period of prohibition includes the date covered by the financial statements and the period during which the attestation service (and compilation service, as described above) is performed. For example, if the CPA is auditing a client’s financial statements for the year ended December 31, 2010, and the date of the auditor’s report is March 12, 2011, no services could be performed on a contingent fee basis by the auditor for the period from January 1, 2010, through March 12, 2011.

Rule 302 also prohibits the CPA from charging a contingent fee to prepare an original or amended tax return or claim for a refund. While independence is not an issue in performing tax services, the AICPA takes the position that it would be unprofessional to charge a fee, for example, based on the amount of refund that may be claimed on the tax return.

**Rule 501 - Acts Discreditable**

A member shall not commit an act discreditable to the profession.

**NOTE:** Rule 501 is very broad. It is basic to ethical conduct, and only through its observance can the profession expect to win the confidence of the public. What constitutes a discreditable act is highly judgmental. There has been no attempt to be specific about what constitutes a discreditable act; however, the AICPA bylaws (Section 7.3) state that the following actions will lead to membership suspension or termination, without the need for a disciplinary hearing:

- If a member commits a crime punishable by imprisonment for more than one year.
- If a member willfully fails to file an income tax return that he or she, as an individual taxpayer, is required by law to file.
- If a member files a false or fraudulent income tax return on his or her behalf, or on a client’s behalf.
- If a member willfully aids in the preparation and presentation of a false and fraudulent income tax return of a client.
- If a member’s certificate as a certified public accountant, or license or permit to practice as such, is revoked by a governmental authority as a disciplinary measure.
Rule 502 - Advertising and Other Forms of Solicitation

A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, overreaching, or harassing conduct is prohibited.

**OBSERVATION:** Members who are not in public practice are exempt from much of Rule 502.

Rule 503 - Commissions and Referral Fees

A. Prohibited Commissions

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

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

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

B. Disclosure of Permitted Commissions

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

C. Referral Fees

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

**NOTE:** A CPA cannot receive a commission for recommending a client’s product or services if the CPA audits or reviews that client’s financial statements or examines that client’s prospective financial information. In addition, no commissions can be received when the CPA compiles a client’s financial statements if the CPA believes that a third party will rely on the statements, unless any lack of independence is disclosed in the compilation report.
OBSERVATION: When a CPA sells products that the CPA has title to directly to clients, this is not considered a commission. However, care should be exercised to ensure that the arrangement does not violate Rule 101 (Independence).

OBSERVATION: As with contingent fees, the most important point for CPAs in public practice to remember is that the Boards of Accountancy may continue to prohibit commissions. Change is coming. However, the practitioner should not violate the law in anticipation of change.

OBSERVATION: The rule has never prohibited calculating the price to be paid for the purchase of an accounting practice as a percentage of fees the purchaser receives from these new clients over some specified period of time such as one, two, three or more years. The AICPA Ethics Executive Committee has stated that the rule does not prohibit the purchase of a portion of a practice (such as the tax practice related to individual returns) or even the purchase of a single client. Further, the purchase may be made through a non-CPA broker who will receive a portion of the purchase price.

The rule also does not prohibit the payment of bonuses to employees even though practice development efforts on the part of the employee are a factor in determining the amount of the bonus.

Rule 504 - Incompatible Occupations (Withdrawn)

The concept of incompatible occupations is covered by Rule 101 (Independence).

Rule 505 - Form of Organization and Name

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

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

NOTE: Also, an owner surviving the death or withdrawal of all other owners may continue to practice under a name which includes the name of past owners for up to two years after becoming a sole practitioner.

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

NOTE: Over the past several decades, the character of the practice of accounting has broadened to include a variety of activities that are beyond the scope of accounting. These activities include, among others, environmental auditing, executive recruitment, and the design of sophisticated computer systems that are not part of the client’s accounting system. With the expansion of the types of services provided by accounting firms, there is an obvious need to recruit personnel who do not have an accounting/auditing background. For many accounting firms, these nontraditional professionals are increasingly important to their growth and development. However, because of the rules adopted by the AICPA, a nontraditional professional, no matter how competent or important to the firm, could not be an owner of the firm. These rules changed about ten years ago, and the updated rules follow.
## Non CPA Ownership of CPA Firms

The AICPA allows a CPA firm to be owned by non-CPAs if the form of ownership is sanctioned by the particular state and if the following guidelines are observed:

- Fifty-one percent of the ownership (as measured by financial interest and voting rights) must be held by CPAs.
- A non-CPA owner must be actively engaged in providing services to clients of the firm.
- A CPA must be ultimately responsible for all services provided by the firm that involve financial statement attestation, compilation services, and “other engagements governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services.”
- A non-CPA may not hold him or herself out as a CPA, but may be referred to as a(n) principal, owner, officer, member, shareholder or other title allowed by state law.

While the resolution allows for accounting firm ownership by non-CPAs, those individuals are not eligible for membership in the AICPA.

**Observation:** Each state is responsible for determining what forms of ownership may be used to practice public accounting; however, the AICPA notes that a practitioner can practice only in a business organization form that conforms to resolutions of the AICPA Council.
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. The fundamental theme of the six principles of the Code of Professional Conduct is:
   a) to be committed to honorable behavior
   b) to sacrifice personal advantage
   c) to be committed to honorable behavior, even at the sacrifice of personal advantage
   d) to make the most money possible in the shortest possible time without violating any laws or standards of decency

2. Which of the following is true regarding Rule 102 – Integrity and Objectivity:
   a) Rule 102 is very broad on purpose
   b) Rule 102 provides a “safe harbor” against allegations of possible violations provided a CPA is following the orders of one’s boss or another superior
   c) Rule 102 provides a very long list of prohibited actions, but the list does not include every possible instance of possible violations
   d) Rule 102 only applies to CPAs doing attest engagements

3. AICPA Rule 201 requires that a CPA be competent. Nash, CPA seeks to provide services to a new client in an industry that he has not previously served. Which of the following is true regarding Nash, CPA providing services to this client:
   a) Rule 201 requires that Nash, CPA have sufficient professional competence prior to accepting any engagement
   b) Rule 201 would not apply in this case since Nash is a CPA. Rule 201 only applies to non-CPA subordinates
   c) Rule 201 allows Nash, CPA to accept the engagement as long as it can be completed competently
   d) Rule 201 would require Nash, CPA to engage the services of an expert in that industry prior to accepting the engagement but would not require that Nash, CPA be competent in that area
CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Being committed to honorable behavior is only a part of the fundamental theme.

B: Incorrect. Personal sacrifice is only a part of the fundamental theme.

C: Correct. Both honorable behavior and personal sacrifice together comprise the fundamental theme.

D: Incorrect. Making money is not part of the fundamental theme.

(See the discussion of the Six Principles in the course material.)

2. A: Correct. The AICPA Code of Professional Conduct could not possibly list every possible violation.

B: Incorrect. Rule 102 specifies that a CPA must not subordinate his or her judgment to others. There is no “safe harbor.”

C: Incorrect. The AICPA Code of Professional Conduct could not possibly list every possible violation and therefore does not even begin to list possible violations.

D: Incorrect. Rule 102 applies to all CPAs. CPAs in industry must not subordinate their judgment to others.

(See Rule 102 in the course material.)

3. A: Incorrect. A CPA should undertake only those engagements that the firm reasonably expects can be completed competently. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate.

B: Incorrect. Rule 201 clearly applies to all CPAs.

C: Correct. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate.

D: Incorrect. Nash, CPA may accept this engagement if he believes he can attain competence prior to completing the engagement. Competence can be attained through training, consulting with colleagues, or other methods deemed appropriate. Nash, CPA is ultimately responsible to ensure that competence is attained.

(See Rule 201 in the course material.)
Chapter 2: Understanding the Code of Professional Conduct

Objectives: After completing this chapter, you will be able to:

- Discuss how rule interpretations apply to the rules themselves.
- Discuss the interpretations as they apply to your practice as a CPA.
- Discuss how you would apply the interpretations in a variety of specific circumstances.
- Describe the difference between principles, rules, and interpretations.

Introduction

The previous chapter outlined the Code of Professional Conduct as set forth by the AICPA. This chapter will assist in applying these Codes to the accounting profession. The Interpretations detailed in this chapter are issued by the AICPA to better explain the Code of Professional Conduct. This material should help illustrate how the codes relate to professional responsibility. The term “covered member” is used throughout the Interpretations. Since all states require a CPA to follow AICPA regulations (or state regulations that are similar), covered member in essence refers to all CPAs, as well as non-CPA owners of CPA firms.

Independence, Integrity, Objectivity

- Independence encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the CPA’s report. The CPA must be free from any obligation to or interest in the client, its management, or its owners.

- Integrity requires the CPA to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. A CPA has a dual responsibility – to the public and to the client.

- Objectivity is a state of mind and a quality that lends value to a CPA’s services. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

AICPA Interpretations of Rules 101 and 102

RULE 101 - INDEPENDENCE

Interpretation 101-1 (Interpretation of Rule 101) Whereas Rule 101 establishes the broad principle that a CPA must be independent (independence in fact), this Interpretation provides more specific guidelines concerning the types of relationships that a CPA should avoid. Independence is considered to be impaired if:

A. During the period of a professional engagement a covered member:
1. Had or was committed to acquire any direct or material indirect financial interest in the client.

2. 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, and
   i) The covered member (individually or with others) had the authority to make investment decisions for the trust or estate; or
   ii) The trust or estate owned or was committed to acquire more than 10 percent of the client's outstanding equity securities or other ownership interests; or
   iii) The value of the trust's or estate's holdings in the client exceeded 10 percent of the total assets of the trust or estate.

3. Had a joint closely held investment that was material to the covered member.

4. Except as specifically permitted in Interpretation 101-5, had any loan to or from the client, or any officer or director of the client, or any individual owning 10 percent or more of the client's outstanding equity securities or other ownership interests.

B. During the period of the professional engagement, a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than five percent of a client's outstanding equity securities or other ownership interests.

C. During the period covered by the financial statements or during the period of the professional engagement, a partner or professional employee of the firm was simultaneously associated with the client as a(n):
   1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;
   2. Promoter, underwriter, or voting trustee; or
   3. Trustee for any pension or profit-sharing trust of the client.

**Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client**

An individual who was formerly: (i) employed by a client, or (ii) associated with a client as an officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit-sharing trust of the client would impair his or her firm's independence if the individual:

1. Participated on the attest engagement team or was an individual in a position to influence the attest engagement for the client when the attest engagement covers any period that includes his or her former employment or association with that client; or
2. Was otherwise a covered member with respect to the client unless the individual first dissociates from the client by:

   a. Terminating any relationships with the client described in Interpretation 101-1C;
   b. Disposing of any direct or material indirect financial interest in the client;
   c. Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation 101-5;
   d. Ceasing to participate in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis; and
   e. Liquidating or transferring all vested benefits in the client’s defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty significant to the benefits is imposed upon liquidation or transfer.

Application of the Independence Rules to a Covered Member’s Immediate Family

Except as stated in the following paragraph, a covered member’s immediate family is subject to Rule 101 and its interpretations and rulings.

The exceptions are that independence would not be considered to be impaired solely as a result of the following:

1. An individual in a covered member’s immediate family was employed by the client in a position other than a key position;
2. In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is a client, is sponsored by a client, or that invests in a client (provided such plan is normally offered to all employees in similar positions):
   a. A partner or manager who provides ten or more hours of non-attest services to the client; or
   b. Any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement.

For purposes of determining materiality under Rule 101, the financial interests of the covered member and his or her immediate family should be aggregated.

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1 See Ethics Ruling No. 107, “Participation in Health and Welfare Plan of Client,” for instances in which participation was the result of permitted employment of the individual’s spouse or spousal equivalent.

2 A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed or market losses that may be incurred as a result of the liquidation or transfer.
Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if:

1. An individual participating on the attest engagement team has a close relative who had:
   a. A key position with the client, or
   b. A financial interest in the client that:
      i. Was material to the close relative and of which the individual has knowledge; or
      ii. Enabled the close relative to exercise significant influence over the client.

2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had:
   a. A key position with the client, or
   b. A financial interest in the client that
      i. Was material to the close relative and of which the individual or partner has knowledge; and
      ii. Enabled the close relative to exercise significant influence over the client.

Q: A potential audit client is owned by the CPA’s stepbrother. Would the CPA be independent with regard to the potential client? What if the CPA is closer to the stepbrother than to his own brother?

A: A stepbrother is not considered a close relative under the independence rules and normally would not impair independence. However, if the relationship between the CPA and stepbrother was close enough to lead a reasonable person, aware of all the facts, to conclude that the situation poses an unacceptable threat to the appearance of independence and the CPA’s objectivity, then the relationship would impair independence.

Grandfathered Employment Relationships

Employment relationships of a covered member’s immediate family and close relatives with an existing attest client that impair independence under the interpretation and that existed as of November 2001, will not be deemed to impair independence provided such relationships were permitted under preexisting requirements of Rule 101 and its interpretations and rulings.

Other Considerations

It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. In the absence of an independence interpretation or ruling under Rule 101 that addresses a particular circumstance, a member should evaluate whether that circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member’s and the firm’s independence. When making that evaluation, members should refer to the risk-
based approach described in the Conceptual Framework for AICPA Independence Standards. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented.³

**Interpretation 101-6 (The Effect of Actual or Threatened Litigation on Independence)** In some circumstances, independence may be considered to be impaired as a result of litigation or the expressed intention to commence litigation as discussed below.

**Litigation Between Client and Member**

The relationship between the management of the client and a covered member must be characterized by complete candor and full disclosure regarding all aspects of the client's business operations. In addition, there must be an absence of bias on the part of the covered member so that he or she can exercise professional judgment on the financial reporting decisions made by the management. When the present management of a client company commences, or expresses an intention to commence, legal action against a covered member, the covered member and the client's management may be placed in adversarial positions in which the management's willingness to make complete disclosures and the covered member's objectivity may be affected by self-interest.

For the reasons outlined above, independence may be impaired whenever the covered member and the covered member's client or its management are in threatened or actual positions of material adverse interests by reason of threatened or actual litigation. Because of the complexity and diversity of the situations of adverse interests which may arise, however, it is difficult to prescribe precise points at which independence may be impaired. The following criteria are offered as guidelines:

1. The commencement of litigation by the present management alleging deficiencies in audit work for the client would be considered to impair independence.
2. The commencement of litigation by the covered member against the present management alleging management fraud or deceit would be considered to impair independence.
3. An expressed intention by the present management to commence litigation against the covered member alleging deficiencies in audit work for the client would be considered to impair independence if the auditor concludes that it is probable that such a claim will be filed.

³ A failure to prepare the required documentation would be considered a violation of Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct. Independence would not be considered to be impaired provided the member can demonstrate that he or she did apply safeguards to eliminate unacceptable threats or reduce them to an acceptable level. [Footnote added, effective April 30, 2006, by the Professional Ethics Executive Committee.]
4. Litigation not related to performance of an attest engagement for the client (whether threatened or actual) for an amount not material to the covered member's firm\(^4\) or to the client company\(^5\) would not generally be considered to affect the relationship in such a way as to impair independence. Such claims may arise, for example, out of disputes as to billings for services, results of tax or management services advice or similar matters.

**Litigation by Security Holders**

A covered member may also become involved in litigation (“primary litigation”) in which the covered member and the client or its management are defendants. Such litigation may arise, for example, when one or more stockholders bring a stockholders’ derivative action or a so-called “class action” against the client or its management, its officers, directors, underwriters and covered members under the securities laws. Such primary litigation in itself would not alter fundamental relationships between the client or its management and the covered member and therefore would not be deemed to have an adverse impact on independence. These situations should be examined carefully, however, since the potential for adverse interests may exist if cross-claims are filed against the covered member alleging that the covered member is responsible for any deficiencies or if the covered member alleges fraud or deceit by the present management as a defense. In assessing the extent to which independence may be impaired under these conditions, the covered member should consider the following additional guidelines:

1. The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the covered member’s firm\(^6\) or to the client.

2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.

3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

\(^4\) Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

\(^5\) Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.

\(^6\) Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.
*Other Third-Party Litigation*

Another type of third-party litigation against the covered member may be commenced by a lending institution, other creditor, security holder, or insurance company who alleges reliance on financial statements of the client with which the covered member is associated as a basis for extending credit or insurance coverage to the client. In some instances, an insurance company may commence litigation (under subrogation rights) against the covered member in the name of the client to recover losses reimbursed to the client. These types of litigation would not normally affect independence with respect to a client who is either not the plaintiff or is only the nominal plaintiff, since the relationship between the covered member and client management would not be affected. They should be examined carefully, however, since the potential for adverse interests may exist if the covered member alleges, in his defense, fraud, or deceit by the present management.

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member (“the plaintiff client”), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member’s firm or to the plaintiff client.

*Effects of Impairment of Independence*

If the covered member believes that the circumstances would lead a reasonable person having knowledge of the facts to conclude that the actual or intended litigation poses an unacceptable threat to independence, the covered member should either: a) disengage himself or herself; or b) disclaim an opinion because of lack of independence. Such disengagement may take the form of resignation or cessation of any attest engagement then in progress pending resolution of the issue between the parties.

*Termination of Impairment*

The conditions giving rise to a lack of independence are generally eliminated when a final resolution is reached and the matters at issue no longer affect the relationship between the covered member and client. The covered member should carefully review the conditions of such resolution to determine that all impairments to the covered member’s objectivity have been removed.

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7 Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment.
RULE 102 – INTEGRITY AND OBJECTIVITY

**OBSERVATION:** It would be impractical to define all situations that would lead to an impairment of objectivity or integrity. Integrity is difficult to judge because any particular fault by omission or commission may be the result of either honest error or lack of integrity.

Interpretation 102-1 (Knowing Misrepresentations in the Preparation of Financial Statements or Records) A member shall be considered to have knowingly misrepresented facts in violation of Rule 102 when he or she knowingly:

a. Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records; or
b. Fails to correct an entity's financial statements or records that are materially false and misleading when he or she has the authority to record an entry; or

Interpretation 102-2 (Conflicts of Interest) A conflict of interest may occur if a member performs a professional service for a client or employer and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity. If the member 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, the rule shall not operate to prohibit the performance of the professional service. When making the disclosure, the member should consider Rule 301, Confidential Client Information.

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under Rule 101, its interpretations, and rulings cannot be eliminated by such disclosure and consent.

The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other appropriate parties could view the relationship as impairing the member's objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
• A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.

• A member serves on a city's board of tax appeals, which considers matters involving several of the member’s tax clients.

• A member has been approached to provide services in connection with the purchase of real estate from a client of the member's firm.

• A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.

• A member recommends or refers a client to a service bureau in which the member or partner(s) in the member's firm hold material financial interest(s).

The above examples are not intended to be all-inclusive.

Q: A CPA firm represents two clients. The clients have adverse interests in a controversy involving a limited partnership of which each client owns a percentage. Can the CPA continue to advise both clients? The work the CPA performs does not require independence.

A: The CPA would have a conflict of interest. If the relationships are disclosed to and consent is obtained from all appropriate parties, the CPA could continue to advise both parties. However, the CPA would have to observe Rule 301: Confidential Client Information.

Interpretation 102-3 (Obligations of a Member to His or Her Employer's External Accountant) Under Rule 102, a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer's external accountant requests written representation.

Interpretation 102-4 (Subordination of Judgment by a Member) Rule 102 prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment:

1. The member should consider whether (a) the entry or the failure to record a transaction in the records, or (b) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.
2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.

3. If, after discussing his or her concerns with the appropriate person(s) in the organization, the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the employer. The member also should consider any responsibility that may exist to communicate to third parties, such as regulatory authorities or the employer's (former employer's) external accountant. In this connection, the member may wish to consult with his or her legal counsel.

4. The member should at all times be cognizant of his or her obligations under Interpretation 102-3.

**OBSERVATION:** In an audit engagement, guidance established by SAS No. 108 (Planning and Supervision) with respect to the subordination of judgment should be observed.

Q: Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended March 31, 2011, Steffen proposes to reduce obsolete inventory to net realizable value. The obsolete items represent a significant amount of total inventory. The CFO concurs with Steffen's position. However, he decides not to go against the CEO whose position is that reducing the inventory this quarter is a discretionary decision and the CEO would prefer to record any such reduction at year end, after Company X completes its anticipated public offering of stock later this year. What are the ethical obligations of Steffen's in this situation?

A: To avoid subordinating her judgment, Steffen should first determine whether the inventory writedown is material. If so, she should restate her concerns to the CFO and CEO and, if the latter persists in not supporting the writedown, Steffen should bring the matter to the attention of the audit committee of the board of directors. She should document the understanding of the facts, the accounting principles involved, the application of the principles to the facts, and the parties with whom discussions were held. Steffen should consider any responsibility that may exist to go outside the company, although legal counsel should be sought on this matter.

**Interpretation 102-5 (Applicability of Rule 102 to Members Performing Educational Services)** Educational services (for example, teaching full- or part-time at a university, teaching a continuing professional education course, or engaging in research and scholarship) are professional services as defined in ET section 92.11 and are therefore subject to Rule 102. Rule 102 provides that the member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.
Interpretation 102-6 (Professional Services Involving Client Advocacy) A member or a member's firm may be requested by a client—

1. To perform tax or consulting services engagements that involve acting as an advocate for the client.
2. To act as an advocate in support of the client's position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

Services provided or actions taken pursuant to such types of client requests are professional services governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, General Standards, Rule 202, Compliance With Standards, and Rule 203, Accounting Principles, and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with Rule 102, which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with Rule 101 of the Code of Professional Conduct.

Moreover, there is a possibility that some requested professional services involving client advocacy may appear to stretch the bounds of performance standards, may go beyond sound and reasonable professional practice, or may compromise credibility, and thereby pose an unacceptable risk of impairing the reputation of the member and his or her firm with respect to independence, integrity, and objectivity. In such circumstances, the member and the member's firm should consider whether it is appropriate to perform the service.

AICPA Interpretations of Rules 201 and 203

RULE 201 – GENERAL STANDARDS

Interpretation 201-1 (Competence) A member's agreement to perform professional services implies that the member has the necessary competence to complete those professional services according to professional standards, applying his or her knowledge and skill with reasonable care and diligence, but the member does not assume a responsibility for infallibility of knowledge or judgment.

Competence to perform professional services involves both the technical qualifications of the member and the member's staff and the ability to supervise and evaluate the quality of the work performed. Competence relates both to knowledge of the profession's standards, techniques and the technical subject matter involved, and to the capability to exercise sound judgment in applying such knowledge in the performance of professional services.

The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. In some cases, however, additional research or consultation with others may be necessary during the performance of the professional services. This does not ordinarily represent a lack of competence, but rather is a normal part of the performance of professional services.
However, if a member is unable to gain sufficient competence through these means, the member should suggest, in fairness to the client and the public, the engagement of someone competent to perform the needed professional service, either independently or as an associate.

**OBSERVATION:** If a CPA is unable to obtain sufficient technical knowledge, he should refer the engagement to someone competent to perform the needed services.

### Case Study

**Competency, Auditing Standards and Other Professional Standards**

Licensee was subject to a Quality Assurance Review by the U.S. Department of Housing and Urban Development, Real Estate Assessment Center (HUD). This review included licensee’s audit work for two county housing authorities. The opinion issued by HUD found that the licensee did not comply with all applicable audit standards while performing audits of HUD assisted properties. Documentation for the audit work was not of sufficient standard.

**LIKELY DISCIPLINARY ACTION:** Violation of Rule 201 – General Standards.

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### RULE 203 – ACCOUNTING PRINCIPLES

**Interpretation 203-1 (Departures from Established Accounting Principles)**

Rule 203 was adopted to require compliance with accounting principles promulgated by the body designated by Council to establish such principles. There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.

However, in the establishment of accounting principles it is difficult to anticipate all of the circumstances to which such principles might be applied. This rule therefore recognizes that upon occasion there may be unusual circumstances where the literal application of pronouncements on accounting principles would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.

The question of what constitutes unusual circumstances as referred to in Rule 203 is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle would be regarded generally by reasonable men as producing a misleading result.

Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances which would not ordinarily be regarded as unusual in the context of Rule 203.
Interpretation 203-2 (Status of FASB, GASB and FASAB Interpretations) Council is authorized under Rule 203 to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Statements of Financial Accounting Standards, together with those Accounting Research Bulletins and APB Opinions which are not superseded by action of the FASB, constitute accounting principles as contemplated in Rule 203. Council has also designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203. Council has also designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities to Rule 203.

In determining the existence of a departure from an accounting principle established by a Statement of Financial Accounting Standards, Accounting Research Bulletin or APB Opinion encompassed by Rule 203, or the existence of a departure from an accounting principle established by a Statement of Governmental Accounting Standards or a Statement of Federal Accounting Standards encompassed by Rule 203, the division of professional ethics will construe such Statements, Bulletin or Opinion in the light of any interpretations thereof issued by the FASB or the GASB.

Interpretation 203-4 (Responsibility of Employees for Preparation of Financial Statements in Conformity with GAAP) Rule 203 provides, in part, that a member shall not state affirmatively that financial statements or other financial data of an entity are presented in conformity with generally accepted accounting principles (GAAP) if such statements or data contain any departure from an accounting principle promulgated by a body designated by Council to establish such principles that has a material effect on the statements or data taken as a whole.

Rule 203 applies to all members with respect to any affirmation that financial statements or other financial data are presented in conformity with GAAP. Representation regarding GAAP conformity included in a letter or other communication from a client entity to its auditor or others related to that entity's financial statements is subject to Rule 203 and may be considered an affirmative statement within the meaning of the rule with respect to members who signed the letter or other communication; for example, signing reports to regulatory authorities, creditors and auditors.

AICPA Interpretations of Rules 301 and 302

RULE 301 – CONFIDENTIAL CLIENT INFORMATION

Interpretation 301-3 (Confidential Information and the Purchase, Sale, or Merger of a Practice) Rule 301 prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client. The rule provides that it shall not be construed to prohibit the review of a member's professional practice under AICPA or state CPA society authorization.
For purposes of Rule 301, a review of a member’s professional practice is hereby authorized to include a review in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice. The member must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information.

Members reviewing a practice in connection with a prospective purchase or merger shall not use to their advantage nor disclose any member's confidential client information that comes to their attention.

Q: The IRS requested that a CPA provide copies of documents relating to a prior client of the CPA. The CPA is not able to locate the client to obtain permission to release the documents. Should the CPA turn the information over to the IRS?

A: No. A CPA cannot release confidential client information without the specific consent of the client unless the CPA receives a validly issued and enforceable subpoena or summons. Information obtained by a licensee can be disclosed in response to an official inquiry from a federal or state government regulatory agency. However, the IRS is considered to be a taxing agency and not a government regulatory agency.

RULE 302 – CONTINGENT FEES

Interpretation 302-1 (Contingent Fees in Tax Matters) This interpretation defines certain terms in Rule 302 and provides examples of the application of the rule.

Definition of Terms

(a) Preparation of an original or amended tax return or claim for tax refund includes giving advice on events which have occurred at the time the advice is given if such advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a return or claim for refund.

(b) A fee is considered determined based on the findings of governmental agencies if the member can demonstrate a reasonable expectation, at the time of a fee arrangement, of substantive consideration by an agency with respect to the member’s client. Such an expectation is deemed not reasonable in the case of preparation of original tax returns.

Examples

The following are examples, not all-inclusive, of circumstances where a contingent fee would be permitted:

1. Representing a client in an examination by a revenue agent of the client's federal or state income tax return.
2. Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.

3. Filing an amended federal or state income tax return (or refund claim) claiming a tax refund in an amount greater than the threshold for review by the Joint Committee on Internal Revenue Taxation ($1 million at March 1991) or state taxing authority.

4. Requesting a refund of either overpayments of interest or penalties charged to a client's account or deposits of taxes improperly accounted for by the federal or state taxing authority in circumstances where the taxing authority has established procedures for the substantive review of such refund requests.

5. Requesting, by means of "protest" or similar document, consideration by the state or local taxing authority of a reduction in the "assessed value" of property under an established taxing authority review process for hearing all taxpayer arguments relating to assessed value.

6. Representing a client in connection with obtaining a private letter ruling or influencing the drafting of a regulation or statute.

The following is an example of a circumstance where a contingent fee would not be permitted:

- Preparing an amended federal or state income tax return for a client claiming a refund of taxes because a deduction was inadvertently omitted from the return originally filed. There is no question as to the propriety of the deduction; rather the claim is filed to correct an omission.

Q: A CPA offers a new client a free one-hour consultation or a 10 percent discount on tax return preparation. Is this acceptable?

A: Yes. These are not prohibited transactions.

**OBSERVATION:** There are currently no rules in the 400 series.

**AICPA Interpretations of Rules 501, 502 and 505**

**RULE 501 – ACTS DISCREDITABLE**

**Interpretation 501-1 (Response to Requests by Clients and Former Clients for Records)**

**Terminology**

The following terms are defined below solely for use with this Interpretation:
• **Client provided records** are accounting or other records belonging to the client that were provided to the member by or on behalf of the client.

• **Client records prepared by the member** are accounting or other records (for example, tax returns, general ledgers, subsidiary journals, and supporting schedules such as detailed employee payroll records and depreciation schedules) that the member was engaged to prepare for the client.

• **Supporting records** are information not reflected in the client’s books and records that are otherwise not available to the client with the result that the client’s financial information is incomplete. For example, supporting records include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) that are produced by the member during an engagement (for example, an audit).

• **Member’s working papers** include, but are not limited to, audit programs, analytical review schedules, and statistical sampling results, analyses, and schedules prepared by the client at the request of the member.

**Interpretation**

When a client or former client (client) makes a request for client-provided records, client records prepared by the member, or supporting records that are in the custody or control of the member or the member’s firm (member) that have not previously been provided to the client, the member should respond to the client’s request as follows:8

• **Client provided records** in the member’s custody or control should be returned to the client.

• **Client records prepared by the member** should be provided to the client, except that client records prepared by the member may be withheld if the preparation of such records is not complete or there are fees due the member for the engagement to prepare those records.

• **Supporting records** relating to a completed and issued work product should be provided to the client, except that such supporting records may be withheld if there are fees due to the member for the specific work product.

Once the member has complied with these requirements, he or she is under no ethical obligation to comply with any subsequent requests to again provide such records or copies of such records. However, if subsequent to complying with a request, a client experiences a loss of records due to a natural disaster or an act of war, the member should comply with an additional request to provide such records.

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8 The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.
Member’s working papers are the member’s property and need not be provided to the client under provisions of this interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

In connection with any request for client-provided records, client records prepared by the member, or supporting records, the member may:

- Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client;
- Provide the requested records in any format usable by the client; and
- Make and retain copies of any records returned or provided to the client.

Where a member is required to return or provide records to the client, the member should comply with the client’s request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that the statutes of the state in which the member practices grants the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation. In addition, certain states have laws and regulations that impose obligations on the member greater than the provisions of this interpretation and should be complied with.

Interpretation 501-2 (Discrimination in Employment Practices) Whenever a member is finally determined by a court of competent jurisdiction to have violated any of the antidiscrimination laws of the United States or any state or municipality thereof, including those related to sexual and other forms of harassment, or has waived or lost his/her right of appeal after a hearing by an administrative agency, the member will be presumed to have committed an act discreditable to the profession in violation of Rule 501.

**OBSERVATION:** These acts are also a violation of federal and state law.

Interpretation 501-3 (Failure to Follow Standards and/or Procedures or Other Requirements in Governmental Audits) Engagements for audits of government grants, government units or other recipients of government monies typically require that such audits be in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards. If a member has accepted such an engagement and undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules and regulations, in addition to generally accepted auditing standards, he is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of Rule 501, unless the member discloses in his report the fact that such requirements were not followed and the reasons therefore.

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9 The member is not required to convert records that are not in electronic format. However, if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client’s request should be honored.
Interpretation 501-4 (Negligence in the Preparation of Financial Statements or Records)  A member shall be considered to have committed an act discreditable to the profession in violation of Rule 501 when, by virtue of his or her negligence, such member –

   a. Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity; or  
   b. Fails to correct an entity’s financial statements that are materially false and misleading when the member has the authority to record an entry; or  
   c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Interpretation 501-5 (Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies)  Many governmental bodies, commissions or other regulatory agencies have established requirements such as audit standards, guides, rules, and regulations that members are required to follow in the preparation of financial statements or related information, or in performing attest or similar services for entities subject to their jurisdiction. For example, the Securities and Exchange Commission, Federal Communications Commission, state insurance commissions, and other regulatory agencies, such as the Public Company Accounting Oversight Board, have established such requirements.

If a member prepares financial statements or related information (for example, management’s discussion and analysis) for purposes of reporting to such bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to generally accepted accounting principles. If a member agrees to perform an attest or similar service for the purpose of reporting to such bodies, commissions, or regulatory agencies, the member should follow such requirements, in addition to generally accepted auditing standards (where applicable). A material departure from such requirements is an act discreditable to the profession, unless the member discloses in the financial statements or his or her report, as applicable, that such requirements were not followed and the reasons therefore.

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Case Study  
Acts Discreditable

According to the Department of Labor, most SIMPLE IRA plans are also subject to Title I of ERISA. Under the Department of Labor regulations at 29 CFR 2510.3-102, salary reduction contributions to these plans must be made to the SIMPLE IRA as of the earliest date on which the contributions can reasonably be segregated from the employer’s general assets, but in no event later than the 30-day deadline described above.

A CPA firm was required to make contributions to the financial institution that managed the CPA firm’s employee SIMPLE IRA plan no later than the close of the 30 day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The CPA firm informed employees that SIMPLE IRA funds would not be deposited by the date required. For a period of two years, the CPA firm did not make timely contributions to the financial institution managing the SIMPLE IRA plan. When the CPA firm deposited the funds, the CPA firm also deposited interest into each employee’s SIMPLE IRA plan.
Interpretation 501-6 (Solicitation or Disclosure of CPA Examination Questions and Answers) A member who solicits or knowingly discloses the May 1996 or later Uniform CPA Examination question(s) and/or answer(s) without the written authorization of the AICPA shall be considered to have committed an act discreditable to the profession in violation of Rule 501.

**OBSERVATION:** Prior to May 1996, exam questions were released after each exam. Accordingly, the prohibition does not apply to exam review courses utilizing pre-1996 exam questions.

Interpretation 501-7 (Failure to File Tax Return or Pay Tax Liability) A member who fails to comply with applicable federal, state, or local laws or regulations regarding the timely filing of his or her personal tax returns or tax returns of the member’s firm, or the timely remittance of all payroll and other taxes collected on behalf of others, may be considered to have committed an act discreditable to the profession in violation of Rule 501.

Interpretation 501-8 (Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection With Audit and Other Attest Services) Certain governmental bodies, commissions, or other regulatory agencies (collectively, regulators) have established requirements through laws, regulations, or published interpretations that prohibit entities subject to their regulation (regulated entity) from including certain types of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services that are required by such regulators or that provide that the existence of such provisions causes a member to be disqualified from providing such services to these entities. For example, federal banking regulators, state insurance commissions, and the Securities and Exchange Commission have established such requirements.

If a member enters into, or directs or knowingly permits another individual to enter into, a contract for the performance of audit or other attest services that are subject to the requirements of these regulators, the member should not include, or knowingly permit or direct another individual to include, an indemnification or limitation of liability provision that would cause the regulated entity or a member to be in violation of such requirements or that would cause a member to be disqualified from providing such services to the regulated entity. A member who enters into, or directs or knowingly permits another individual to enter into, such an agreement for the performance of audit or other attest services that would cause the regulated entity or a member to be in violation of such requirements, or that would cause a member to be disqualified from providing such services to the regulated entity, would be considered to have committed an act discreditable to the profession.

RULE 502 – ADVERTISING AND OTHER FORMS OF SOLICITATION

Interpretation 502-2 (False, Misleading or Deceptive Acts in Advertising or Solicitation) Advertising or other forms of solicitation that are false, misleading, or deceptive are not in the public interest and are prohibited. Such activities include those that:

- Create false or unjustified expectations of favorable results
- Imply the ability to influence any court, tribunal, regulatory agency or similar body or official
- Contain a representation that specific professional services in current or future periods will be performed for a stated fee, estimated fee or fee range when it was likely at the time of the representation that such fees would be substantially increased and the prospective client was not advised of that likelihood
- Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

Case Study

Public Communications and Advertising

Smith CPA LLC circulated an advertisement in a local newspaper that stated the following:

“Professional Service Warranty which guarantees you the largest refund possible with the lowest tax liability.”

The advertisement guaranteed the reader the largest refund possible with the lowest tax liability. The advertisement did not state or explain how the services could be verified to provide the largest refund or the lowest tax liability.

Interpretation 502-5 (Engagements Obtained Through Efforts of Third Parties) Members are often asked to render professional services to clients or customers of third parties. Such third parties may have obtained such clients or customers as the result of their advertising and solicitation efforts.

Members are permitted to enter into such engagements. The member has the responsibility to ascertain that all promotional efforts are within the bounds of the Rules of Conduct. Such action is required because the members will receive the benefits of such efforts by third parties, and members must not do through others what they are prohibited from doing themselves by the Rules of Conduct.
RULE 505 – FORM OF ORGANIZATION AND NAME

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

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

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

Firm Names

No firm title need name every owner. Such a requirement could become unworkable. The firm may use the names of all or some of the owners. Or the firm may follow the name of one or more owners with designations “Company”, “and Company”, or “associates.” Thus, the firm “Howard, Fine and Howard” could choose instead to describe itself (among other possibilities) as “The Mo Howard Company,” “Mo Howard and Company,” “Howard, Fine and Associates,” or “Fine, Howard and Company.”

The firm name is a valuable asset, protected by law; it represents the professional competence and reliability of each member of the firm, whether the member’s own name is included in the title or not. No wonder the firm is slow to change it – even when individual owners die, retire or strike out on their own.

Rule 505 acknowledges this concern for continuity:

Names of one or more past owners may be included in the firm name of a successor organization. Also, an owner surviving the death or withdrawal of all other owners may continue to practice under a name which includes the name of past owners for up to two years after becoming a sole proprietor.

Fictitious Names

The rules over the years have historically prohibited the use of fictitious names or names that indicated a specialty.

It was felt that the rule regarding firm name should be consistent with the rule on advertising. The only restriction now left on advertising is that it not be false, misleading or deceptive. Since a member may now advertise a specialty, there is no reason a firm name should not be allowed to do so if the false, misleading, or deceptive test is met.

Q: Three CPA firms wish to form an association – not a partnership – to be known as “Smith, Jones and Assoc.” Is there any impropriety in this?

A: The use of such a title is not permitted since it might mislead the public into thinking a true partnership exists. Instead, each firm is advised to use its own name on its letterhead, indicating the other two as correspondents.
Interpretation 505-1 Deleted.

Interpretation 505-2 (Application of Rules of Conduct to Members Who Own a Separate Business) A member in the practice of public accounting may own an interest in a separate business that performs for clients any of the professional services of accounting, tax, personal financial planning, litigation support services, and those services for which standards are promulgated by bodies designated by Council. If the member, individually or collectively with his or her firm or with members of his or her firm controls the separate business (as defined by generally accepted accounting principles [GAAP] in the United States of America), the entity and all its owners (including the member) and employees must comply with all of the provisions of the Code of Professional Conduct. For example, in applying Rule 503, Commissions and Referral Fees, if one or more members individually or collectively can control the separate business, such business would be subject to Rule 503, its interpretations and rulings. With respect to an attest client, Rule 101 and all its interpretations and rulings would apply to the separate business, its owners and employees.

If the member, individually or collectively with his or her firm or with members of his or her firm, does not control the separate business, the provisions of the Code would apply to the member for his or her actions but not apply to the entity, its other owners and employees. For example, the entity could enter into a contingent fee arrangement with an attest client of the member or accept commissions for the referral of products or services to such attest client.

Interpretation 505-3 (Application of Rule 505 to Alternative Practice Structures) Rule 505, Form of Organization and Name, states, “A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council.” The Council Resolution requires, among other things, that a majority of the financial interests in a firm engaged in attest services (as defined therein) be owned by CPAs. In the context of alternative practice structures (APS) in which: 1) the majority of the financial interests in the attest firm is owned by CPAs; and 2) all or substantially all of the revenues are paid to another entity in return for services and the lease of employees, equipment, and office space, questions have arisen as to the applicability of Rule 505.

The overriding focus of the Resolution is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. The Resolution contains many requirements that were developed to ensure that responsibility. In addition to the provisions of the Resolution, other requirements of the Code of Professional Conduct and bylaws ensure that responsibility:
a. Compliance with all aspects of applicable state law or regulation.
b. Enrollment in an AICPA-approved practice monitoring program.
c. Membership in the SEC practice section if the attest work is for SEC clients (as defined by Council).
d. Compliance with the independence rules prescribed by Rule 101, Independence.
e. Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, Compliance With Standards) and all other provisions of the Code, including, Applicability.

Taken in the context of all the above-mentioned safeguards of the public interest, if the CPAs who own the attest firm remain financially responsible, under applicable law or regulation, the member is considered to be in compliance with the financial interests provision of the Resolution.
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. A potential audit client is owned by the CPA’s stepsister. Which of the following is true regarding Rule 101 (independence):
   a) a stepsister is considered a close relative and would impair independence
   b) a stepsister is not considered a relative and would never impair independence
   c) if the CPA’s relationship to the stepsister is very close, independence may be impaired
   d) none of the above

2. A CPA represents two clients. The clients have adverse interest involving a limited partnership of which both clients own a percentage. Which of the following is true regarding Rule 102:
   a) the CPA lacks independence and may not do any work for either of the clients
   b) the CPA lacks independence and must cease working for one of the clients
   c) although the CPA has a conflict of interest, he may continue working for both clients provided: 1) the work performed does not require independence, and 2) the relationships are disclosed to and consent is obtained from all appropriate parties
   d) none of the above

Use the following fact pattern for the next 4 questions

Jim Smith, CPA (Smith) prepares tax returns for a large number of clients. Smith has prepared the Form 1040 and Schedule C for Joe Jones for the last ten years. Joe Jones (Jones) keeps no business records except for a profit/loss summary that Jones’s wife prepares using Quicken. Smith has always calculated depreciation and made all other tax related adjustments to Jones’s Quicken report to prepare Jones’s Form 1040. Jones provides all the necessary documents to Smith and asks Smith to prepare Jones’s current year tax return. Smith prepares Jones’s current year tax return even though Jones still owes Smith fees for preparing last year’s tax return as well as year-end tax planning. Jones has not communicated any reason why he has not paid the past due fees, and Smith has not discussed the unpaid fee issue with Jones. Smith does not use any type of client engagement letter since he only prepares tax returns.
3. Assume that Smith demands payment of all past due fees as well as payment for the current year tax return preparation prior to releasing the tax return to Jones. Which of the following is true regarding releasing the current year tax return to Jones under AICPA rules:

a) the AICPA does not have any rules relating to releasing client records
b) Smith must release the current year tax return regardless of the status of unpaid fees
c) Smith may withhold releasing the current year tax return pending the payment of past due fees but may not demand payment of current year fees prior to issuing the tax return
d) Smith may withhold releasing the current year tax return until all current and past due fees are paid

4. Jones refuses to pay any of the current or past due fees and demands a copy of all of Smith’s workpapers as well as the return of all documents provided to Smith. Which of the following is true under AICPA rules:

a) Smith need not return any client records nor supply copies of any workpapers
b) Smith must return any client supplied records but need not provide copies of any workpapers
c) Smith must return any client supplied records and prior year depreciation records that are in Smith’s prior year workpapers but not contained in the prior year tax return
d) Smith must return any client supplied records and copies of all workpapers

5. Jones decides to prepare his current year tax return himself. Jones does not have a copy of his prior year tax return, and a copy is not available from the IRS. Jones was due a small refund and never filed his prior year tax return and subsequently lost his copy. Jones demands that Smith provide a copy of Jones’s prior year tax return and the depreciation workpapers for the current year that Smith prepared for Jones’s current year tax return. Which of the following is true:

a) Smith is not required to provide Jones a copy of the prior year tax return or the current year depreciation workpapers
b) Smith must provide Jones a copy of the current year depreciation workpapers but not a copy of the prior year tax return
c) Smith must provide Jones a copy of the prior year tax return but not the current year depreciation workpapers
d) Smith must provide Jones a copy of the prior year tax return and the current year depreciation workpapers

6. At this point, both Smith and Jones have spent numerous unproductive hours arguing over client records, releasing tax returns, and collecting payment. Jones has threatened to file a complaint against Smith with the AICPA. Smith has looked into filing a lawsuit in Small Claims Court against Jones. What could Smith and Jones have done to avoid this mess:

a) probably nothing; problems like this occur in business and are simply a fact of life
b) use an engagement letter to outline the obligations and expectations of both client and CPA
c) communicated with each other before the problem arose
d) both b and c would have helped
CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A stepsister is not automatically considered a close relative.
   
   B: Incorrect. A stepsister could be a close relative.
   
   C: Correct. Independence is impaired only if the relationship is close.
   
   D: Incorrect. Independence may be impaired.
   
   (See Interpretation 101-1 in the course material.)

2. A: Incorrect. The clients have the adverse interest, not the CPA.
   
   B: Incorrect. A CPA may do work for two clients with adverse interests.
   
   C: Correct. The clients are better served by allowing the CPA to continue serving them both.
   
   D: Incorrect. The CPA has a conflict but may continue working for both clients.
   
   (See Interpretation 102-2 in the course material.)

3. A: Incorrect. The AICPA has extensive rules relating to CPA workpapers and the return of client records. In fact, failure to return client records is one of the most common complaints received by the AICPA ethics committee.
   
   B: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA’s workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to demand the release of the return prior to paying fees as required by the CPA.
   
   C: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA’s workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to pay only a portion of the fees and demand release of the tax return.
   
   D: Correct. Prior to being released, the completed tax return is considered to be part of the CPA’s workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. A completed tax return is not considered to be client records until released to the client.
   
   (See Rule 501 and Interpretation 501-1 in the course material.)
4. A: Incorrect. Rule 501 requires the return of all client provided records upon request. Client provided records may not be withheld pending payment of current or prior engagement fees.

**B: Correct.** Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Note that some state laws require CPA prepared client records like depreciation records be released to the client regardless of the payment status.

C: Incorrect. Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Note that some state laws require CPA prepared client records like depreciation records be released to the client regardless of the payment status. Under AICPA rules, the CPA may withhold the depreciation schedules pending payment of the fees from the engagement to prepare those records, but may not withhold the depreciation records pending payment of fees from another engagement.

D: Incorrect. Rule 501 requires the return of all client provided records upon request. Under Interpretation 501-1, CPA workpapers including CPA prepared client records may be withheld pending payment of fees related to that engagement. Under AICPA rules, the CPA may withhold the depreciation schedules pending payment of the fees from the engagement to prepare those records, but may not withhold the depreciation records pending payment of fees from another engagement. Likewise, other supporting documents may be withheld pending payment of the fees related to the engagement that created the supporting documents. Under no circumstances, per AICPA Rule 501, is the CPA required to release the remainder of the CPA’s workpapers. Note that some state laws require that CPA prepared client records like depreciation records and other supporting records must be released to the client regardless of the payment status of current or past due fees.

(See Interpretation 501-1 in the course material.)
5. **A: Incorrect.** The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return, but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation schedule is considered to be part of Smith’s work product, and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

**B: Incorrect.** The current year depreciation is considered to be part of Smith’s work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them. The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees.

**C: Correct.** The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation schedule is considered to be part of Smith’s work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

**D: Incorrect.** The prior year tax return has already been issued and therefore must be provided upon request. Smith may require payment of a reasonable charge for copying the return but may not hold the return hostage pending payment of other outstanding fees. The current year depreciation is considered to be part of Smith’s work product and is the property of Smith. Since the current year tax return was never provided to Jones, the depreciation records are not considered client records and Smith need not release them.

(See Interpretation 501-1 in the course material.)
6. A: Incorrect. Problems like this do occur, but they are not unavoidable. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both CPA and client. Also, good communication goes a long way in avoiding problems.

B: Incorrect. Although this is true, it is not the best answer. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both the CPA and client. The fact that Smith’s practice is limited to preparing tax returns is not an excuse for not using an engagement letter. Although sending out a separate engagement letter might seem awkward, Smith could incorporate it into the annual client organizer that Smith sends out to clients.

C: Incorrect. Although this is true, it is not the best answer. Good communication goes a long way in avoiding problems. Jones could have disclosed additional facts such as the fact that he has a gambling problem and this has left him broke but that he no longer gambles and hopes to begin making payments to Smith and the many others that Jones owes debts to.

D: Correct. Using an engagement letter along with effective communication could have avoided this problem. A good engagement letter would have specified when payment was due and otherwise specified the expectations and obligations of both CPA and client. By communicating information, such as that a gambling problem had left Jones broke, but that he no longer gambles and hopes to begin making payments to Smith, Jones could have avoided this mess. Likewise, if Smith had communicated his displeasure in not receiving payment from Jones instead of holding the tax return hostage, Smith might have avoided this mess, helped a client, collected some of the past due debt, and saved valuable billable hours.

In addition, the CPA should consult his state board of accountancy rules regarding client records. Most states have more stringent rules requiring the unconditional release of client records prepared by the CPA and supporting records found in CPA workpapers.

(See Rule 501 in the course material.)
Chapter 3: Missouri Specific Laws, Regulations & Case Studies

Objectives: After completing this chapter, you will be able to:

- Recognize the Missouri CPA licensing requirements.
- Describe some common reasons for complaints against CPAs.
- Discuss how the Missouri Code of Professional Conduct references the AICPA Code of Professional Conduct.

IMPORTANT INFORMATION REGARDING CHANGES IN THE MISSOURI ACCOUNTANCY LAW

The following Missouri specific information is reprinted from past Board newsletters and other publications. Although it was published several years ago, it is important enough to warrant inclusion in this course.

2 Tier to 1 Tier

Under the Missouri Uniform Accountancy Act (MUAA), there will no longer be lifetime certificates with a second requirement of a license (permit) to practice public accounting. A license will now be issued that will fulfill the requirements of both instruments under old law. An individual licensed on or after August 28, 2001 must have a current license to use the CPA credential in any capacity.

Since 2002, new licenses and renewals have been issued on a biennial (2 year) cycle.

- CPA = CPA
- A single license is issued by the Board of Accountancy (Board).
- A license is obtained by passing the CPA exam, an Ethics exam, and meeting the experience requirement.
- 1-year experience, to be verified by a CPA, is required for licensure.
- A license will expire and will need to be renewed every two years.
- License renewal will be subject to continuing education requirements.
- A CPA who performs attest services must do so through a licensed CPA firm, and must have an additional year of experience including attest experience under the supervision of a licensee.

Titles

Under the MUAA, the CPA credential/title is no longer a lifetime credential/title. For individuals applying for licensure on or after August 28, 2001, the CPA credential/title is valid only for the period of current licensure. Certificates issued prior to the enactment of the MUAA will be considered to be a lifetime credential/title unless revoked or surrendered in accordance with the Missouri Accountancy statutes.
• The title “Certified Public Accountant,” “CPA,” or any title or designation likely to be confused with the titles “Certified Public Accountant” or “Public Accountant,” is restricted to an individual who holds a current license or a Provisional License in accordance with Missouri law, or to an individual issued a certificate under the old law (prior to August 28, 2001).
• Old law certificate holders must hold a current license to use the CPA credential if they are practicing public accounting.
• For licenses issued on or after August 28, 2001, the title “Certified Public Accountant (CPA)” shall be used only during the time an individual’s license is current and valid.
• A retired or non-practicing CPA, with a current Inactive status license, may use “Certified Public Accountant (CPA)” only if the designation is immediately followed by “inactive,” “retired,” or “ret.”
• “Certified Public Accountant (CPA)” in conjunction with a firm name requires that the firm have a valid firm permit in the State of Missouri.

Substantial Equivalency

Substantial equivalency shall be used to evaluate a Provisional License applicant for short-term practice in the State of Missouri without obtaining full licensure. Substantial equivalency is a method of evaluating applicants from other jurisdictions for temporary licensure using education, examination, and experience requirements that meet or exceed those of the State of Missouri, or who have been individually assessed and determined to have met or exceeded Missouri’s requirements for licensure.

• The Board may issue a Provisional License to a CPA licensed in another jurisdiction if that jurisdiction has been deemed to be substantially equivalent to the State of Missouri.
• The Board may issue a Provisional License to a licensed CPA, from a jurisdiction not deemed to be substantially equivalent, if the individual’s qualifications are deemed to be substantially equivalent to Missouri’s requirements.
• Individuals performing audits, reviews, or compilations must practice through a firm that is registered in the State of Missouri.
• Firms licensed in jurisdictions that are deemed to be substantially equivalent may be granted a permit in conjunction with the issuance of a Provisional License to an individual practitioner. The firm permit shall be valid only for the period of time in which there is a current individual Provisional License.

Inactive Status

MO-UAA provides for an “inactive” license status for licensees who do not engage in the practice of public accounting. Inactive status requires that the licensee use the word “inactive,” “retired,” or “ret.” immediately following their CPA designation.

• Inactive status does not require CPE. However, returning to active status requires the licensee to obtain 40 hours of CPE per year for the period of inactivity up to, and not to exceed, 120 hours. This must be accomplished within the first year of reactivation.
• An inactive status licensee will be required to maintain a current inactive license.
• Inactive status is required only of licensees, initially licensed on or after August 28, 2001, who wish to use the CPA designation.
• Certificate holders, certified under the old law, may elect to enter into inactive status in order to continue to receive state Board communications and literature. Old law certificate holders will not be required to use the inactive or retired designation behind the CPA designation.
• Inactive/retired CPAs may not practice public accounting, in any setting, while in inactive status.

Mandatory Peer Review & Attest Services

Old law did not require CPAs or CPA firms in Missouri to undergo peer review as a condition of licensure. The MO-UAA requires any CPA or CPA firm performing audits, reviews, or compilations to undergo peer review every three (3) years. CPA firms performing fewer than three (3) attest services during each calendar year were exempt from this requirement until January 1, 2008. The type and scope of the required peer review will be based on the practice of each firm. The Board will promulgate rules to ascertain how the peer review process will be implemented, and will establish an approved oversight program and fee.

• All attest services must be performed through a licensed CPA firm.
• MUAA requires peer review as a prerequisite for firm licensing if the firm performs attest, and/or other services under Statements on Standards for Accounting and Review Services (SSARS).
• Licensees who perform fewer than three attest services per calendar year were exempt from peer review until January 2008.

Sole-Proprietorships and Sole-Practitioners

• Sole-proprietorships or sole-practitioners cannot use the word “Associates” in the name of their business, and can only use a name that is in the singular form or represents themselves in a neutral manner.

Question: Bob Jones is a sole practitioner who employs a part-time secretary who is not a CPA. May Bob Jones use the firm “Bob Jones and Company, Certified Public Accountants?”

Answer: No. Bob Jones has violated the rules in two ways. First, the use of “and company” implies more than one CPA. Because the secretary is not a CPA, the plural designation is not permitted.

Firm Permits

Under the MO-UAA, CPAs who perform audits, reviews, and compilations must do so in a CPA firm with an active permit. Under old law, many CPAs who maintain a professional (CPA) staff, and/or who performed audits, reviews, and compilations are registered with the Board as sole-practitioners, rather than obtaining a sole-proprietorship firm permit. Under the new law, these individuals will be required to obtain firm permits. A licensee who renders services to the public, but does not perform audits,
reviews, or compilations, and does not have additional professional staff, is not required to practice from a firm, but must register with the Board as a sole-practitioner.

A firm permit is required if your practice:

- Has one or more professional CPAs on staff (including the owner); and/or
- Performs audits, reviews, or compilations.

A firm permit is not required if you are a licensee who:

- Does not perform audits, reviews, or compilations;
- Has no additional professional staff (CPAs).

**Fictitious Firm Names**

Fictitious firm names are allowed if they are not misleading and do not use qualitative adjectives or terms (e.g., biggest, best, cheapest). The name of the firm cannot contain the name or initials of a non-CPA owner.

**Non-CPA Ownership of Firms**

MUAA allows for non-CPA ownership of public accounting firms, provided that CPA ownership is at least a simple majority (51%). Non-CPA owners must be individual natural persons and must be active participants in the firm or its affiliated entities.

**Causes for Disciplinary Action by the State Board of Accountancy**

MUAA provides additional causes for the discipline of a licensee and allows the Board to recover the costs of investigations and assess fines not to exceed $2,000 per violation.

**THINGS TO KNOW ABOUT YOUR BOARD**

**ADDRESS CHANGE** – All licensees are required to notify the Missouri State Board of Accountancy within 30 days of an address change. The notification can be submitted in writing to the Missouri State Board of Accountancy, P. O. Box 613, Jefferson City, Missouri 65102, by fax at (573) 751-0890, or by e-mail at mosba@pr.mo.gov.

**DUPLICATE LICENSE** – Licensees can be issued a duplicate license by contacting the Missouri State Board of Accountancy at P. O. Box 613, Jefferson City, Missouri 65102, or by telephone at (573) 751-0012.

**WALL-HANGING CERTIFICATE** – Licensees can request a duplicate wall hanging by submitting a written request, along with a $25.00 fee, to the Missouri State Board of Accountancy, P.O. Box 613, Jefferson City, Missouri 65102.

**LICENSURE VERIFICATION TO ANOTHER STATE** – A licensee must submit the required verification/certification form from the state in which licensure is being requested to the Missouri State Board of Accountancy, P. O. Box 613, Jefferson City, Missouri 65102.
RENEWALS – Renewals are mailed to all licensees with current licenses on or around July 1 of each year. Renewals are mailed to the most current addresses on file with the Missouri State Board of Accountancy.

*Please be sure to contact the Board office immediately when you have a change of address.

MISSOURI STATE BOARD OF ACCOUNTANCY
OFFERS ADVISORY OPINIONS

One of the main objectives of the Missouri State Board of Accountancy is to protect the public. By assisting the licensee with issues that arise, the Board believes that the public will benefit. The vast majority of licensees are intent upon doing the right thing, but don’t always understand the rules guiding the practice of public accounting. The issuance of advisory opinions allows a licensee to better understand the rules by which the licensee is governed, and thus eliminates violations of the law, as well as reduces the number of complaints that are filed against the licensee.

To request an advisory opinion, write a letter to the Missouri State Board of Accountancy, P. O. Box 613, Jefferson City, Missouri 65102-0613. In a separate attachment to the letter, state in detail the facts and circumstances regarding your questions and the specific section(s) of Chapter 326 RMSO, or the Board’s rules and regulations that you want clarified. This attachment should be in a redacted format that protects the identity of all principals, including the requesting individual or firm. The Board’s Advisory Opinion Committee will review your request and respond to you in writing.

The Board’s advisory opinions are public information and will be posted on its website at www.pr.mo.gov/accountancy-advisory.asp for you and other licensees to review. However, to maintain confidentiality regarding your CPA practice or internal operating procedures, your name and address will be redacted.

The Board will not issue advisory opinions on matters involving the technical aspects of accounting standards or auditing standards. These issues should be referred to the AICPA.

AN OUNCE OF PREVENTION

The old adage “an ounce of prevention is worth a pound of cure” has never been more applicable. Given the current politically charged environment and the exponentially increasing negative press regarding the accounting profession, the Missouri State Board of Accountancy knows that CPAs across the state are highly sensitized to the need to stay absolutely in compliance with the regulations of the profession. This regulation, beyond that of the AICPA and the federal government, includes the accountancy laws and regulations in the State of Missouri.

The Board’s role is to regulate the practice of public accounting across the state. In fact, its mission is to protect the interests of all the citizens of the state of Missouri by examining, certifying, licensing, and regulating certified public accountants and firms of certified public accountants. The Board is to ensure the competence and ethical standards of practitioners; regulate and enforce the practice of public accounting;
investigate complaints and violations of Chapter 326 and related rules; and determine appropriate discipline for those who are found to have violated the statutes or regulations.

Over the last three years, the Board has opened more than 400 complaints against CPAs or those holding themselves out as CPAs. With a little proactive “prevention” on the part of licensees, the complaint volume could be reduced dramatically. This would be a win-win situation for all parties involved. No one likes the unpleasant reality of dealing with a complaint filed against them, and the Board resources could be put to much better use by focusing time and energy on serious violations of state statutes and public protection issues.

The Board wishes to be proactive in helping CPAs practicing in the state of Missouri stay in compliance with the state’s laws and regulations. In reviewing the complaints filed against CPAs over the past several years, it would seem that a few tips and reminders could help significantly reduce the number of complaints that may be filed in the future.

**Keep Your License Current**

In the past three years, 44% of complaints were opened because CPAs were practicing public accounting but had not renewed their license. Typical excuses given for not renewing in a timely manner include “my secretary must have forgotten to mail it in” or “I moved and/or changed employers and didn’t get the renewal forms from the Board.” Please remember that it is the licensee’s responsibility to maintain an active license. Board rule also requires that licensees notify the Board within 30 days of a change of address. A simple change of address form can be completed on-line on the Board’s website at www.pr.mo.gov/accountancy-coa.asp, or the licensee may send in a change of address notification by mail or email. Remember, too, that firm licenses are also required to practice public accounting in Missouri, and those licenses must also be renewed in a timely manner. The deadline for individual renewals is September 30, and the deadline for firm license renewals is October 31.

**Return Client Records**

Six percent (25 of the 400) of recent complaints involved issues regarding failure to return client records and failure to complete accounting work as engaged. In many of these cases, a fee dispute is involved. Either the client owes the licensee fees, or the client believes he/she is being billed for work not performed or that the bill is above the “verbally” agreed to fee amount. The Board’s policy has been that it does not get involved in fee disputes, but it must require that licensees return client records, as such records are defined in the AICPA Professional Standards. Practitioners are encouraged to use written engagement letters, with fees clearly stipulated, in order to ensure understanding of the engagement by both the client and the licensee.
Client Records and Working Papers

Licensees may not withhold client records and working papers based on the client’s refusal to pay the licensee’s fees.

The Code of Conduct requires licensees to provide to a client or former client any records belonging to or obtained from or on behalf of the client, and a copy of the licensee’s working papers, to the extent that the working papers include records that would ordinarily constitute part of the client’s records and are not otherwise available to the client.

The requirement to return client records and working papers differs depending on whether or not the licensee has issued the work product that is the subject of the engagement.

- A client’s request for return of records that is made within a reasonable time and that occurs prior to the issuance of a tax return, financial statement, report or other document prepared by a licensee: the licensee shall furnish, within a reasonable time to the client or former client any accounting or other records belonging to, or obtained from or on behalf of the client that the licensee received for the client’s account or removed from the client’s premises.

**Explanation:** If the CPA received any records owned by the client, the records must be returned. Client records do not include the work product or working papers of the CPA.

- A client’s request for return of records that is made within a reasonable time and that occurs after the issuance of a tax return, financial statement, report or other document prepared by a licensee: the licensee shall furnish, within a reasonable time to the client or former client:
  1. A copy of a tax return, financial statement, report or other document issued by a licensee to or for such client or former client;
  2. Any accounting or other records belonging to or obtained from or on behalf of the client that the licensee removed from the client’s premises or received for the client’s account; and
  3. A copy of the licensee’s working papers, to the extent that the working papers include records that would ordinarily constitute part of the client’s records and are not otherwise available to the client.
  4. Working papers, for this rule, include but are not limited to all statements, records, schedules, general ledgers, journals, trial balances and depreciation schedules made by a licensee incident to or in the course of rendering services to a client or former client. Working papers are and shall remain the property of the licensee in the absence of an express agreement to the contrary between the licensee and the client.

**Explanation:** The licensee is required to provide a copy of the work product that was issued for the engagement and return any records obtained from the client. The requirement to return the working papers may vary; for example, if the client has a complete accounting system including a general ledger, sub ledgers, a fixed asset accounting process and maintains their own account analysis and reconciliations, only copies of the adjusting entries with explanations and any supporting working papers would be necessary.

The client may have a general ledger, but may depend on the CPA to adjust and close the general ledger. In that event, copies of both adjusting entries, with explanations and any supporting papers, and closing entries would be provided to the client.
If the client does not have a general ledger and only provides the CPA with transaction summaries that the CPA uses to prepare a working trial balance, copies of the adjusted working trial balance, transaction entries, adjusting entries with explanations and any supporting working papers, and closing entries would be provided to the client.

If the CPA prepared the fixed asset depreciation schedule because the client does not have one, or because the CPA adjusted the client’s schedule, a copy must be provided.

If the CPA prepared a bank reconciliation because the client did not do one, a copy must be provided.

If the CPA determines and prepares schedules of account balances that the client does not ordinarily prepare, and the CPA reported on such schedules, copies must be provided to the client. Examples of such schedules include, but are not limited to:

<table>
<thead>
<tr>
<th>Investments</th>
<th>Accounts payable</th>
<th>Prepaid expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued liabilities</td>
<td>Owner’s equity</td>
<td>Current portion of long-term debt</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>Bad debts</td>
<td>Income tax expenses and payable</td>
</tr>
</tbody>
</table>

If the client determined the account balances and provided schedules, copies of the schedules with the CPA notes and conclusions are not required to be provided.

Copies of the CPA notes, or conclusions on any accounts or transactions, are only required to be provided to the client if the account balances or transactions reported on cannot be understood without consulting the CPA notes or conclusions.

The decision whether to provide copies of all or part of the accountant’s work papers depends on whether the client’s records include the same information as the licensee’s work product. The client must have sufficient documentation to explain or prove transactions or events that are reported by the licensee in the client’s tax returns or financial statements when called upon to do so. If the documentation is sufficient and can be used for such explanation and proof, copies of work papers are not necessary. If the documents are not sufficient, copies of the appropriate work papers are required.

### Case Study

**Client records and working papers**

**Requested records**

In 2010, Green decided to close her public accounting office and accept a position in private industry. Green notified clients that she was closing her office and referred clients to another Certified Public Accountant.

Client “A” received the notification from Green. In 2011, Client “A” needed a copy of her depreciation schedule to complete 2010 tax returns. Client “A” left telephone messages for Green. Green did not return Client’s calls and did not provide Client with a copy of the requested depreciation schedule.

Green was required to retain client working papers and provide Client “A” with a copy of the depreciation schedule.

**POSSIBLE BOARD ACTION:** Violation of AICPA Rule 501 Acts Discreditable.
**Keep CE Current**

Every year the Board conducts a licensee CE audit. Under the current system, licensees are not required to provide documentation of CE achieved unless selected, generally at random, for this audit. Instead, licensees must simply certify on their renewal applications that they have met the CE requirements. If selected for the audit, documentation of all CE received must be sent to the Board office for inspection. In a number of cases, the licensee has not received adequate CE or has not retained appropriate documentation. Please remember that CE records should be maintained for at least five years (two reporting cycles) and should include the sponsoring organization; location of course (city and state); title, description, or both, of content; dates attended or completed; and hours earned.

**Consider Use of Advisory Opinion Service**

Many practitioners do not realize that the Board of Accountancy will issue advisory opinions. This service is specifically designed to help CPAs take the guesswork out of staying in compliance with the Board’s statute and regulations on a prospective basis. Examples of previously issued advisory opinions are posted on the Board’s website for review. The Board encourages CPAs to be proactive in regulatory compliance, and this is an excellent tool to use.

The Board hopes these tips and reminders will help Missouri CPAs stay in compliance with the laws and regulations of the state. Remember that it is easier for both licensees and the Board if complaints do not have to be opened in the first place. Don’t hesitate to contact the Board of Accountancy staff at its office in Jefferson City with any questions, or if you need assistance with forms or other information. The Board office phone number is (573) 751-0012.

**Pay Your Taxes**

All persons and business entities renewing a license with the Division of Professional Registration are required to have paid all state income taxes, and also are required to have filed all necessary state income tax returns for the preceding three years.

If you have failed to pay your taxes or have failed to file your tax returns, your license will be subject to immediate revocation within 90 days of being notified by the Missouri Department of Revenue of any delinquency or failure to file.
Case Study

Holding Out as a Certified Public Accountant
Professional Misconduct – State Tax Defaults

Murphy neglected to file tax returns or pay state income tax liabilities for tax years 2008 through 2010. The Department of Revenue notified the Board of Accountancy. The Board suspended Murphy’s CPA license until such time that Murphy filed tax returns and paid outstanding taxes to Department of Revenue.

During the time that Murphy’s permit to practice was suspended, Murphy held himself out as a CPA when he signed 75 individual income tax returns, displayed his CPA wall certificate, and used business cards that included the CPA designation.

LIKELY BOARD ACTION:
First Action: State tax default
Second Action: Use of title or designation “Certified Public Accountant” or “CPA.”

Missouri Code of Professional Conduct

Effective June 30, 2004 the Missouri Code of Professional Conduct references the AICPA Code. This means that Missouri CPAs are legally required to follow the AICPA Code.
CASE STUDIES AND ANALYSIS

Case Study

Integrity and Objectivity

Brown CPA provided tax services to Mr. and Mrs. Taylor for the last 14 years of their marriage. Brown CPA had knowledge of financial information that related to both husband and wife based on Brown’s prior services to Mr. and Mrs. Taylor.

When the couple decided to divorce, Brown CPA accepted an engagement from Mr. Taylor to assist him with consultation and tax matters related to the divorce proceedings.

Brown CPA prepared the final joint tax return for Mr. and Mrs. Taylor after the date of the divorce.

While Brown CPA represented the couple, Brown CPA was also representing Mr. Taylor with services that were related to the divorce proceedings. These separate services were adversarial to Mrs. Taylor.

Brown CPA did not request permission of Mrs. Taylor to represent only Mr. Taylor. Brown CPA accepted the engagement with Mr. Taylor even though it was adverse to Mrs. Taylor.

Brown CPA violated the rule on integrity and objectivity by accepting a separate engagement from Mr. Taylor which was adversarial to his engagement to Mr. and Mrs. Taylor.

BOARD ACTION: Violation of Rule 102 Integrity and Objectivity.

Commissions, Contingent Fees & Referral Fees

Rules 302 and 503 describe the circumstances when licensees are prohibited from paying or receiving commissions, referral fees and contingent fees. The prohibitions apply when the holder of a permit or any partner, officer, shareholder, member, manager or owner of the firm performs any of the following services for a client who is also the subject of the commissions, referral fees or contingent fees:

- Audit, review or agreed-upon-procedures of a financial statement,
- Examination of prospective financial information, or
- Compilation of a financial statement if the compilation report does not disclose a lack of independence between the client and the licensee.

The prohibitions also apply during the period in which the certified public accountant, public accountant or firm is engaged to perform the services listed, including the period that is subject of the report and the period covered by any historical financial statements involved in the listed services.
What Is Meant By “During the Period”

The period of prohibition begins at the time the licensee has accepted an engagement to perform attest or compilation services, includes the period covered by the engagement, and extends through the report date on the engagement.

If the licensee is engaged to do attest or compilation services for a subsequent period, there would be no period of time that the licensee is not covered by this prohibition. The prohibition could extend until it is implicit that the firm is no longer providing attest or compilation services for the client, especially if the firm has been providing such services on an on-going periodic basis. Issuing a letter of resignation from providing the services would be considered reasonable documentation of the termination.

Case Study

Competence and Technical Standards

Brown prepared Client’s tax returns and calculated that Client would receive a $6,000 tax refund from Arizona, owe $7,000 in taxes to Missouri, and owe $6,500 in taxes to the Internal Revenue Service. Client took tax information to another Certified Public Accountant who completed the returns and made the following determination: Client would receive a $10,000 refund from Arizona, owe $6,000 to Missouri, and owe $5,500 to the IRS.

Brown agreed that he did not prepare Client’s tax return correctly.

BOARD ACTION: Violation of Rule 202.

Case Study

Competency and Technical Standards

Able Accountants, CPAs (Firm) audited XYZ Company in 2008 and 2009. XYZ Company provided investment and money management services to clients, many of which were union pension trusts and health and welfare plans. XYZ Company managed a total portfolio of about one billion dollars.

A division of Firm prepared a valuation report of XYZ Company that valued XYZ Company at just under $5 million dollars. XYZ Company’s growth in fee income was fueled by a collateralized note program that was critical to Firm’s valuation. The collateralized note program included loans made by XYZ Company to its affiliate ABC Company. By 2009, the collateralized note program with its affiliate ABC Company had accounted for 25% of the total assets managed by XYZ Company and 45% of the fees charged by XYZ Company.
ABC Company suffered losses during the years 2008 through 2010 and had a stockholders’ deficit of $109 million at the end of September 2010. ABC Company filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. The 2010 audit report for ABC Company was prepared by another firm. The audit report expressed substantial doubt about ABC Company’s ability to continue as a going concern.

Firm audited XYZ Company during calendar years 2008 and 2009 and issued unqualified opinions for both years.

**BOARD ACTION:** Violations of Generally Accepted Auditing Standards in both 2008 and 2009.

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**Case Study**

**Competence – Preparation of Tax Return**

Mr. and Mrs. Client donated an old house to the fire department for a training exercise during 2009. The fire department burned the donated house. Green, CPA prepared Client’s 2009 tax return and took a charitable contribution deduction for the appraised value of the donated house.

The IRS notified Client that it would audit their tax return for 2009. Client contacted Green CPA and asked if Green would represent Client during the audit. Green CPA told Client that they didn’t need to be represented and instructed Client to represent themselves.

The IRS disallowed the charitable contribution of the donated house. When Client told Green CPA that the IRS disallowed the charitable contribution for the house, Green CPA did not question the findings of the IRS auditor, but instead prepared an amended state tax return for Client at no cost.

Green CPA took inconsistent positions when he prepared the original tax return and when he prepared the amended federal tax return without verifying the validity of the tax deduction.

**LIKELY BOARD ACTION:** Violation of Rule 201 Failure to complete an engagement with due professional care.
Case Study

Competence and Other Professional Standards

Able CPA provided professional services to Mrs. Frank during a divorce settlement. Able also prepared a business valuation of a dental practice owned by Mrs. Frank’s husband. The valuation was prepared for use in the divorce proceedings.

The business valuation of the dental practice was not prepared according to professional standards or similar pronouncements by a generally recognized authority. Instead, it was found that Able did not properly use industry statistics and had an overall lack of knowledge of standards. Able held out to Mrs. Frank that he could perform services that he was not competent to perform.

Likely Board Action: Violation of Rule 202 Compliance with Standards.

Engagement Letters

The Board receives frequent inquiries regarding fees charged by licensees. Many times the caller is surprised by the amount of a bill they have received for CPA services and report it to the Board as a complaint.

It is up to the accountant to determine the appropriate fee to charge for services provided. Licensees can avoid this situation by providing an engagement letter that spells out the fee arrangement during the initial appointment.

An engagement letter describes the services to be performed, the amount to be charged and other provisions that may affect the services provided.

Common provisions in an engagement letter include the following:
- identification of the client
- description of the agreement and its limitations
- timing of the work and staffing of the engagement
- client information and responsibilities
- designation of the party to work with the CPA
- identification of intended users of the CPA’s work product
- fees and payments
- withdrawing from and/or terminating the engagement
- responding to discovery requests, subpoenas, and outside inquiries
- alternative dispute resolution as a means of resolving disputes
- where applicable, disclosures recommended or required by the AICPA
- client signature

Take time to review the engagement letter with the client before services are performed and provide a copy with the client’s signature and your signature to the client with a copy for the file.

Well-structured engagement letters help reduce misunderstandings regarding fees and services to be performed, decreasing the likelihood that the client will have complaints about fees charged.
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. A Missouri licensee may enter into “inactive” license status, and practice a limited amount of public accountancy.
   
   a) true
   b) false
1. A: True is incorrect. If a licensee chooses “inactive” license status, the licensee may not engage in the practice of public accountancy.

B: **False is correct.** An “inactive” license status is available to licensees who do not engage in the practice of public accounting. Inactive CPAs may not practice public accounting, in any setting, while in inactive status.

(See pages 3-2 to 3-3 of the course material.)
# Glossary of Ethics Terms

The terms included in this glossary are related to the ethics area in general, but may not be specifically used in this material. They are provided for greater clarification and educational purpose.

<table>
<thead>
<tr>
<th>TERM</th>
<th>DEFINITION</th>
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<tr>
<td>Alternative Practice Structures (APS)</td>
<td>A nontraditional structure for the practice of public accounting in which a traditional CPA firm engaged in auditing and other attestation services might be closely aligned with another organization, public or private, that performs other professional services (e.g., tax and consulting).</td>
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<tr>
<td>American Institute of Certified Public Accountants (AICPA)</td>
<td>The national professional organization for all certified public accountants (CPAs).</td>
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<tr>
<td>Client’s records</td>
<td>Any accounting or other records belonging to the client that were given to the member by, or on behalf of, the client.</td>
</tr>
<tr>
<td>Close relative</td>
<td>Close relatives are the member’s nondependent children (including grandchildren and stepchildren), brothers and sisters, grandparents, parents, and parents-in-law. Spouses of any of the above are also close relatives. The SEC definition of close relatives expands the above to include a spouse’s brothers and sisters and their spouses.</td>
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<tr>
<td>Code of Professional Conduct (the Code)</td>
<td>The Code was adopted by the membership of the AICPA to provide guidance and rules to all members on various ethics requirements. The Code consists of: 1) Principles, 2) Rules, 3) Interpretations, and 4) Ethics Rulings.</td>
</tr>
<tr>
<td>Conflict of interest</td>
<td>A conflict of interest may occur if a member performs a professional service for a client or employer, and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member’s professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member’s objectivity.</td>
</tr>
<tr>
<td>Consulting process</td>
<td>The analytical approach applied in performing a consulting service. The process typically involved some combination of the following: Determining the client’s objective, Fact-finding, Defining problems or opportunities, Evaluating alternatives, Formulating proposed actions, Communicating results, Implementing, Following up</td>
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<tr>
<td>Consulting services</td>
<td>Professional services that use the practitioner’s technical skills, education, observations, experiences, and knowledge of the consulting process.</td>
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<tr>
<td>Contingent fee</td>
<td>A fee for performing any service in which the amount of the fee (or whether a fee will be paid) depends on the results of the service.</td>
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<tr>
<td>Direct financial interest</td>
<td>A direct financial interest is created when a member invests in a client entity.</td>
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<tr>
<td>Disqualifying services</td>
<td>Term used to refer to the following services, which when performed for a client prohibit the member from accepting a contingent fee or commission:</td>
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<tr>
<td></td>
<td>a. An audit or a review of a financial statement.</td>
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<tr>
<td></td>
<td>b. An examination of prospective financial information.</td>
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<tr>
<td></td>
<td>c. A compilation of a financial statement expected to be used by third parties except when the compilation report discloses a lack of independence.</td>
</tr>
<tr>
<td>Ethics Rulings</td>
<td>Part of the Code of Professional Conduct. Rulings summarize the application of rules and interpretations to a particular set of factual circumstances.</td>
</tr>
<tr>
<td>Firm</td>
<td>A form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof.</td>
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<tr>
<td>Former practitioner</td>
<td>A proprietor, partner, shareholder or equivalent of a firm, who leaves by resignation, termination, retirement, or sale of all or part of the practice.</td>
</tr>
<tr>
<td>Holding out as a CPA</td>
<td>Includes any action initiated by a member, whether or not in public practice, that informs others of his or her status as a CPA.</td>
</tr>
<tr>
<td>Independence in appearance</td>
<td>If there are circumstances that a reasonable person might believe are likely to impair independence, the CPA is not independent in appearance. To be recognized as independent, the auditor must be free from any obligation to or interest in the client, its management, or its owners.</td>
</tr>
<tr>
<td>Independence in fact</td>
<td>To be independent in fact (mental independence), the CPA must have integrity and objectivity. If there is evidence that independence is actually lacking, the auditor is not independent in fact.</td>
</tr>
<tr>
<td>Indirect financial interest</td>
<td>An indirect financial interest is created when a member invests in a nonclient entity that has a financial interest in a client.</td>
</tr>
<tr>
<td>Integrity</td>
<td>An element of character fundamental to professional recognition. It is the quality from which public trust derives and the benchmark against which a member must ultimately test all decisions.</td>
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<tr>
<td>Term</td>
<td>Definition</td>
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<tr>
<td>Internal audit outsourcing</td>
<td>Internal audit outsourcing involves performing audit procedures that are generally of the type considered to be extensions of audit scope applied in the audit of financial statements. Examples of such procedures might include confirming receivables, analyzing fluctuations in account balances, and testing and evaluating the effectiveness of controls.</td>
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<tr>
<td>Interpretations of rules of conduct</td>
<td>Part of the Code of Professional Conduct. Interpretations are pronouncements issued by the AICPA’s Division of Professional Ethics to provide guidelines concerning the scope and application of the rules of conduct.</td>
</tr>
<tr>
<td>Joint closely held business investment</td>
<td>An investment that is subject to control by the member, or the member’s firm, client or its officers, directors, or principal stockholders, or any combination of the above.</td>
</tr>
<tr>
<td>Joint Ethics Enforcement Program (JEEP)</td>
<td>The AICPA and most state societies cooperate in the Joint Ethics Enforcement Program (JEEP) in bringing enforcement actions against their members.</td>
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<tr>
<td>Member</td>
<td>In its broadest sense, “member” is a term used to describe a member, associate member, or international associate of the AICPA. All members must adhere to the AICPA’s Code of Professional Conduct. For the purposes of applying the independence rules, the term “member” identifies the people in a CPA firm and their spouses, dependents, and cohabitants who are subject to the independence requirements.</td>
</tr>
<tr>
<td>Multidisciplinary practices (MDP)</td>
<td>Arrangements in which CPAs share fees with attorneys or other professionals.</td>
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<tr>
<td>National Association of State Boards of Accountancy (NASBA)</td>
<td>A voluntary organization composed of the state boards of accountancy. It promotes communication, coordination, and uniformity among state boards.</td>
</tr>
<tr>
<td>Objectivity</td>
<td>The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Objectivity is a state of mind, a quality that lends value to a member’s services.</td>
</tr>
<tr>
<td>Period of professional engagement</td>
<td>The period of engagement starts when the member begins the service requiring independence and ends upon termination of the relationship (by the member or the client) or, if later, when the report is issued. The period does not stop when the report is issued and restart with the beginning of the next engagement. The period of engagement typically covers many periods.</td>
</tr>
<tr>
<td><strong>Practice of public accounting</strong></td>
<td>According to the Code of Professional Conduct, the practice of public accounting consists of the performance for a client, by a member or a member’s firm, while holding out as CPAs, of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements on Standards for Tax Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements. However, a member or member’s firm, while holding out as CPAs, is not considered to be in the practice of public accounting if the member or the member’s firm does not perform, for any client, any of the professional services described in the preceding paragraph.</td>
</tr>
<tr>
<td><strong>Principles</strong></td>
<td>Positive statements of responsibility in the Code of Professional Conduct that provide the framework for the rules, which govern performance.</td>
</tr>
<tr>
<td><strong>Professional services</strong></td>
<td>Includes all services performed by a member while holding out as a CPA.</td>
</tr>
<tr>
<td><strong>Rules</strong></td>
<td>Broad but specific descriptions of conduct that would violate the responsibilities stated in the principles in the Code of Professional Conduct.</td>
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<tr>
<td><strong>Securities and Exchange Commission (SEC)</strong></td>
<td>A federal government regulatory agency with responsibility for administering the federal securities laws.</td>
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<tr>
<td><strong>State boards of accountancy</strong></td>
<td>State government regulatory organizations. Each state government issues a license to practice within the particular state under that state’s accountancy statute.</td>
</tr>
<tr>
<td><strong>State societies of CPAs</strong></td>
<td>Voluntary organizations of CPAs within each individual state.</td>
</tr>
<tr>
<td><strong>Statements on Standards for Tax Services (SSTS)</strong></td>
<td>SSTS superseded and replaced the AICPA’s Statements on Responsibilities in Tax Practice (SRTP). They are enforceable standards of conduct for tax practice under the Code of Professional Conduct.</td>
</tr>
<tr>
<td><strong>Unpaid fees</strong></td>
<td>Fees for: 1) audit, and 2) other professional services that relate to certain prior periods that are delinquent as of the date the current year’s audit engagement begins, if the client is an SEC registrant, or the date the audit report is issued for non-SEC clients (i.e., AICPA rule).</td>
</tr>
<tr>
<td><strong>Yellow Book</strong></td>
<td>Governmental Auditing Standards issued by the Government Accountability Office.</td>
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