Professional Education Services, LP

A CPA's Guidebook to Ethical Behavior for Texas CPAs

#4160

COURSE MATERIAL

PES

Professional Education Services, LP

The Professional's Choice for Quality CPE.

4208 Douglas Blvd. • Suite 50

Granite Bay, CA 95746 • www.mypescpe.com

1-800-998-5024 • Customer Service: 1-800-990-2731

Fax: 916-791-4099

TABLE OF CONTENTS

NOTICE

This course and test have been adapted from supplemental materials and information contained in the materials entitled *A CPA's Guidebook to Ethical Behavior for Texas CPAs*. Use of these materials or services provided by Professional Education Services, LP ("PES") is governed by the *Terms and Conditions* on PES' website (www.mypescpe.com). PES provides this course with the understanding that it is not providing any accounting, legal, or other professional advice and assumes no liability whatsoever in connection with its use. PES has used diligent efforts to provide quality information and material to its customers, but does not warrant or guarantee the accuracy, timeliness, completeness, or currency of the information contained herein. Ultimately, the responsibility to comply with applicable legal requirements falls solely on the individual licensee, not PES. PES encourages you to contact your state Board or licensing agency for the latest information and to confirm or clarify any questions or concerns you have regarding your duties or obligations as a licensed professional.

Program Publication Date 2/15/2017

ABOUT THE COURSE

Recommended CPE Hours:	4 CPE credit hours will be granted based on a 50-minute hour in accordance with the standards of the Texas State Board of Public Accountancy.
Prerequisites:	None
Field of Study:	Behavioral Ethics
Program level:	Basic
Advance Preparation:	None
Program Description:	A CPA is challenged in today's work world to not only serve his/her client or employer but also to protect the public interest by ensuring that there is transparency in financial reporting or there is fair administration of the tax laws. In balancing the two interests, a CPA may find him or herself in an ethical dilemma. This course covers not only basic ethical frameworks, but also specific rules governing CPA practice and responsibilities. It concludes with a section on how a CPA can put his or her ethics into action.
Course Approval:	This course has been specifically reviewed and approved by the Texas State Board of Public Accountancy.
TSBPA Sponsor Number:	005928

THIS PAGE INTENTIONALLY
LEFT BLANK.

COURSE OBJECTIVES

1. To educate licensees in the ethics of professional accounting for Texas CPAs.
2. To convey the *intent* of the Rules of Professional Conduct in the performance of professional accounting services/work, not to adhere to the mere *technical* compliance of such rules.
3. To assist the Texas CPA in applying ethical judgment in interpreting the rules and determining public interest. Public interest should be placed ahead of self-interest, even if it means a loss of job or client.
4. To review and discuss the Rules of Professional Conduct and their implications for persons in a variety of practices, including:
    - a) CPAs in client practice of public accountancy who perform attest and non-attest services per § 501.52.
    - b) CPAs employed in industry who provide internal accounting and auditing services.
    - c) CPAs employed in education or in government accounting or auditing.

THIS PAGE INTENTIONALLY
LEFT BLANK.

INTRODUCTION

Accounting scandals. Embezzlement. Fraud. “Taking the easy way out.” All too often we read these words in the paper or hear it on the evening news. Most of the tales tell of the failure by individuals in their fiduciary duty to properly handle, manage and/or report company assets and operations.

Values. Ethics. Integrity. Morality. Principles. Courage. “Doing the right thing.” Far more rarely reported are stories of those who are not only steadfast in their values, but also take action to right a wrong, despite the many factors that can pull an individual in many directions. Greed, management pressure, fear, and expediency are some of the many different aspects that divert an individual from a righteous path to the slippery slope of moral compromise.

In an era of some managements’ over-focus on analysts’ expectations and pressure to meet profit and loss targets, there are unfortunately many examples of cutting corners and so-called “earnings management” which later are labeled by the action’s real names: unethical behavior, criminal activity and fraud. In certain cases, the accountants become complicit, either wittingly or unwittingly, in the scandal.

How is a Certified Public Accountant (“CPA”) expected to navigate such treacherous shoals?

The following course material is designed to assist the CPA in learning how to manage the ethical challenges that arise in today’s work environment. We will examine in Part I the basic ethical philosophies and values that individuals rely on to determine which actions are right and which are wrong. Part II will review the various guidelines, such as the AICPA Code of Conduct and/or state specific rules, to which CPAs must adhere. After covering rules, thoughts and philosophies, Part I and II can assist the CPA in determining the rightness and wrongness of an action. Part III will discuss ways in which individuals can improve their chances of behaving ethically. Woven throughout the material are real-world case studies to illustrate various points.

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART I: VALUES - A STRAIGHT AND NARROW PATH OR A MINEFIELD?

What are ethics? The *Encyclopedia of Philosophy* gives a helpful definition:

1. A general pattern or "way of life,"
2. A set of rules of conduct or "moral code," and
3. Inquiry about ways of life and rules of conduct.[1]

Items 2 and 3 above are focused on determining what is acceptable or unacceptable based on one's values or existing rules. We will cover various schools of ethical thought as well as the specific rules governing CPA conduct in Parts I and II, respectively, of this course material.

While it goes without saying that it is essential that a person have some frame of reference to determine the correctness of an action, the greater challenge is in Item 1 above, integrating this knowledge of ethical action into a way of life. Ideally, one's values and ethical rules are so internalized that doing the right thing becomes more of a reflex than conscious decision. This topic will be covered in Part III of this course.

THE ETHICAL FRAMEWORK

Two of the primary branches of ethics are ***normative ethics*** and ***applied ethics***.[2]

Normative ethics address the issues of right and wrong actions. A normative theory makes claims or offers guidelines or norms about how to discern the right action. We will be focusing on the various types of normative ethics in this segment.

Applied ethics investigates how a normative system plays out in a practical situation. Business and Accounting ethics are a type of applied ethics. We will discuss in Part III how to put our values and ethical rules into practice in our everyday work lives.

Normative Ethical Theory

There are three major normative ethical schools of thought – consequentialism, deontological theory and virtue ethics.[3]

Consequentialism

Consequentialism focuses on choosing the right action, which is determined by looking at the consequences of that action.

1. The Encyclopedia of Philosphy, e. Paul Edwards, Macmillan Publishing Co., Inc., New York, 1967 Vol. 3, pp. 81-82.
2. Jackson, Cecil, Detecting Accounting Fraud: Analysis and Ethics (NJ: Pearson, 2015), pg. 25.
3. Jackson, page 25.

One of the noted consequentialists from the late 1700s was Jeremy Bentham, who espoused the concept of *utilitarianism*. This theory states that the correct action is the one that maximizes good. Good is defined as pleasure and Evil as pain. The weakness in this theory is the fact that an individual may define good as the action that brings him or herself pleasure without regard to whether or not the action brings good or bad results to others. Complete focus on pleasure for one's self is called *hedonism*. Henry Sidgwick, a Victorian philosopher pointed out that the downside is that when the objective is pleasure, pleasure becomes elusive. This is known as the "hedonist's paradox."

Bentham contemporary John Stuart Mill refined this theory by stating that actions have utility when they maximize happiness. He focused on the pleasure of <u>all</u> who would be affected by the action not just one's own pleasure.[4]

The oft-repeated maxim, *the end justifies the means*, is often used to describe an individual's desire to achieve a particular outcome irrespective of whether the actions taken to realize the goal are good or bad in themselves. This ethical framework in itself is certainly a valid one assuming that the end result has a noble purpose that outweighs the cost of achieving it.

For example, many of us viewing in isolation the techniques used during military boot camp might consider the harsh physical activity, sleep deprivation, unyielding structure, and yelling to be cruel and unnecessary. All military branches are responsible for transforming undisciplined, out-of-shape, and sometimes unmotivated young recruits into physically capable and mentally controlled individuals that are able to obey orders and complete the mission even in the face of confusing, chaotic or dangerous situations. Why? Because in many cases, our country depends on these young men and women to do their jobs in order to keep the rest of us safe. If the recruits had not been subjected to such extensive and rigorous training, their superiors could not rely on them to execute orders in crucial situations and all could be lost. Likewise, businesses may have to ask employees to work overtime to reach a particular short-term goal. Another appropriate example is choosing not to "fix" an immaterial accounting error since the time and resources needed to rectify the situation outweigh any benefit that could be derived.

The phrase *the end justifies the means* more often conjures up visuals of dramatic characters, such as the Machiavellian mobster family in the popular television show, *The Sopranos*, who are willing to commit any brutal or repulsive act in order to "maintain peace in the 'family.'" And indeed, there are many real-world financial statement fraud cases where *the end justifies the means* theory of ethical thought has been misused by management teams overly focused on achieving analysts' expectations. We do not have to go back many years to recall the spate of accounting scandals that set new lows on the financial statement manipulation that companies were willing to employ. The shock of the WorldCom, HealthSouth, and Enron failures were unfortunately eclipsed by Bernie Madoff and the many players in the recent mortgage crisis − Lehman Brothers, Goldman Sachs, Moody's, AIG, JP Morgan, and Countrywide − to name a few. So many of these organizations justified their unethical business practices based on the short-term benefits (mostly to themselves) to be derived. Little consideration was given to the devastating impact to the shareholders, the employees and indeed the global economy. Thus, one of the major shortcomings of consequentialism is the fact that sometimes the full extent of the outcome is not always known at the time the act occurs.

---

4. Jackson, page 25-26.

In early June, 2016, a pair of would-be robbers held up a McDonald's restaurant on the outskirts of Paris, seizing approximately $2,000. What was probably obvious to the criminals is the fact that there was a chance of being caught by the police during the course of the robbery, assuming the authorities would be able to arrive on time. Perhaps in the thieves' minds, the benefits of obtaining the loot (the ends) outweighed the calculated possibility of being caught by the police. What was not anticipated by these burglars was the fact that eleven armed members of the French Paramilitary Special Forces (France's version of the Navy Seals or Army Rangers) were eating lunch at the restaurant that day. It goes without saying that the soldiers acted decisively to efficiently apprehend the crooks in record time.[5]

The criminals may have contemplated a particular consequence (apprehension by the police) and its attendant risk (only a remote possibility of being captured) with respect to robbing the bank but the risk ended up being far higher and the outcome far more painful.

This story is an unfortunate parallel for the unintended consequences that often occur as a result of financial statement fraud. Recent studies have found that the more the management is focused on meeting analysts' expectations or internal metrics, the less transparent financial reporting becomes. Thus, the accountants may be under great pressure to "fudge" numbers or improperly shade transactions in order to meet executives' demands for the financial statements to conform to the desired goal. Unfortunately, this short-term focus on meeting expectations comes at the price of at a minimum, "bad/aggressive accounting" which can easily lead to fraud. Most individuals do not intend to commit white-collar crime, but they fail to look past the immediate pressure to see that their wrongful act can lead to loss of license, suspension, jail time, and a stigma that would be hard for a family to bear.

Case Study: Willful Ignorance and the Subprime Mortgage Crisis

Much ink has been spilled in the aftermath of the Great Recession, which was spurred on in large part by the greed and ignorance of the major players on the financial stage. Unfortunately, it becomes a cautionary tale of what can occur if individuals and institutions look ONLY to their own interests and do not consider at all the catastrophic consequences such actions leave in its wake.

It seemed that no one, from the major banks, insurers and ratings agencies down to the mortgage brokers and homebuyers, cared about the long-term devastating impact to the global economy in general and to themselves in particular. One of the biggest culprits of the financial meltdown from 2007 to 2010 was associated with the mortgage crisis. A brief discussion of the major events that lead to the implosion of the global economy is warranted.

Prior to the securitization of debt (which will be discussed below), banks traditionally would lend money − via mortgages or a line of credit − to customers who were depended upon to pay the funds back at an agreed-upon time. Since most banks kept the mortgage or notes until maturity, it was critical that both the borrower was solvent and trustworthy and that the asset being mortgaged was stable and valuable enough to satisfy the note should it become repossessed.

5. https://www.washingtonpost.com/news/morning-mix/wp/2016/06/08/two-guys-allegedly-tried-to-rob-a-french-mcdonalds-but-off-duty-special-forces-unit-was-eating-inside/ . Downloaded 7/17/2016 1:23 p.m.

Case Study: Willful Ignorance and the Subprime Mortgage Crisis (continued)

Starting in the 1970s, banks discovered that it was far more lucrative to sell financial products securitized by a bundle of mortgages to the public and other financial institutions. These products were also known as mortgage-backed securities ("MBSs"). If there was interest or dividends due to the MBS investor or they wanted to be redeemed out, the Banks would need to rely on a steady cash flow from borrowers consistently paying off their mortgages. The beauty of this scheme is that poor-quality mortgages – known as subprime – could be mixed in with AAA rated mortgages without significantly impacting the MBS holder's risk of loss under the theory that the underlying assets were diversified. It seemed that the public's appetite for MBSs was endless, and many of the major financial institutions were happy to rake in the profits. There were also some other players indirectly benefitting from the MBS golden goose: insurance companies who gleefully received billions in premiums in exchange for insuring what they considered the unlikely event of loss should certain tranches of mortgages underlying the MBSs fail. These products were known as "credit default swaps" or "CDSs." There were infinite permutations and secondary markets of the MBSs and CDSs and many came to the party. What many people failed to realize was that billions of dollars of "wealth" all hinged on whether the underlying assets – the bundle of mortgages – were current and that the houses which they secured had at least as much or more value than the money that was owed on them.

Unfortunately, a catastrophic number of mortgages defaulted, causing the MBSs to drop tremendously in value. Those owning the MBSs sustained direct losses, as did the insurance companies that underwrote them. Storied firms such as Lehman Brothers and Bear Stearns disappeared or were swallowed up by others. Massive lay-offs and the freezing of the credit markets caused the economy to go into a death spiral. Ordinary citizens who had little to do with the mortgage crisis found themselves as collateral damage. Most of us know of friends, relatives and perhaps yourself who experienced loss of job, reduction in wages, and tremendous financial stress. No one was unscathed. What were some of the factors, which led to this monetary Armageddon?

- ***Mortgage companies*** such as Countrywide who were willing to lend money to individuals who were either not credit worthy or simply did not have the income level to support large mortgages. These companies knew they could underwrite faulty loans and profitably unload them on conglomerates who were repackaging them and selling them off in pieces via the CDSs. NINJA (No income, no job, no assets) loans, subprime mortgages, "liar" loans and unconscionable adjustable rate mortgages ultimately became some of the instruments of destruction. These mortgage companies neither knew nor cared whether the loans would go into default because it would not be their problem once the asset had been peddled to someone else.
- ***Regulators*** such as the Office of the Comptroller of the Currency and the Office of Thrift Supervision which looked the other way even when the attorney generals of some of the states reported predatory real estate financing by several of the banks.

Case Study: Willful Ignorance and the Subprime Mortgage Crisis (continued)

- ***Banks*** such as Goldman Sachs, Lehman Brothers, Bear Stearns, Citibank and JPMorgan, who recklessly purchased these mortgages and essentially foisted them upon investors even though a quick cursory review would have revealed that the MBSs would be based on financial quicksand. These financial institutions also carried an enormous amount of debt compared to their equity, in some cases 40-to-1. This created the situation where even a modest decrease in the value of the bank's assets would almost immediately cause insolvency.

- ***Insurers*** such as AIG who recklessly issued policies via the CDSs without performing due diligence. The losses sustained during the meltdown were greater than they had resources to cover. The U.S. taxpayers ended up bailing out most of these insurers via the billions injected by the Federal Reserve.

- ***Ratings Agencies*** such as Moody's, Standard & Poor's, and Fitch's which allowed their clients to "buy" excellent ratings on these investments. The purpose of the agency ratings is to indicate to the investing public the risk level of the financial product, and in theory these ratings are supposed to be impartial. However, the investment's sponsor was the one having to pay for the analysis. As a result, agencies would oblige their customers with inflated ratings in fear of losing their business. Investors therefore bought MBSs and other derivatives – and insurers issued CDSs – based on these strong ratings not knowing or perhaps not caring that they were taking on far more risk than they had anticipated.

- ***Freddie Mac/Fannie Mae*** strayed from their original purpose of being the purchaser and/or insurer of last resort for troubled mortgages. Originally, these entities were designed to be a mechanism for keeping capital smoothly flowing into the lending market. Due to misguided governmental expansionist policies, Freddie and Fannie became willing dumping grounds for these home loans that would have never happened had the lender been completely accountable for the losses. When a critical number of the mortgages that had been guaranteed started to go into default, Freddie and Fannie experienced huge losses. They were then unable to continue purchasing any more mortgages, resulting in a freezing in liquidity and adding precipitous momentum to what became the Great Recession.

Case Study: Willful Ignorance and the Subprime Mortgage Crisis (continued)

- ***Individuals*** who were willing to borrow up to the limit of the money the mortgage companies were offering even though common sense would have easily shown that they did not have the personal wherewithal to support the debt. Many people allowed the promise of sudden riches by "flipping" houses cloud their judgment and sign on to loans that were unsustainable. One could argue that had individuals not been enthralled by the idea of owning their "dream home" or by greed of quick success, they would have borrowed only a sensible amount. Then the real estate bubble may not have been as dramatic, and perhaps the implosion of the economy would have been far more muted.

What becomes obvious in reviewing this debacle is that all the characters involved were acting almost entirely in their own interests and were indifferent as to how their individual callous and unethical behavior would collectively bring the world economy nearly to a complete collapse. In the interim, many individuals who had nothing to do with the mortgage shenanigans were indelibly affected through loss of job, home and family. Suicide became more prevalent as some people became increasingly more desperate as the Great Recession dragged on. It can be argued that those parties who willingly participated in what many people described as a mortgage Ponzi scheme have blood on their hands.

Deontology

Another normative ethical theory is *deontology*. A *deontologist* espouses the maxim that one should do the right thing based solely on the fact that it is right, irrespective of the consequences of the action. Their mantra would be "do your duty for duty's sake." A person therefore must tell the absolute truth even though the fall-out could be significant. A deontologist does not look to the future or the effect of an action. They merely do the right thing because it is the right thing to do.

One of the leading deontologists from the mid-18th century was Immanuel Kant. He championed the belief that an act is moral because it is right, not because of its consequences. He held that if we have a duty, we must perform that duty without exception.[6]

Deontologists base their decisions about what's right on broad abstract universal ethical principles or values such as honesty, promise-keeping, fairness, loyalty, rights (to safety, privacy), justice, responsibility, compassion, and respect for human beings and property. According to some deontological approaches, certain moral principles are binding, regardless of the consequences. Therefore, some actions would be considered wrong even if the consequences of the action were good. In other words, a deontologist focuses on doing what is right whereas a consequentialist concentrates on doing what will maximize societal welfare.

During World War II, some of the individuals being interrogated would lie to Nazis and state that they were not hiding Jews even though they were in fact doing so. While we generally have a duty to tell the truth to authorities, in this case the individuals found that the value of human life outweighed the duty

6. Jackson, pgs. 26-27.

to tell the truth. A deontologist would not consider being untruthful to the authorities since lying in itself is a bad act, even though such a confession would put another's life into peril. A consequentialist would condone lying in that circumstance since a human being is more important than telling a lie.

The downside to deontology is that there can be over focus on merely doing one's duty or "following the rules" without considering the bigger picture. Often, accountants will look for guidance (e.g., GAAP, IFRS, tax law) to determine how to treat a particular transaction. While it is appropriate to gather this information, this should not be the end of the inquiry. Meeting the rules should be the starting point for whether or not a matter is ethical, not the end of the investigation. After ensuring that the transaction meets the minimum legal requirements, CPAs should then ask additional questions: Is the transaction ethical? Even though it meets the letter of the law, does the proposed treatment subvert the policy for which the rule exists? Is it the right thing to do? Does the transaction "smell bad?"

Case Study: Toronto-Dominion Bank Lives Its Values

The shenanigans of selling mortgage-backed securities to an unsuspecting public were not limited to the United States. In Canada, similar products called asset-backed commercial paper (ABCP) were also being widely sold. ABCPs were short-term debt instruments issued by a trust and secured by assets such as mortgages. The weakness of this product was that the ABCP depended on the cash flow of its underlying assets. If mortgages started defaulting, then there potentially could be a lack of funds to satisfy the ABCP when they became due. We can see in hindsight that many of the mortgages did begin to falter, and a liquidity crisis ultimately ensued starting in mid- 2007. However, the management of Toronto-Dominion Bank, one of the largest conglomerates in the Canadian financial sector, had the foresight in 2005 to exit the structured loans products market, including interest rate derivatives and MBSs. Their CEO, Edmund Clark, had determined that the business model underlying the ABCP was faulty and incomprehensible.

Further, the specter of potential default presented far more risk to the shareholders than was conscionable. Most of Toronto-Dominion's profits in 2005 and later were generated by traditional but stodgy sources, such as consumer lending and money management. Competitors from 2005 to 2007 seemed to be riding high by comparison due to the outsized returns from the ABCP. Toronto-Dominion practically became a laughingstock during this period due to its conservative strategic choices. However, Clark's foresight in rejecting transactions that were not based on his contemporaries' business paradigms became enviable once the mortgage crisis took hold in Canada. Of the five major banks, only Toronto-Dominion escaped relatively unscathed.

Story as relayed by Brooks, Leonard, and Dunn, Paul, Business & Professional Ethics: For Directors, Executives & Accountants, 7th ed., (CT: Cenage, 2015) pgs. 605-607.

Virtue Ethics

The third normative ethical theory is *virtue ethics*, which espouses that the most important aspect of morality is having the right character. In other words, possessing the right set of virtues is central to morality because what makes an action right is that it is one that a virtuous person would take.[7]

7. Jackson, page 27.

Virtue ethics states that having the right character, or virtues, is the most important aspect of morality. Aristotle is the most famous proponent of virtue ethics. He championed a list of major virtues that each individual should possess or be in the process of obtaining:

1. Courage
2. Temperance – moderation
3. Liberality – spending money well
4. Magnificence – living "well"
5. Pride – taking pleasure in accomplishments
6. High handedness – concern with the noble, not with the petty
7. Diligence – between reckless ambition and total lack of effort
8. Gentleness – concern for others
9. Truthfulness – not being boastful
10. Wit – pleasure in group discussions
11. Friendliness – pleasure in group associations
12. Modesty – pleasure in personal conduct
13. Righteous indignation
14. Justice[8]

The virtue ethics approach focuses more on the integrity of the moral *actor* than on the moral *act* itself (the decision or behavior). The goal here is to be a good person because that is the type of person you wish to be. A virtue ethics perspective considers the actor's character, motivations, and intentions. According to virtue ethics, it is important that the individual intends to be an upright being and exerts effort to develop him or herself as a moral agent.[9]

While we may sometimes feel that based on the numerous stories in the media that corporate wrong-doing seems to be the norm rather than the exception, certain organizations – such as Toronto-Dominion Bank discussed above – consistently uphold their values and are shining examples of what it means to be ethical even when it seems that no one else is playing by the rules.

8. Cherrington, Owen, and Cherrington, David, Moral Leadership and Ethical Decision Making (UT: CHC Forecast, 2000), pgs. 18-19.
9. Trevino, Linda and Nelson, Katherine, Managing Business Ethics: Straight Talk About How to Do It Right, 6th edition (NJ: Wiley, 2014), pg 46.

Example: The Whistleblowers

Time Magazine's 2002 Persons of the Year included whistleblowers Sherron Watkins (Enron) and Cynthia Cooper (WorldCom). Both of these women discovered discrepancies in their respective employers' financial records, which led them to uncover underlying fraudulent transactions. Both of their companies ultimately collapsed under the weight of the financial deceptions.

CPAs who find themselves in similar circumstances can use any of the three ethical frameworks we discussed above to help him or her determine whether or not to alert the authorities about any irregularities.

In considering ***Consequentialism***, the individual may ask, "if I disclose/don't disclose to the appropriate individuals this fraud, what will be the impact to the shareholders, employees, lenders, investors, board, and customers?"

The CPA analyzing his or her potential actions using ***Deontology*** would contemplate, "What is my duty? What does the law/applicable rule say must be done?" Consequences of the action would not be part of the decision.

Finally, an individual relying on ***Virtue Ethics*** will use character and virtues to guide him or her. The main determination here will be, "what would a courageous, truthful, and just person do in this situation?" A person relying on virtue ethics would not consider the consequences of their choice or even whether or not any parameters apply (such as a confidentiality agreement or a law). Their focus is acting in a way that a righteous person would behave.

THE BOTTOM LINE

The ethical theories discussed above can aid an individual in establishing his or her values. Values oftentimes are also a result of upbringing, experiences, environment, and perhaps even "the school of hard knocks." These standards can help guide a person in determining what actions are acceptable or unacceptable when faced with a moral dilemma.

We will discuss values and its role in shaping ethical *behavior* in Part III.

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART I: TEST YOUR KNOWLEDGE

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

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1.	**Which of the following is <u>not</u> one of the three major normative ethical schools of thought:** **A.** Consequentialism **B.** Deontological Theory **C.** Virtue Ethics **D.** Applied Ethics
2.	**A person who has adopted the Consequentialism school of ethical thought would be most likely to take which of the following actions:** **A.** act only in a way that a virtuous person would act at all times, even if the end result would be disastrous **B.** engage in actions that some may view as harsh in order to achieve a worthy and noble goal **C.** ask, “what is my duty?” and behave accordingly irrespective of the outcome **D.** engage in actions to achieve one’s own selfish goal even if the end result causes severe repercussions to many others

3.	**Which of the following items did <u>not</u> contribute to the mortgage crisis during the Great Recession of 2007-2010:** **A.** regulators who did not hold banks accountable for reckless lending practices **B.** financial institutions, such as Lehman Brothers and Bear Sterns, which over-leveraged themselves and put themselves in a situation where they would be instantly insolvent should there be an even modest decline in their balance sheet assets **C.** rating agencies, such as Standard & Poor's or Moody's, which gave many mortgage-backed investments stellar ratings even though it was apparent that the assets underlying the MBSs were troubled **D.** banks, such as Toronto-Dominion, which refused to sell MBSs (known as ABCPs in Canada) due to their inherently high risk of loss

PART I: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. Consequentialism is one of the three major normative ethical schools of thought along with Deontology and Virtue Ethics. **B.** Incorrect. Deontology is one of the three major normative ethical schools of thought along with Consequentialism and Virtue Ethics. **C.** Incorrect. Virtue ethics is one of the three major normative ethical schools of thought along with Consequentialism and Deontology. **D.** CORRECT. Normative ethics deals with how to discern whether something is right or wrong. Applied Ethics takes the next step of how to apply a normative system into a practical situation, such as acting morally in a business situation. *(See page 3 of the course material.)*
2.	**A.** Incorrect. This is an example of Virtue Ethics. **B.** CORRECT. Consequentialism focuses on the overall end result, not on the actions needing to be taken to achieve it. **C.** Incorrect. This is an example of Deontology. **D.** Incorrect. Inherent in the theory of "the end justifies the means" is the premise that the end is worthy and noble, not a self-serving act that harms many others. *(See pages 3 to 5 of the course material.)*
3.	**A.** Incorrect. Sloppy regulation allowed banks to carry on reckless practices. **B.** Incorrect. Most of the major financial institutions were willing to take on heavy debt loads so they could chase easy and large profits. This increased exponentially the risk that shareholders and employees could lose their investments and their jobs should their bank become insolvent. **C.** Incorrect. Had the ratings agencies properly evaluated the MBSs, investors would have had a true indication of the risk they were taking on and would have either not purchased the securities or bought them at an appropriate price. This alone would have reduced or eliminated the unwarranted bubble in real estate prices. **D.** CORRECT. Had all financial institutions acted as Toronto Dominion, most of the banks would not have put themselves at such high risk of insolvency as discussed in the course materials. *(See page 9 of the course material.)*

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART II: CODES OF CONDUCT FOR CPAs

> *"[These] Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage."*
>
> *--ET § 0.300.020.2*

Part II will review guidelines that apply to CPAs, specifically the Texas Rules of Professional Conduct[1] and the AICPA Code of Professional Conduct.[2]

TEXAS RULES OF PROFESSIONAL CONDUCT

The rules governing the behavior of Texas CPAs can be found in the Texas Rules of Professional Conduct ("TX RPC"), which are located in the Texas Administrative Code in Title 22, Part 22, Chapter 501.[3] The TX RPC strive to impress upon the CPA that he/she is in essence a *public servant* due to the intricate nature of accountancy and the community's dependence on the practitioner's *good judgment* in carrying out his/her duties. The Preamble states that the practitioner is expected to "establish and maintain high standards of competence and integrity in the practice of public accountancy and to insure that the conduct and competitive practices of licensees serve the purposes of the [Public Accountancy] Act and the best interest of the public."[4] These rules obligate the Texas CPA to:

- Maintain independence in fact and in appearance
- Continuously improve professional skills
- Hold the affairs of clients in confidence
- Maintain high standards of personal and professional conduct in all matters[5]
- Refrain from committing acts discreditable to the profession.[6]

Services covered under the TX RPC are as follows:

- accounting, auditing and other assurance services,

1. The Texas Public Accountancy Act in these materials is current as of September 10, 2016. Please be aware that the Act is being constantly updated. The latest version can be found on the following website http://texreg.sos.state.tx.us/public/readtac$ext.ViewTAC?tac_view=3&ti=22&pt=22.

2. It should be noted that the International Ethics Standards Board for Accountants ("IESBA") issued new ethics standards in late July, 2016, aimed at resolving potential conflicts of interest for internal and external accountants and auditors who feel bound by strict client confidentiality rules, even when they uncover wrongdoing. While the IESBA has no enforcement authority, it is anticipated that many national accounting organizations will adopt the IESBA code.

3. The Texas Public Accountancy Act in these materials is current as of October 15, 2010. Please be aware that the Act is being constantly updated. The latest version can be found on the following website - http://info.sos.state.tx.us/pls/pub/readtac$ext.ViewTAC?tac_view=3&ti=22&pt=22.

4. Texas State Board of Public Accountancy, Rules of Professional Conduct, (Texas State Board of Public Accountancy), § 501.51(a).

5. Texas State Board of Public Accountancy, Rules of Professional Conduct, (Texas State Board of Public Accountancy),§ 501.51(b).

6. Texas State Board of Public Accountancy, Rules of Professional Conduct, (Texas State Board of Public Accountancy), § 501.51(e).

- taxation,
- financial advisory services,
- litigation support,
- internal auditing,
- forensic accounting, and
- management advice and consultation.[7]

Even if a Texas CPA is not engaged in client practice of public accountancy, he/she is still bound by the TX RPC. This includes licensees working in industry who provide internal accounting or auditing services. Also covered are CPAs employed in education or in government in accounting or auditing.

The Rules of Professional Conduct are comprised of 5 subchapters:

SUBCHAPTER A	GENERAL PROVISIONS
SUBCHAPTER B	PROFESSIONAL STANDARDS
SUBCHAPTER C	RESPONSIBILITIES TO CLIENTS
SUBCHAPTER D	RESPONSIBILITIES TO THE PUBLIC
SUBCHAPTER E	RESPONSIBILITIES TO THE BOARD/PROFESSION

Each Subchapter is divided up into a number of rules. Selected provisions of the RPC will be discussed below.

AICPA CODE OF PROFESSIONAL CONDUCT

In addition, the AICPA Code of Professional Conduct ("ET"or "Code")[8] is one of the sources that govern all CPA's ethical and professional conduct in the process of servicing clients or employers. It consists of multiple parts which sometimes overlap, especially in the situation where a CPA has several roles. In addition, the license holder may also be subject to other rules such as specific codes from state boards of public accountancy, the Security and Exchange Commission, the General Accounting Office, the Treasury Department, the Internal Revenue Code, common law and other national or international rule-setting bodies. In all cases, the CPA should apply the most restrictive provision.[9]

The Code consists of three components:

- Principles

7. Texas State Board of Public Accountancy, Rules of Professional Conduct, (Texas State Board of Public Accountancy), § 501.51(e).
8. The AICPA Code of Professional Conduct, in these materials are effective as of December 15, 2014 and have been updated for all releases up to December 10, 2015. Please be aware that the Code is being constantly updated. The latest version can be found on the following website - http://pub.aicpa.org/codeofconduct/Ethics.aspx#.
9. American Institute of Certified Public Accountants, Code of Professional Conduct, §§ 0.100.02 and 1.110.010.18.

- Rules
- Interpretations and other guidance

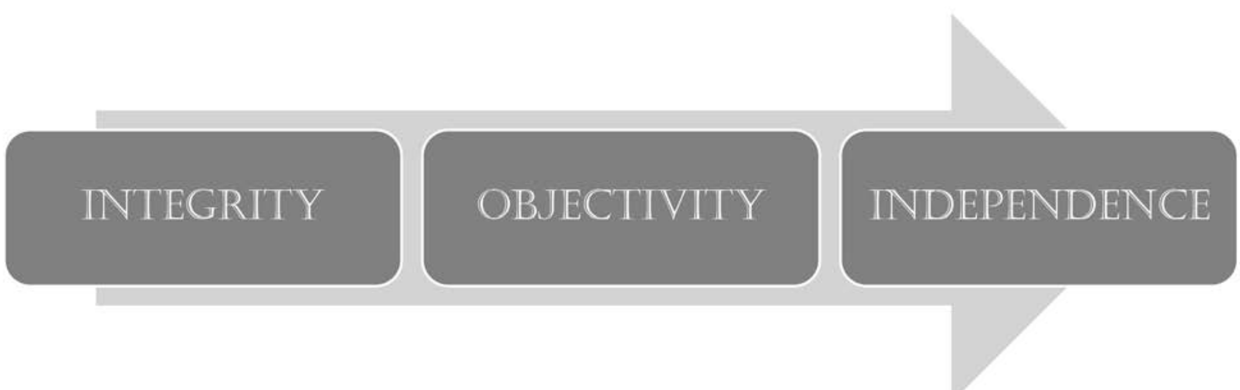
The Code is organized in the following four sections:

- The Preface, which is applicable to all members
- Part I, which covers the rules for members in public practice
- Part II, which details rules for members in business/industry
- Part III, which applies to members other than those in public practice or industry. Examples are individuals who are retired or not currently employed

The Code covers members working in public accounting, industry, or those who are retired or unemployed. Activities covered include attest, tax, consulting and other traditional accounting functions. Attest services include audits, reviews, examination of prospective financial information and PCAOB engagements.[10]

Note

Some of the Code rules discussed below have parallels in the other parts. Where possible, reference will be made to all the sections that cover a particular concept or rule. The Preface is designated by the "ET § 0.XXX.XX.X" numbering format. Part I, Part II and Part III have the number prefix 1, 2, and 3, respectively.



10. https://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&cad=rja&uact=8&ved=0ahUKEwjbkejWsovOAhUGwYMKHaQIChgQFggkMAI&url=http%3A%2F%2Fwww.aicpa.org%2Fadvocacy%2Fdocuments%2Fattestfaqs.docx&usg=AFQjCNGpwkxZt7Z2iisevIfquZ8rDqCd-g&sig2=BeYkUD3fv4-EL3wwukIL4w

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

-- ET § 0.300.40.3

TX RPC §501.73 – Integrity and Objectivity

(a) A person in the performance of professional accounting services or professional accounting work shall maintain integrity and objectivity, shall be free of conflicts of interest and shall not knowingly misrepresent facts nor subordinate his or her judgment to others. In tax practice, however, a person may resolve doubt in favor of his client as long as any tax position taken complies with applicable standards such as those set forth in Circular 230 issued by the IRS and the AICPA's SSTSs.

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

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

(d) A person shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs independence or objectivity in rendering professional accounting services or professional accounting work. . .

Source Note: The provisions of this §501.73 adopted to be effective June 11, 2000, 25 Tex. Reg. 5338; amended to be effective February 4, 2004, 29 Tex. Reg. 963; amended to be effective February 17, 2008, 33 Tex. Reg. 1093; amended to be effective December 7, 2011, 36 Tex. Reg. 8234

ET § 1.100.001.01/2.100.001.01 Integrity and Objectivity Rule

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

"***Objectivity*** *is a state of mind, a quality that lends value to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.* ***Independence*** *precludes relationships that may appear to impair a member's objectivity in rendering attestation."*

--ET § 0.300.50.2

TX RPC §501.70 – Independence

A person in the performance of professional accounting services or professional accounting work, including those who are not members of the AICPA, shall conform in fact and in appearance to the independence standards established by the AICPA and the board, and, where applicable, the SEC, the U.S. GAO, the PCAOB and other national or international regulatory or professional standard setting bodies.

Source Note: The provisions of this §501.70 adopted to be effective June 11, 2000, 25 Tex. Reg. 5337; amended to be effective February 15, 2001, 26 Tex. Reg. 1340; amended to be effective April 3, 2002, 27 Tex. Reg. 2436; amended to be effective February 17, 2008, 33 Tex. Reg. 1092; amended to be effective December 7, 2011, 36 Tex. Reg. 8233

ET § 0.400.21 (Definitions)- Independence

Independence consists of two elements, defined as:

a) ***Independence of mind*** is the state of mind that permits a member to perform an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b) ***Independence in appearance*** is the avoidance of circumstances that would cause a reasonable and informed third party who has knowledge of all relevant information, . . . to reasonably conclude that the integrity, objectivity, or professional skepticism . . . is compromised.

Case Study: Integrity and Objectivity

James, a CPA working as a manager in a company's financial reporting department, was asked by his supervisor to offset period expenses with "cookie jar reserves" – such as a warranty liability account – instead of properly charging such items through the P & L (profit and loss statement). James has determined that his bosses' request would run afoul of the IFRS guidelines and applicable FASB rules, although it would result in analysts' expectations being met for this quarter's earnings release. He is also aware that year-end bonuses could be affected and that the stock price could plunge if expectations are not met. It was also rumored that some time back a former co-worker who had refused to comply with a similar request had been marginalized and ultimately "laid off." James has a stay-at-home spouse and three young school-aged children.

Case Study: Integrity and Objectivity (continued)

While James knows that the correct treatment of the expenditure in question is to currently expense it through the P & L, James may feel conflicted since he knows that potentially, his career (and by extension his family) could be adversely affected should his boss decide to retaliate. The Code requires James to show integrity and objectivity by using the correct accounting treatment despite the possible consequences. James must act independently of his management and cannot subordinate his own judgment to his supervisor's.

THREATS TO INDEPENDENCE

ET § 1.210.010 Conceptual Framework for Independence[11]

.10 Many different relationships or circumstances . . . can create threats to compliance with the "Independence Rule" [1.200.001]. . . Many threats fall into one or more of the following seven broad categories: adverse interest, advocacy, familiarity, management participation, self-interest, self-review, and undue influence.

11. For the parallel section on Independence for CPAs in industry, please see American Institute of Certified Public Accountants, Code of Professional Conduct § 2.000.010.

What Are These Threats?

- ***Adverse interest threat.*** The threat that a member will not act with objectivity because the member's interests are opposed to the interests of the employing organization.
- ***Advocacy threat.*** The threat that a member will promote an employing organization's interests or position to the point that his or her objectivity is compromised.
- ***Familiarity threat.*** The threat that, due to a long or close relationship with a person or an employing organization, a member will become too sympathetic to their interests or too accepting of the person's work or employing organization's product or service.
- ***Management participation threat.*** The threat that a member will take on the role of client management or otherwise assume management responsibilities.
- ***Self-interest threat.*** The threat that a member could benefit . . . from an interest in. . . the employing organization or persons associated with the employing organization.
- ***Self-review threat.*** The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member.
- ***Undue influence threat.*** The threat that a member will subordinate his or her judgment to that of an individual associated with the employing organization or any relevant third party due to that individual's position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member.

--ET § 1.210.010 Conceptual Framework for Independence

Threats to Independence	Examples
Adverse Interest[12]	An external auditor is being sued by its client.
Advocacy[13]	In exchange for a commission, a tax practitioner recommends an investment sponsored by Client A to Client B.
Familiarity[14]	A CPA performing an external audit on a company has a close friend or relative in a key management position of the client.
Management Participation[15]	The license holder designs and implements internal controls for an attest client; CPA is an officer or director of the client.
Self Interest[16]	The member has an outstanding loan; license holder earns a significant amount of its fees from a client; CPA acquires direct financial interest in an attest client.
Self- Review[17]	The CPA prepares source documents for the client's financial statements; Member reviews the tax provision but also prepares the tax return.
Undue Influence[18]	License holder receives gifts from its client; management threatens to fire CPA over disagreement on application of an accounting principle.

THREATS TO INTEGRITY AND OBJECTIVITY

12. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.10.
13. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.11.
14. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.12.
15. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.13.
16. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.14.
17. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.15.
18. American Institute of Certified Public Accountants, Code of Professional Conduct, § 1.000.010.16.

ET § 1.130.020 Subordination of Judgment

.1 The "Integrity and Objectivity Rule" [1.100.001] prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services for a client, for an employer, or on a volunteer basis.

.10 Nothing in this interpretation precludes a member from resigning from the organization at any time. However, resignation may not relieve the member of responsibilities in the situation, including any responsibility to disclose concerns to third parties, such as regulatory authorities or the employer's (former employer's) external accountant.

Case Study: WorldCom Part I - Subordination of Judgment

Buddy Yates, Troy Norman, and Betty Vinson, three mid-level managers at WorldCom along with Controller David Myers produced interim financial statements that fell short of analysts' expectations in 2000. CFO Scott Sullivan demanded that several expenses be charged against reserves on the balance sheet or to capital expenditure accounts, thereby improving bottom line net income as well as WorldCom's overall balance sheet. With these changes, the analysts would be satisfied. When Myers, Yates, Norman and Vinson requested an explanation for this different treatment (which coincidentally did not meet any of the accounting standards), Sullivan's reply was that there was an "error" in the statements which, based on "The Rule of Ten," would reverse itself the next quarter. There was no other support for Sullivan's accounting stance. Incredibly, it was eventually revealed that "The Rule of Ten" was completely fictitious and a figment of Sullivan's imagination. Despite the proffered flimsy justification, Myers and his team subordinated their judgment and produced materially false financial statements.

Unfortunately, the "error" never reversed and the magnitude of the fraud grew exponentially in later quarters. The fraud was ultimately uncovered by tenacious investigation by WorldCom's internal auditors.

Two years after the first falsified financial statements, the FBI and other federal officials raided the WorldCom headquarters. Sullivan, Myers, Yates, Vinson and CEO Bernie Ebbers were later convicted and served jail time

As told in Cooper, Cynthia, Extraordinary Circumstances (NJ: Wiley & Sons, 2008).

What Are Examples of Conflicts of Interest?

- Preparing valuations of assets for two clients who are in an adversarial position with respect to the same assets.
- Representing two clients at the same time regarding the same matters who are in a legal dispute with each other, such as during divorce proceedings or the dissolution of a partnership.
- Providing a report for a licensor on royalties due under a license agreement while at the same time advising the licensee of the correctness of the amounts payable under the same license agreement.
- Advising a client to invest in a business in which, for example, the immediate family member of the member has a financial interest in the business.
- Advising a client on the purchase of a product or service while having a royalty or commission agreement with one of the potential vendors of that product or service.
- Providing forensic investigation services to a client for the purpose of evaluating or supporting contemplated litigation against another client of the firm.
- Providing tax or personal financial planning services for several members of a family whom the member knows to have opposing interests.
- Referring a personal financial planning or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement.
- Being responsible for selecting a vendor for the member's employing organization when the member or his or her immediate family member could benefit financially from the transaction.

--ET §§ 1.110.010.04/2.110.010.04

ET §§ 1.110.010/2.110.010 Conflicts of Interest

.1 A member or his or her firm may be faced with a conflict of interest when performing a professional service. In determining whether a professional service, relationship or matter would result in a conflict of interest, a member should use professional judgment, taking into account whether a reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists.

.11 When a conflict of interest exists, the member should disclose the nature of the conflict to the relevant parties, including to the appropriate levels within the employing organization and obtain their consent to undertake the professional service. The member should disclose the conflict of interest and obtain consent even if the member concludes that threats are at an acceptable level.

ET § 1.130.010 Knowing Misrepresentations in the Preparation of Financial Statements or Records

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

a) Makes, or permits or directs another to make, materially false and misleading entries in an entity's financial statements or records;

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

c) Signs, or permits or directs another to sign, a document containing materially false and misleading information.

Case Study: Conflicts of Interest/Knowing Misrepresentation of a Financial Statement

Buca, Inc., is an Italian restaurant company with Bucca di Beppo locations in 26 states and 2 foreign countries. In 2006, the SEC brought action against Buca's former CFO, Greg Gadel, and former Controller, Daniel Skrypek. The SEC found that the duo had from 2000 to 2004: 1) significantly understated compensation for Gadel and Joseph Micatrotto, Sr, Buca's former CEO, President and Chairman of the Board; and 2) failed to disclose significant related party transactions with Micatrotto and Gadel.

The SEC contended in its filing that Gadel and Skrypek were not merely "asleep at the wheel" in terms of protecting the integrity of the financial statements, but provided a lax accounting culture whereby improper reimbursements and transactions could proliferate unabated. It was found that Micatrotto was repaid by Buca nearly $850,000 for personal expenditures such as the purchase and renovation of an Italian villa and three other homes, ATM withdrawals, a wedding dinner, and $127,000 for the same airplane tickets submitted multiple times. Gadel likewise charged Buca for non-business expenses such as family vacations and visits to strip clubs. These items were hidden in Buca's accounting system and were not attributed to Micatrotto and Gadel as taxable compensation.

Gadel was one of the primary owners of a small IT consulting group. With Skrypek's assistance, Gadel's company was paid nearly $1.5 million by Buca even though few IT services were ever rendered.

Case Study: Conflicts of Interest/Knowing Misrepresentation of a Financial Statement (continued)

To add insult to injury, the duo also orchestrated capitalizing expenditures that should have been treated as a period cost by charging improper accounts and using over-billing schemes in concert with its vendors. The accountants would fraudulently reclassify actual costs until the numbers equaled analysts' expectations.

In total, Buca improperly inflated income by $12 million between 2000 and 2004. Gadel was ultimately sentenced to over a year in prison and fined for criminal charges. He and Skrypek settled separate charges with the SEC. Micatrotto was sentenced to 13 months and fined. Skrypek was sentenced to 150 hours of community service.

As recounted in Jackson, Cecil, "Detecting Accounting Fraud: Analysis and Ethics" (NJ: Pearson, 2015), pgs. 290-300. Also, Norris, Floyd, "3 Executives Will Admit Fraud Charges Filed by U.S.," New York Times, June 8, 2006.

ET § 1.140.010 Client Advocacy

.1 An advocacy threat to compliance with the "Integrity and Objectivity Rule" [1.100.001] may exist when a member or the member's firm is engaged to perform non-attest services, such as tax and consulting services, that involve acting as an advocate for the client or to support a client's position on accounting or financial reporting issues either within the firm or outside the firm with standard setters, regulators, or others.

DEALING WITH THREATS

ET § 1.000.10/2.000.10 Conceptual Framework for Members

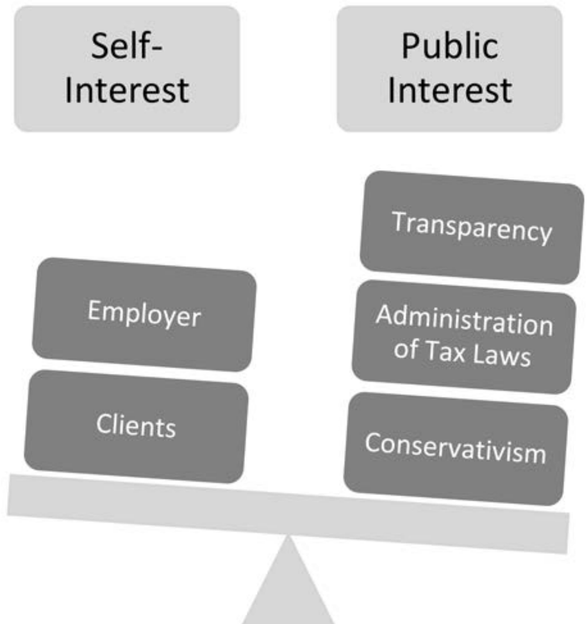
.01 *[M]embers* should identify *threats* to compliance with the rules and evaluate the significance of those threats. . . . *Members* should perform three main steps in applying the conceptual framework approach:

a) *Identify threats.* The relationships or circumstances that a *member* encounters in various engagements and work assignments will often create different *threats* to complying with the rules. . . . The existence of a *threat* does not mean that the *member* is in violation of the rules; however, the *member* should evaluate the significance of the *threat*.

b) *Evaluate the significance of a threat.* In evaluating the significance of an identified *threat*, the member should determine whether a *threat* is at an *acceptable level*. A *threat* is at an *acceptable level* when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* would not compromise the *member's* compliance with the rules . . .

c) *Identify and apply safeguards.* If, in evaluating the significance of an identified *threat*, the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. . . . In other cases, an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an *acceptable level*, or the *member* will be unable to implement effective *safeguards*. Under such circumstances, providing the specific *professional services* would compromise the *member's* compliance with the rules, and the *member* should determine whether to decline or discontinue the *professional services* or resign from the engagement.

RESPONSIBILITIES TO THE PUBLIC



*"A distinguishing mark of a profession is acceptance of its **responsibility to the public**. The accounting profession's public consists of clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of members to **maintain the orderly functioning of commerce**. This reliance imposes a public interest responsibility on members."*

--ET § 0.300.30.2

TX RPC §501.83 - Firm Names

(a) General rules applicable to all firms:

(1) A firm name may not contain words, abbreviations or other language that are misleading to the public, or that may cause confusion to the public as to the legal form or ownership of the firm.

(2) A firm licensed by the board may not conduct business, perform or offer to perform services for or provide products to a client under a name other than the name in which the firm is licensed.

TX RPC §501.83 - Firm Names (continued)

(3) A word, abbreviation or other language is presumed to be misleading if it:

(A) is a trade name or assumed name that does not comply with paragraph (4)(A) or (B) of this subsection;

(B) states or implies the quality of services offered, special expertise, expectation as to outcomes or favorable results, or geographic area of service;

(C) includes the name of a non-owner of the firm;

(D) includes the name of a non-CPA, except as provided in paragraph (4)(B) of this subsection;

(E) states or implies educational or professional attainment not supported in fact;

(F) states or implies licensing recognition for the firm or any of its owners not supported in fact; or

(G) includes a designation such as "and company," "company," "associates," "and associates," "group" or abbreviations thereof or similar designations implying that the firm has more than one employed licensee unless there are at least two employed licensees involved in the practice. Independent contractors are not considered employees under this subsection.

(4) A word, abbreviation or other language is presumed not misleading if it:

(A) is the name, surname, or initials of one or more current or former CPA owners of the firm, its predecessor firm or successor firm;

. . .

(C) indicates the legal organization of the firm; or

(D) states or implies a limitation on the type of service offered by the firm, such as "tax," "audit" or "investment advisory services," provided the firm in fact principally limits its practice to the type of service indicated in the name. . .

(b) Additional Requirements Based on Legal Form or Ownership.

TX RPC §501.83 - Firm Names (continued)

(1) The names of a corporation, professional corporation, limited liability partnership, professional limited liability company or other similar legal forms of ownership must contain the form of ownership or an abbreviation thereof, such as "Inc.," "P.C.," "L.L.P." or "P.L.L.C."; except that a limited liability partnership organized before September 1, 1993 is not required to utilize the words "limited liability partnership" or any abbreviation thereof.

(2) Sole Proprietorships:

(A) The name of a firm that is a sole proprietor must contain the surname of the sole proprietor as it appears on the individual license issued to the sole proprietor by the board.

(B) A partner surviving the death of all other partners may continue to practice under the partnership name for up to two years after becoming a sole proprietor, notwithstanding subsection (d) of this section.

(c) The name of any current or former owner may not be used in a firm name during any period when such owner is prohibited from practicing public accountancy and prohibited from using the title "certified public accountant," "public accountant" or any abbreviation thereof, unless specifically permitted by the board. . .

Source Note: The provisions of this §501.83 adopted to be effective October 13, 2005, 30 Tex. Reg. 6432; amended to be effective December 7, 2011, 36 Tex. Reg. 8236

ET § 1.820.030 Misleading Firm Names

.01 The "Form of Organization and Name Rule" [1.800.001] prohibits a member from practicing public accounting under a firm name that is misleading.

ET § 1.400.090 False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services

.01 A member would be in violation of the "Acts Discreditable Rule" [1.400.001] if the member promotes or markets the member's abilities to provide professional services or makes claims about the member's experience or qualifications in a manner that is false, misleading, or deceptive.

TX RPC §501.82 – Advertising

(a) A person shall not use or participate in the use of:

(1) any communication having reference to the person's professional services that contains a false, fraudulent, misleading or deceptive statement or claim; nor

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

(b) Definitions:

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

(A) contain a misrepresentation of fact;

(B) is likely to mislead or deceive because it fails to make full disclosure of relevant facts;

(C) is intended or likely to create false or unjustified expectations of favorable results;

(D) implies educational or professional attainments or licensing recognition not supported in fact;

(E) represents that professional accounting services can or will be completely performed for a stated fee when this is not the case, or makes representations with respect to fees for professional accounting services that do not disclose all variables that may reasonably be expected to affect the fees that will in fact be charged;

(F) contains other representations or implications that in reasonable probability will cause a reasonably prudent person to misunderstand or be deceived;

(G) implies the ability to improperly influence any court, tribunal, regulatory agency or similar body or official due to some special relations;

(H) consists of self-laudatory statements that are not based on verifiable facts;

(I) makes untrue comparisons with other accountants; or

TX RPC §501.82 – Advertising (continued)

(J) contains testimonials or endorsements that are not based upon verifiable facts.

. . .

(6) Duress--Any conduct which overpowers the will of another.

(7) Harassing--Any word, gesture, or action which tends to alarm and verbally abuse another person.

(8) Intimidation--Willfully to take, or attempt to take, by putting in fear of bodily harm.

(9) Overreaching--Tricking, outwitting, or cheating anyone into doing an act which he would not otherwise do.

. . .

(c) It is a violation of these rules for a person to persist in contacting a prospective client when the prospective client has made known to the person, or the person should have known the prospective client's desire not to be contacted by the person.

(d) In the case of an electronic or direct mail communication, the person shall retain a copy of the actual communication along with a list or other description of parties to whom the communication was distributed. Such copy shall be retained by the person for a period of at least 36 months from the date of its last distribution.

(e) Subsection (d) of this section does not apply to anyone when:

(1) the communication is made to anyone who is at that time a client of the person;

(2) the communication is invited by anyone to whom it was made; or

(3) the communication is made to anyone seeking to secure the performance of professional accounting services.

. . .

Source Note: The provisions of this §501.82 adopted to be effective June 11, 2000, 25 Tex. Reg. 5340; amended to be effective February 17, 2008, 33 Tex. Reg. 1096; amended to be effective June 17, 2009, 34 Tex. Reg. 3947; amended to be effective December 7, 2011, 36 Tex. Reg. 8236.

ET § 1.600.001 Advertising and Other Forms of Solicitation Rule

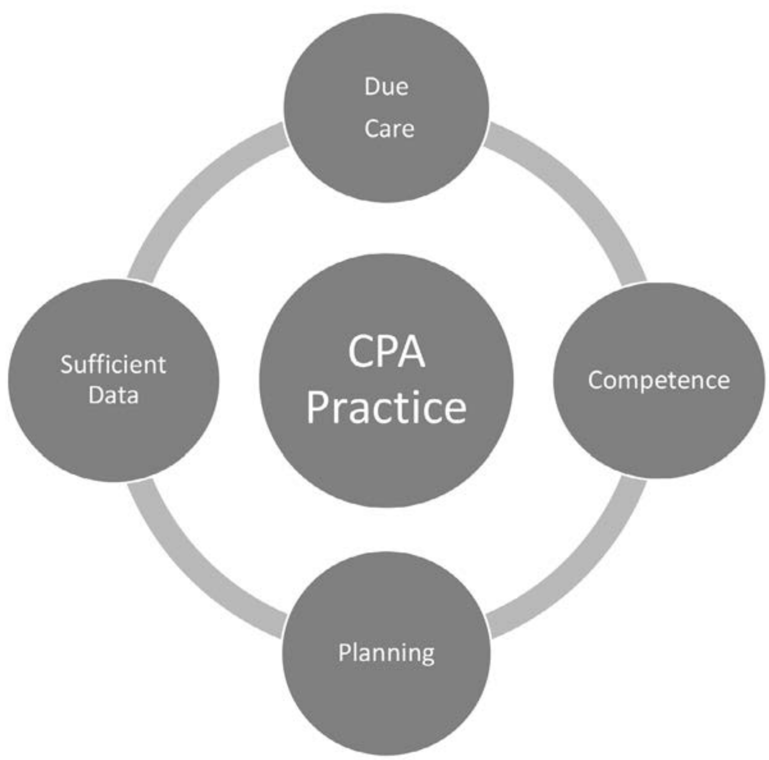
.01 A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited.

What Are Examples of False and Misleading Advertising or Solicitation?

- Statements that create false or unjustified expectations of favorable results.
- Advertising that implies the ability to influence any court, tribunal, regulatory agency, or similar body or official.
- Brochures that contain a representation that the member will perform specific professional services in current or future periods for a stated fee, estimated fee, or fee range when it is likely at the time of the representation that such fees would be substantially increased and the member failed to advise the prospective client of that likelihood.
- Other items that contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

--ET § 1.600.010.02

RESPONSIBILITIES TO CLIENTS/EMPLOYERS



--ET § 1.300.001 General Standards Rule

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

-- ET § 0.300.060.2

TX RPC §501.74 – Competence

(a) A person shall not undertake any engagement for the performance of professional accounting services or professional accounting work which he cannot reasonably expect to complete with due professional competence . . .

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

(2) If a person is unable to gain sufficient competence to perform professional accounting services or professional accounting work, the person shall suggest to the client the engagement of someone competent to perform the needed professional accounting or professional accounting work service, either independently or as an associate.

(b) A person shall exercise due professional care in the performance of professional services.

(c) A person shall adequately plan and supervise the performance of professional services.

(d) A person shall obtain and maintain appropriate documentation to afford a reasonable basis for conclusions and recommendations in relation to any professional services performed. . .

Source Note: The provisions of this §501.74 adopted to be effective June 11, 2000, 25 Tex. Reg. 5338; amended to be effective February 17, 2008, 33 Tex. Reg. 1093; amended to be effective December 7, 2011, 36 Tex. Reg. 8234

ET § 0.300.060 Due Care

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

ET § 1.300.010 Competence

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

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

TX RPC §501.76 – Records and Work Papers

(a) Records.

(1) A person shall return original client records to a client or former client within a reasonable time (promptly, not to exceed 10 business days) after the client or former client has made a request for those records. Original client records are those records provided to the person by the client or former client in order for the person to provide professional accounting services to the client or former client. Original client records also include those documents obtained by the person on behalf of the client or former client in order for the person to provide professional accounting services to the client or former client and do not include the electronic and hard copies of internal work papers. The person shall provide these records to the client or former client, regardless of the status of the client's or former client's account and cannot charge a fee to provide such records. Such records shall be returned to the client or former client in the same format, to the extent possible, that they were provided to the person by the client or former client. The person may make copies of such records and retain those copies.

(2) A person's work papers, to the extent that such work papers include records which would ordinarily constitute part of the client's or former client's books and records and are not otherwise available to the client or former client, shall also be furnished to the client within a reasonable time (promptly, not to exceed 20 business days) after the client has made a request for those records. The person can charge a reasonable fee for providing such work papers. Such work papers shall be in a format that the client or former client can reasonably expect to use for the purpose of accessing such work papers. . .

(b) Work papers. Work papers, regardless of format, are those documents developed by the person incident to the performance of his engagement which do not constitute records that must be returned to the client in accordance with subsection (a) of this section. Work papers developed by a person during the course of a professional engagement as a basis for, and in support of, an accounting, audit, consulting, tax, or other professional report prepared by the person for a client, shall be and remain the property of the person who developed the work papers.

TX RPC §501.76 – Records and Work Papers (continued)

(c) For a reasonable charge, a person shall furnish to his client or former client, upon request from his client made within a reasonable time after original issuance of the document in question:

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

(2) a copy of any report or other document previously issued by the person to or for such client or former client . . .

Source Note: The provisions of this §501.76 adopted to be effective June 11, 2000, 25 Tex. Reg. 5339; amended to be effective December 6, 2001, 26 Tex. Reg. 9859; amended to be effective February 4, 2004, 29 Tex. Reg. 963; amended to be effective February 17, 2008, 33 Tex. Reg. 1094; amended to be effective October 15, 2008, 33 Tex. Reg. 8512; amended to be effective December 7, 2011, 36 Tex. Reg. 8234; amended to be effective August 30, 2016, 41 Tex. Reg. 6498

ET § 1.230.010 Unpaid Fees

.2 Threats to the covered member's compliance with the "Independence Rule" [1.200.001] would not be at an acceptable level . . . if a covered member has unpaid fees from an attest client for any previously rendered professional service provided more than one year prior to the date of the current-year report. Accordingly, independence would be impaired. Unpaid fees include fees that are unbilled or a note receivable arising from such fees.

ET §1.400.200 Records Requests

.4 Unless a member and the client have agreed to the contrary, when a client makes a request for member- prepared records or a member's work products that are in the member's custody or control and that have not previously been provided to the client, the member should respond to the client's request as follows:

a) The member should provide member-prepared records relating to a completed and issued work product to the client, except that such records may be withheld if fees are due to the member for that specific work product.

b) Member's work products should be provided to the client, except that such work products may be withheld

   i. if fees are due to the member for the specific work product;

   ii. if the work product is incomplete;

   iii. if for purposes of complying with professional standards (for example, withholding an audit report due to outstanding audit issues); or

   iv. if threatened or outstanding litigation exists concerning the engagement or member's work.

.7 Working papers are the member's property, and the member is not required to provide such information to the client. However, state and federal statutes and regulations and contractual agreements may impose additional requirements on the member.

.8 In fulfilling a request for client-provided records, member-prepared records, or a member's work products, the member may

a) charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that the client pay the fee before the member provides the records to the client.

TX RPC §501.75 – Confidential Client Communications

(a) Except by permission of the client or the authorized representatives of the client, a [CPA] shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional accounting services or professional accounting work rendered to the client by the person. Such information shall be deemed confidential. . .

(b) The provisions contained in subsection (a) of this section do not prohibit the disclosure of information required to be disclosed by:

(1) the professional standards for reporting on the examination of a financial statement . . .;

(2) applicable federal laws, federal government regulations, including requirements of the PCAOB;

(3) a summons . . or under a court order signed by a judge if the summons or the court order:

(A) is addressed to the license holder;

(B) mentions the client by name; and

(C) requests specific information concerning the client.

(4) the public accounting profession in reporting on the examination of financial statements;

(5) a congressional or grand jury subpoena;

(6) investigations or proceedings conducted by the Board;

(7) ethical investigations conducted by a private professional organization of certified public accountants;

TX RPC §501.75 – Confidential Client Communications (continued)

(8) a peer review; or

(9) a review in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice if both firms enter into a written nondisclosure agreement with regard to all client information shared between the firms.

(c) The provisions contained in subsection (a) of this section do not prohibit the disclosure of information already made public, including information disclosed to others not having a confidential communications relationship with the client or authorized representative of the client. . .

Source Note: The provisions of this §501.75 adopted to be effective June 11, 2000, 25 TexReg 5338; amended to be effective February 4, 2004, 29 TexReg 963; amended to be effective February 17, 2008, 33 TexReg 1094; amended to be effective June 11, 2008, 33 TexReg 4503; amended to be effective January 28, 2009, 34 TexReg 428; amended to be effective October 7, 2009, 34 TexReg 6853; amended to be effective February 9, 2011, 36 TexReg 545; amended to be effective June 13, 2013, 38 TexReg 3606; amended to be effective August 4, 2016, 41 TexReg 5549

ET § 1.400.070/2.400.070 Confidential Information Obtained From Employment or Volunteer Activities

.1 A member should maintain the confidentiality of his or her employer's or firm's (employer) confidential information . . .

.4 When a member changes employment, a member should not use confidential employer information acquired as a result of a prior employment relationship to his or her personal advantage or the advantage of a third party, such as a current or prospective employer. . . . However, the member is entitled to use experience and expertise gained through prior employment relationships.

ET § 1.700.001 Confidential Client Information Rule

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

Case Study: Client Confidentiality

As a senior KPMG partner in charge of the firm's Pacific Southwest audit practice, Scott London was at a place that many people would have considered to be the top of his career. However, he was sentenced to 14 months in prison for passing on insider information in 2010 through 2012 on clients such as Herbalife and Skechers to help out friend Bryan Shaw who was experiencing financial difficulties. While Shaw ultimately realized trading profits of over $1.2 million, London by comparison did not benefit financially in any meaningful way despite having violated the Code of Professional Conduct and numerous federal laws. When asked in a later interview how London could reconcile violating the same rules that he expected his clients to follow, he replied, "To be honest, I can't. I knew the rules and followed them for 26 years [as a CPA working for KPMG]. I take full responsibility for what I did, but I am at a loss to say exactly why I allowed myself to break my moral and ethical code . . . Between the long tenure of being in the same position in my firm for possibly too long, and the desire to help out a friend, those factors may have lead to an impairment of judgment on my part."

London adds, "Dealing with the onslaught of media and the embarrassment of the arrest were the toughest battles of my life. The really hard part was damage to those innocent of my actions; my family, my employer and friends. . . It goes without saying, but I never intended any harm. . . Probably the most difficult was the loss of friends and colleagues at my former employer. Aside from the chance meetings in restaurants and such, I have not seen or heard from any of them. I worked there for nearly 30 years, and there are some long time relationships that are no longer."

As told in "Former KPMG Partner Scott London Shares Cautionary Tale Before Prison," Forbes Magazine, June 16, 2014.

TX RPC §501.72 - Contingency Fees

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

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

TX RPC §501.72 - Contingency Fees (continued)

(c) A person shall not perform an engagement as a testifying accounting expert for a contingent fee. A testifying accounting expert is one that at any time during the proceeding becomes subject to disclosure and discovery under the procedural rules of the forum where the matter for which his services were engaged is pending. . .

Source Note: The provisions of this §501.72 adopted to be effective June 11, 2000, 25 Tex. Reg. 5338; amended to be effective April 7, 2004, 29 Tex. Reg. 3474; amended to be effective April 13, 2005, 30 Tex. Reg. 2067; amended to be effective October 13, 2005, 30 Tex. Reg. 6432; amended to be effective February 17, 2008, 33 Tex. Reg. 1093

ET § 1.510.001 Contingent Fees Rule

.1 A member in public practice shall not

a) 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,

i. an audit or review of a financial statement . . .

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

TX RPC §501.71 - Receipt of Commission, Compensation or Other Benefit

(a) A person shall not for a commission, compensation or other benefit recommend or refer to a client any product or service or refer any product or service to be supplied to a client, or receive a commission, compensation or other benefit when the person also performs services for that client requiring independence under §501.70 of this chapter (relating to Independence).

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

(c) A person who receives, expects or agrees to receive, pays, expects or agrees to pay, other compensation in exchange for services or products recommended, referred, or sold by him shall, no later than the making of such recommendation, referral, or sale, disclose to the client in writing the nature, source, and amount, or an estimate of the amount when the amount is not known, of all such other compensation.

(d) This section does not apply to payments received from the sale of all, or a material part, of an accounting practice, or to retirement payments.

Source Note: The provisions of this §501.71 adopted to be effective June 11, 2000, 25 Tex. Reg. 5337; amended to be effective February 4, 2004, 29 Tex. Reg. 963; amended to be effective February 17, 2008, 33 Tex. Reg. 1092; amended to be effective April 15, 2009, 34 Tex. Reg. 2379; amended to be effective December 7, 2011, 36 Tex. Reg. 8233.

ET § 1.520.001 Commissions and Referral Fees Rule

.1 *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 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.

.4 *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.

ET § 1.700.020 Disclosing Information From Previous Engagements

.2 When a member withdraws from an engagement due to, for example, discovery of irregularities in a client's tax return, if contacted by the successor, the member should suggest that the successor ask the client to permit the member to discuss all matters freely with the successor.

ET § 1.700.030 Disclosing Information to Persons or Entities Associated With Clients

.1 When a member is engaged to prepare a married couple's joint tax return, both spouses are considered to be the member's client, even if the member was engaged by one spouse and deals exclusively with that spouse.

.2 Accordingly, if the married couple is undergoing a divorce and one spouse directs the member to withhold joint tax information from the other spouse, the member may provide the information to both spouses, in compliance with the "Confidential Client Information Rule" [1.700.001], because both are the member's clients.

RESPONSIBILITIES TO THE BOARD/PROFESSION

ET § 0.300.020 Responsibilities

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

TX RPC §501.90 - Discreditable Acts

A person shall not commit any act that reflects adversely on that person's fitness to engage in the practice of public accountancy. A discreditable act includes but is not limited to:

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

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

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

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

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

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

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

(8) a conviction or final finding of unethical conduct by state or federal agencies or boards, local governments or commissions for violations of laws or rules on ethics by licensees that engage in activities regulated by those entities including but not limited to: the Public Company Accounting Oversight Board, Internal Revenue Service, U.S. Securities and Exchange Commission, U.S. Department of Labor, U.S. General Accounting Office, U.S. Housing and Urban Development, Texas State Auditor, Texas State Treasurer, Texas Securities Board, Texas Department of Insurance, and the Texas Secretary of State;

TX RPC §501.90 - Discreditable Acts (continued)

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

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

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

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

(13) intentionally misrepresenting facts or making a misleading or deceitful statement to a client, the board, board staff or any person acting on behalf of the board;

(14) giving intentional false sworn testimony or perjury in court or in connection with discovery in a court proceeding or in any communication to the board or any other federal or state regulatory or licensing body;

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

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

(17) voluntarily disclosing information communicated to the person by an employer, past or present, or through the person's employment in connection with accounting services rendered to the employer, except:

(A) by permission of the employer;

(B) pursuant to the Government Code, Chapter 554 (commonly referred to as the "Whistle Blowers Act");

(C) pursuant to:

(i) a court order signed by a judge;

(ii) a summons under the provisions of:

TX RPC §501.90 - Discreditable Acts (continued)

(I) the Internal Revenue Code of 1986 and its subsequent amendments;

(II) the Securities Act of 1933 (15 U.S.C. §77a et seq.) and its subsequent amendments; or

(III) the Securities Exchange Act of 1934 (15 U.S.C. §78a et seq.) and its subsequent amendments;

(iii) a congressional or grand jury subpoena; or

(iv) applicable federal laws, federal government regulations, including requirements of the PCAOB;

(D) in an investigation or proceeding by the board;

(E) in an ethical investigation conducted by a professional organization of CPAs;

(F) in the course of a peer review under §901.159 of the Act (relating to Peer Review); or

(G) any information that is required to be disclosed by the professional standards for reporting on the examination of a financial statement.

(18) breaching the terms of an agreed consent order entered by the board or violating any Board Order. . .

Source Note: The provisions of this §501.90 adopted to be effective June 11, 2000, 25 Tex. Reg. 5340; amended to be effective October 16, 2002, 27 Tex. Reg. 9573; amended to be effective February 4, 2004, 29 Tex. Reg. 964; amended to be effective June 7, 2006, 31 Tex. Reg. 4642; amended to be effective February 17, 2008, 33 Tex. Reg. 1097; amended to be effective August 17, 2008, 33 Tex. Reg. 6372; amended to be effective January 28, 2009, 34 Tex. Reg. 429; amended to be effective June 17, 2009, 34 Tex. Reg. 3948; amended to be effective December 7, 2011, 36 Tex. Reg. 8237; amended to be effective June 13, 2013, 38 Tex. Reg. 3608; amended to be effective October 8, 2014, 39 Tex. Reg. 7919

ET § 1.400.001 Acts Discreditable Rule

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

ET § 1.400.010/2.400.010 Discrimination and Harassment in Employment Practices

.01 A member would be presumed to have committed an act discreditable to the profession, in violation of the “Acts Discreditable Rule” [1.400.001] if a final determination, no longer subject to appeal, is made by a court or an administrative agency of competent jurisdiction that a member has violated any antidiscrimination laws of the United States, a state, or a municipality, including those related to sexual and other forms of harassment.

ET § 1.400.030/2.400.030 Failure to File a Tax Return or Pay a Tax Liability

.01 A member who fails to comply with applicable federal, state, or local laws or regulations regarding (a) the timely filing of the member's personal tax returns or tax returns of the member's firm that the member has the authority to timely file or (b) 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 the "Acts Discreditable Rule"

ET § 1.400.040 Negligence in the Preparation of Financial Statements or Records

.01 A member shall be considered in violation of the "Acts Discreditable Rule" [1.400.001] if the member, by virtue of his or her negligence, does any of the following:

a) Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity.

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.

c) Signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .05 of ET section 501]

ET § 1.400.050 Governmental Bodies, Commissions, or Other Regulatory Agencies

.01 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 SEC; the Federal Communications Commission; state insurance commissions; and other regulatory agencies, such as the PCAOB, have established such requirements.

.2 If a member prepares financial statements or related information for purposes of reporting to such bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations, in addition to the applicable financial reporting framework.

.4 A member's material departure from such requirements would be considered a violation of the "Acts Discreditable Rule" [1.400.001] unless the member discloses in the financial statements or his or her report, as applicable, that such requirements were not followed and the applicable reasons.

TX RPC §501.80 - Practice of Public Accountancy

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

(b) Any licensee of this board in good standing as a CPA or public accountant may use such designation whether or not the licensee is in the client, industry, or government practice of public accountancy. However, a licensee who is not in the client practice of public accountancy may not in any manner, through use of the CPA designation or otherwise, claim or imply independence from his employer or that the licensee is in the client practice of public accountancy.

Source Note: The provisions of this §501.80 adopted to be effective June 11, 2000, 25 Tex. Reg. 5339; amended to be effective February 4, 2004, 29 Tex. Reg. 964; amended to be effective June 9, 2004, 29 Tex. Reg. 5626; amended to be effective February 17, 2008, 33 Tex. Reg. 1095; amended to be effective December 7, 2011, 36 Tex. Reg. 8235; amended to be effective June 10, 2015, 40 Tex. Reg. 3565

ET § 1.400.100 Use of the CPA Credential

.01 . . . A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the "Acts Discreditable Rule"

ET § 1.800.001 Form of Organization and Name Rule

.2 A member shall not practice public accounting under a firm name that is misleading.

.3 Names of one or more past owners may be included in the firm name of a successor organization.

ET § 2.400.040 Negligence in the Preparation of Financial Statements or Records

.1 A member shall be considered in violation of the "Acts Discreditable Rule" [2.400.001] if the member, by virtue of his or her negligence, does any of the following:

a) Makes, or permits or directs another to make, materially false and misleading entries in the financial statements or records of an entity.

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.

c) Signs, or permits or directs another to sign, a document containing materially false and misleading information. [Prior reference: paragraph .05 of ET section 501]

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART II: TEST YOUR KNOWLEDGE

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

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Bob, a sole practitioner CPA, serves as an external auditor for Spicy Suds Car Wash and Taco Stand, Inc. Bob owns 25% of the voting stock of Spicy Suds but does not serve on its management team. Which of the following statements is <u>false</u>:**

A. Bob has a conflict of interest since he owns a significant stake in Spicy Suds

B. there are no issues that would prevent Bob from performing the audit despite his ownership interest since Bob is not part of Spicy Suds's management team

C. Bob, in his role as auditor, would be challenged to be objective since adverse findings would directly impact the value of his stake in Spicy Suds

D. Bob's independence has the appearance of being compromised

2. **Christopher is on an attest engagement for Ray and Tom's Car Repair and Gelato shop. Which situation below would lead to Christopher's independence being compromised:**

A. Christopher is in the process of suing Ray and Tom due to food poisoning symptoms Christopher experienced after eating some of his client's gelato

B. Christopher has been on this audit team for 12 years and at this point is close friends with both Ray and Tom

C. Ray and Tom have asked Christopher to serve on the Board of Directors

D. all of the above

3.	**Krishna is on the audit team of Luciano's Pizza and Tanning Salon. Which situation below would lead to her independence being compromised:** **A.** Krishna is also a stockbroker on the side and has recommended to her clients to buy stakes in Luciano's. She will receive a commission for each stake she sells **B.** Luciano's has told Krishna that they will hire all of her five children as summer interns if certain EPS targets are reached **C.** Krishna's firm had previously been engaged for a series of extensive tax planning projects, some of which were aggressive. Krishna is finding herself having to evaluate these tax planning projects as part of putting together the tax provision **D.** all of the above
4.	**As detailed in the course material, the accountants at WorldCom, under pressure from the CFO, agreed to change the interim financial statements so that expenditures, which should have been currently expensed through the P & L were instead capitalized or charged against "cookie jar" reserves. The accountants had determined earlier that expensing was the correct treatment, but they made the changes anyway, even though the CFO was unable to come up with any support. Which of the following best describes the accountants' actions:** **A.** subordination of judgment **B.** "boss management" **C.** a legal act in most states **D.** none of the above
5.	**What are the main steps a CPA should apply as it pertains to threats to independence:** **A.** identify any threats **B.** evaluate the significance of the threat **C.** identify and apply effective safeguards **D.** all of the above

6.	**The Due Care principle under TX RPC § 501.74 includes which of the following:** **A.** strive to continually improve competence **B.** work to improve quality of services **C.** discharge professional responsibility to the best of the CPA’s ability **D.** all of the above

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART II: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

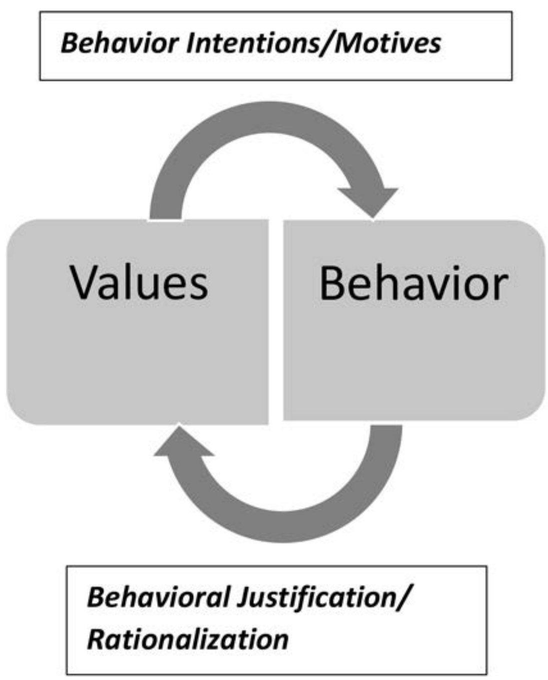
1.	**A.** Incorrect. E.T. § 1.110.010 states that ownership interest in a client, especially one as significant as in this example (25%), constitutes a conflict of interest. **B.** CORRECT. States that an interest in the client presents a self-interest threat to Independence. **C.** Incorrect. This situation describes the classic conflict of interest situation per TX RPC § 501.73. **D.** Incorrect. Even if Bob argues that his independence is not actually compromised, he certainly has the appearance of compromise, per ET § 0.400.21. *(See pages 22 to 24 of the course material.)*
2.	**A.** Incorrect. While this situation is an example of adverse interest, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **B.** Incorrect. While this situation is an example of familiarity, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **C.** Incorrect. While this situation is an example of management participation, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **D.** CORRECT. All of the above situations show that the CPA's independence may be compromised due to management participation, adverse interest or familiarity with management per ET § 1.210.010. *(See pages 22 to 24 of the course material.)*
3.	**A.** Incorrect. While this situation is an example of advocacy, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **B.** Incorrect. While this situation is an example of self-interest, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **C.** Incorrect. While this situation is an example of self-review, all of the situations described indicate a threat to independence. Therefore the answer is all of the above. **D.** CORRECT. All of the above situations show that the CPA's independence may be compromised due to advocacy, self-interest, and self-review ET § 1.210.010. *(See pages 22 to 24 of the course material.)*

4.	**A.** CORRECT. The fact that the accountants were willing to "cave" to the CFO's demands despite the lack of support constitutes subordination of judgment per ET § 1.130.020. **B.** Incorrect. A CPA is not justified in carrying out an action merely to appease the boss. **C.** Incorrect. The accountants committed a fraudulent act which violates all states' laws as well as federal laws, such as those promulgated by the SEC. **D.** Incorrect. Their acts constitute subordination of judgment as described in answer "A" above. *(See page 25 of the course material.)*
5.	**A.** Incorrect. The main steps also include evaluation of the significance of the threat and identification and application of effective safeguards. **B.** Incorrect. The main steps also include identification of any threats and identification and application of effective safeguards. **C.** Incorrect. The main steps also include identification of any threats and evaluation of the significance of the threat. **D.** CORRECT. All the steps above are needed to manage threats to independence per ET §§ 1.000.010/2.000.010. *(See page 29 of the course material.)*
6.	**A.** Incorrect. Due Care also includes to work to improve quality of services and discharge professional responsibility to the best of the CPA's ability. **B.** Incorrect. Due Care also includes to strive to continually improve competence and discharge professional responsibility to the best of the CPA's ability **C.** Incorrect. Due care also includes to strive to continually improve competence and work to improve quality of services. **D.** CORRECT. Due Care includes all of the above per TX RPC § 501.74. *(See page 36 of the course material.)*

PART III: BEHAVING ETHICALLY: PUTTING THE RULES INTO ACTION

Owen and David Cherrington, in their book *Moral Leadership and Ethical Decision Making*, describe the relationship between values and a person's behavior. Ideally, one's internal compass should be demonstrated outwardly by the person's usual behavior. So, a person who has high moral standards would normally act in an ethical way in most circumstances. If this individual started behaving in a way contrary to his or her values, a person's conscience would cause him or her to return back to being consistent with established values. If this person was bound and determined to persist in bad acts even though it was not reflective of established values, the individual would have to start rationalizing his or her behavior in order to quell the power of the conscience.

Herein lies the crux of the matter: most people *know* what is the right thing to do, but they sometimes do not want to do it either because of greed, feelings of entitlement, or other factors. Rationalization helps neutralize the power of the conscience to put us back on the straight and narrow. The unfortunate side effect is that this rationalization can then change a person's values because of a need for "cognitive consistency."



From Cherrington, Owen, and Cherrington, David, Moral Leadership and Ethical Decision Making (UT: CHC Forecast, 2000), pg. 40.

This cycle can either be used to help an individual attain higher moral standards or lower moral standards, but rarely can a person stay static. Case in point: if an individual commits to changing his or her eating habits from junk food to healthy choices, the new menu may initially feel uncomfortable and unnatural. However, as the person gets used to the good food, they may start to enjoy feeling healthier and may start to crave all the new cuisine. Later, when the dieter is offered his or her old food choices, it becomes easy to refuse them as he or she has now established a new way of life.

One's ethical life is similar: a good ethical choice begets a habit, a habit begets an attitude, and an established attitude becomes internalized. Once an action becomes a way of life, an individual may experience slight aberrations from time to time, but will generally act consistently with his or her nature. Unfortunately, the reverse is true as well. A person can start off with high moral standards, but through a series of compromise can eventually find him or herself in an ethical quagmire, which could lead to very serious consequences. Below are examples of justifications used by individuals to rationalize bad behavior:

ETHICS ALARMS: UNETHICAL RATIONALIZATIONS AND MISCONCEPTIONS[1]

1. The Golden Rationalization, or "Everybody does it."
2. Ethics Surrender, or "We can't stop it."
3. A Sicilian Ethics, or "They had it coming"
4. Marion Barry's Misdirection, or "If it isn't illegal, it's ethical."
5. The "Tit for Tat" Excuse
6. The Trivial Trap ("No harm no foul")
7. The Unethical Tree in the Forest, or "What they don't know won't hurt them."
8. The King's Pass, The Star Syndrome, or "What Will We Do Without Him?"
9. The Saint's Excuse, "It's for a good cause"
10. The Futility Illusion: "If I don't do it, somebody else will."
11. The Perfect Diversion: "Nobody's Perfect?" or "Everybody makes mistakes?"
12. The Victim's Distortion "I'm being punished for doing the right thing."
13. The Prospective Repeal: "It's a bad law/stupid rule"
14. The Troublesome Luxury: "Ethics is a luxury we can't afford right now"
15. "We've never had a problem with it!"
16. The Apathy Defense, or "Nobody Cares."
17. Tessio's Excuse, or "It's just business"
18. "I'm all right with it!" organizational abuse

1. From https://ethicsalarms.com/rule-book/unethical-rationalizations-and-misconceptions/ downloaded 7/7/2016 1:30 p.m.

The list above is obviously the mere tip of the iceberg on the rationalizations posited for bad behavior. The real tragedies are the individuals, employers, shareholders, and customers who are gravely impacted as an end result. The case study below illustrates how the corrupt actions of one individual nearly destroyed a thriving internationally known family business that had served its community in Central Texas for over 100 years.[2]

Case Story: Collin Street Bakery

Collin Street Bakery is synonymous with the word “fruitcake,” a Christmas-time delicacy mostly desired and occasionally derided. The family-owned business was founded in 1896 in the small town of Corsicana, Texas, just 50 miles south of Dallas. Due to the high quality of its cakes and consistently excellent management (now in its fourth generation), Collin Street Bakery outlasted its worthy competitors and boasts an international following, shipping 3 million pounds of fruitcake every year to 196 countries. Its clientele included Will Rogers, The Ringling Brothers Circus, and more recently, Princess Caroline of Monaco, Vanna White, Ernest Borgnine, Estee Lauder, Zubin Mehta, among many other luminaries.

Sadly, this highly profitable and major regional employer nearly had to shut its doors. Sandy Jenkins, the Company’s Controller, was arrested in 2013 for embezzling around $17 million of Company funds over a nine-year period.

Sandy and his wife, Kay, had lived a quiet, solidly middle-class existence on a $50,000 a year salary in 2004, the year the defalcations began. He was known to be an introverted, non-descript man with “zero personality” – basically invisible. Kay was far more outgoing and sociable. However, the couple’s outside activities were limited, based on their income level, to volunteering at church and cooking gourmet dishes at home. Reporter Katy Vine, writing for *Texas Monthly*, posits that the main motivation for this crime was the desire to join the local high-roller set, whose multi-generational millionaire lifestyles had been funded by oil, natural gas, cattle and – as it pertained to the upper-level management team – the bakery.

At first, Sandy was able to easily steal from petty cash due to poor internal controls on the accounting system. He rationalized that he was doing three different jobs at the bakery and was under-compensated. Before long, Sandy found he could write a manual check on the bakery’s register to cover his personal expenses. His actions lay undiscovered for almost nine years since Sandy would cancel the manual check on the company’s register, but would then subsequently input the same amount of payment except using the name of a legitimate vendor.

The vendor’s check would never be mailed, but the first manual check would be cashed. Since the overall general ledger and cash account would tie out, no one ever verified the actual entity that endorsed the check. Sandy began to enjoy the finer things in life. He was no longer invisible.

2. Vine, Katy, “Just Dessserts,” Texas Monthly, January, 2016. http://www.texasmonthly.com/articles/just-desserts/ (downloaded 8/4/2016 2:21 p.m. CST). Clientele list and history from https://www.collinstreet.com/clientele (downloaded 8/6/2016 3:38 p.m. CST).

Case Story: Collin Street Bakery (continued)

Within a short period of time, Sandy and Kay were spending up to $98,000 a month on their credit cards, which would be summarily paid by Collin Street Bakery funds. The couple found they had the wherewithal to have major renovations done on their home and to buy a second house in Santa Fe.

Additionally, they joined exclusive local supper-clubs, the top country club, and collected bottles of wine costing up to hundreds, if not thousands, of dollars each. Sandy outfitted himself with several new luxury watches, some costing more than $25,000, to accessorize his new $600 Armani and Hermes shirts and Gucci shoes. For Kay, Sandy would purchase hundreds of thousands of dollars worth of jewels, furs and clothes. Brand-new luxury cars would rotate through the Jenkins' garage with dizzying speed. Private chartered jet trips averaging around $500,000 a year were de rigueur during this period.

Interestingly, it was a newly hired, lower level accountant who discovered the discrepancies. In all, Sandy had stolen more than $114,000 in cash and $16.7 million in checks over ***nine hundred occasions!*** Ultimately, Sandy was convicted and sentenced to ten years in prison. Kay received a sentence of 5 years probation. The Jenkins' house and all of their belongings were sold at auction to pay back, albeit only in part, Sandy's former employer.

Thankfully, Collin Street Bakery was able to weather these staggering losses and continues its business of supplying fruitcakes to the world.

While the case study above is a notorious example of an individual's poor personal choices, companies, due to an immoral tone from the top, can become a dissolute cesspool replete with corrupt business practices that ultimately cause an implosion of the organization. Noted author and speaker Marianne Jennings discusses common factors that indicate an organization has started spiraling downward morally. She posits in her recent book, "ethical collapse occurs when any organization has drifted from the basic principles of right and wrong."[3] If your employer or client exhibits any of the seven signs listed below, consider it a "red flag" or "warning sign."

Seven Signs That An Organization Is on the Verge of an Ethical Collapse

- **Pressure to maintain numbers –** Management teams, which have an unreasonable and unrealistic *obsession* with meeting qualitative goals (some to the extent that they make promises to the market), will be more likely to either shade the truth or commit outright fraud.
- **Fear and silence –** Companies in which employees, upon raising questions or concerns, are fired, demoted or transferred are creating a perfect environment for cover-up.

3. Jennings, Marianne, Seven Signs of Ethical Collapse: How to Spot Moral Meltdowns in Companies . . . Before It's Too Late" (NY: St. Martin's Press, 2006), pg. xii.

Seven Signs That An Organization Is on the Verge of an Ethical Collapse (continued)

- **Young'uns and a larger-than-life CEO –** A sycophantic – and often young and inexperienced – management team has the potential to be steamrolled by a charismatic or iconic CEO. These executives may find it difficult to refuse the CEO's demands and may find themselves complicit in the CEO's bad acts.
- **A weak board –** A board, in which the directors are not fully engaged, is unable to check a bad leader if his or her agenda becomes unethical.
- **Conflicts of interest and nepotism –** Managers that hire outsiders or family members because of their own self-interest, instead of which individual is the best fit for the organization, are compromising interests of the shareholders, creditors and other stakeholders.
- **Innovation like no other –** Company leaders that achieve quick success through a product innovation or a novel approach to doing business can find themselves eschewing arrogance and believing that the rules under which mere mortals are subject to do not apply to them.
- **Belief that goodness in some areas atones for wrongdoing in others –** Often, perpetrators rationalize that generous charitable donations and showy support of worthy causes act as an offset to their embezzlement.

All of us can easily see the commonalities in the list above and some of the headline grabbing failures such as Dynergy, MCI, WorldCom, Enron, and the rest of the well-known fiascos. When a CPA finds him or herself part of an organization where there are signs that questionable activity is taking place, what should be his or her response? Cherrington and Cherrington describe common situations in which moral failure is more likely to occur:

1. The individual fails to recognize the existence of a moral problem.
2. The person may recognize a moral dilemma but does not know how to resolve it.
3. The employee knows the right thing to do but fails to do it because he or she puts a higher priority on other values
4. The involved party does the right thing occasionally but not all the time.[4]

4. Cherrington, pgs.61-64.

Case Study: HealthSouth - A Lesson on How to Intimidate 5 CFOs

HealthSouth, another former Fortune 500 company high-flyer located in Birmingham, Alabama, is a textbook case of an organization which did collapse ethically due in large part to HealthSouth's larger-than-life CEO, Richard Scrushy. He was credited at its height for putting together the largest U.S. consortium of occupational therapy centers, surgical centers, diagnostic centers, and outpatient clinics among other lines of business. Scrushy though, was also known to control others, alternating charm with fear and intimidation. Around 1996, it became apparent that the financial statements would not meet analyst expectations. That was the start of the long-running fraud at HealthSouth, with the accountants essentially being the trigger men. Scrushy demanded that the accounting department engage in acts such as overestimating insurance reimbursements, improperly categorizing fixed-asset accounts and related capital expenses, and excessively charging reserve accounts. These actions ultimately caused $2.7 billion of fake revenues to be recognized over a six-year period.

All of the last five CFOs, up to the time HealthSouth was raided by the FBI in March 2003, plead guilty to various criminal charges. Aaron Beam, Jr., Michael D Martin, William T. Owens, Weston Smith, and Malcolm "Tadd" McVay also agreed to testify against Scrushy, but even this action did not prevent all of them from serving jail time. For those of us in the accounting community, it boggles the mind that not one of the five CFOs was willing to stand up to what many described as an intimidating, petulant, mercurial and abusive boss who publicly berated those who failed to satisfy his demands. The August, 2012 edition of *Journal of Accountancy* states in its article, "What's Your Fraud IQ?" that the main reason CFOs commit financial fraud is *not* because they are trying to hide their own errors or benefit directly, but because of pressure from the CEO. One would surmise that of all of the individuals in Finance, the CFO would be most likely the one to weather any storm financially or to be able to obtain another job quickly. With these kind of options, it seems that these five people would have had every incentive to walk away from their jobs rather than blatantly break the law and subject themselves to jail time, financial ruin, and the devastating fallout for their families.

As recounted by Beam, Aaron, HeathSouth: The Wagon to Disaster (AL: Wagon Publishing, 2009).

The AICPA Code of Professional Conduct gives guidance to CPAs as to when a moral problem or dilemma exists.

ET § 1.000.020/2.000.20 Ethical Conflicts

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

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

b) Conflicts in applying relevant professional standards or legal standards

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

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

Once an ethical conflict is recognized, the CPA *must* intentionally put the public interest (e.g., properly reflecting the financial condition of the CPA's client or employer, or properly administering the tax laws) over the directives of management or over the CPA's own interests. There is no more dramatic example of how two groups of CPAs working for the same company handled a conflict of interest than the accountants of WorldCom, a former Fortune 500 company, which in mid-2002 was raided by the FBI and other government officials for perpetuating an accounting fraud, which ultimately topped over $11 billion. In Part II, we detailed in a case study the subordination of judgment by the financial accountants to improperly book expenses to either liabilities or capital accounts, thereby distorting net income and the balance sheet. Below, we will discuss the courageous actions of a second group of accountants, the internal auditors. The group investigated and uncovered the fraud even though they were under tremendous pressure from the management to look the other way.

Case Study: WorldCom Part II - The Auditors Stand Firm

WorldCom financial accountants, David Myers, Betty Vinson, Troy Norman and Buddy Yates, had started improperly raiding the "cookie jar" reserves and capitalizing expenses as early as 2000 after having been pressured to do so by CFO Scott Sullivan in order to meet analysts' expectations. In mid-2002, WorldCom's internal audit team, ignorant of the fraud that had been taking place, began to look at some of these accounts and were unable to find appropriate supporting documentation. Vice President Cynthia Cooper took her team's findings to Sullivan only to be rebuffed. He and others on the management team became hostile and demanded that the internal audit department stop combing through the capital expenditure accounts.

Understanding that something was badly amiss, Cooper and her team found themselves at a crossroads: they could choose to comply and turn a blind eye to the situation, or they could continue investigating even though it could mean the loss of their jobs. The auditors determined that it was more important to find out the truth despite the possibility of negative personal consequences. They decided to download the general ledger at night and on weekends to an external server they had purchased and to mine the data for incongruities during non-business hours. Had they tried these functions during regular business hours, it would have slowed down the accounting system to the extent that those antagonistic to their operations could have become suspicious. For months, this dedicated group worked their day jobs as usual, then during all other waking hours continued to gather documentation of the fraud.

Case Study: WorldCom Part II - The Auditors Stand Firm (continued)

Cooper, finally armed with incontrovertible proof that at least $3 billion of expenses had been improperly classified, chose to notify directly a member of the Company's Audit Committee and Farrell Malone, a KPMG partner heading the external audit. By this time, it was apparent that attempting to get the issue resolved through internal channels, e.g., through Financial Accounting and ultimately through the CFO, would be futile. Cooper realized that her actions posed significant risk not only to herself but her entire team as well. If no one ultimately backed her department's findings, the internal audit department would have essentially committed political suicide and they would be forced to leave.

Likewise, Malone and KPMG, recent successors to the audit following Arthur Andersen's demise, also found themselves in a predicament. Bringing up significant accounting aberrations to a management team that clearly wanted to follow their own agenda could mean that the accounting firm could quickly lose a client should WorldCom decide to go shopping for an opinion.

Fortunately, both the internal audit team and KPMG made the deliberate choice to expose the fraud despite the potential consequences. This set in motion WorldCom ultimately declaring bankruptcy. The internal auditors along with most of the other 100,000 employees lost their jobs and KPMG lost a client. However, their actions at the end of the day ensured that the perpetrators were brought to justice and the integrity of the U.S. accounting system and by extension, the capital markets, were protected.

As told in Cooper, Cynthia, Extraordinary Circumstances (NJ: Wiley & Sons, 2008).

Cynthia Cooper discusses at the end of her book, principles which she relied upon when she and her team made the crucial decision to defy management and investigate the accounting irregularities. Despite the immoral headwinds that they faced, the internal audit group at the end of the day had to make a gritty decision to see the situation through, even though it was likely to lead to the demise of the organization.

The Bottom Line: Keeping Yourself on the Straight and Narrow

- Know what you believe is right and wrong. Write down the values you will live by and what you will do if your values collide. Is your moral compass pointed in the right direction? Are your priorities in the right order?
- When making decisions, apply the Golden Rule: Treat other people the way you would want to be treated . . .
- Guard against being lulled into thinking you're not capable of making bad decisions. . . Keep in mind that what is legal and what is ethical are sometimes different . . .

The Bottom Line: Keeping Yourself on the Straight and Narrow (continued)

- Ask yourself: Would I be comfortable with my decisions landing on the front page of a newspaper? . .
- Practice ethical decision making every day . . .
- Discuss tough ethical dilemmas with others you respect. Find your courage. [“Courage is fear that has said its prayers.”]
- Apply the same code of ethics whether at home, work, school or a house of worship. . .
- Pay attention to your instincts . . .
- Above being loyal to your superiors, be loyal to your principles . . .

Summarized from Cooper, Cynthia, Extraordinary Circumstances (NJ: Wiley & Sons, 2008), pgs. 365-366.

Similar to these WorldCom internal auditors, CPAs must be unflinching in protecting the public interest if faced with an ethical dilemma even if it is accompanied by tremendous pressure to ignore bad behavior or to become complicit. What is a CPA to do if, during a time of momentary weakness, the accountant has failed in some way to uphold the standards and behavior that is expected? Fortunately, moral character is not static and a person always has an opportunity to improve his or her character. Cherrington and Cherrington lays out actions for rebuilding moral character:[5]

5. *Cherrington, pg. 47.*

As mentioned earlier, the CPA *must* choose public good (e.g., transparency in accounting, fair administration of the tax laws) over his or her own wishes or the agendas of the client, should they come into conflict.

What will you do when you face ethical challenges?

CONCLUSION

One of the most important tools is to know what is the right thing to do. In some cases, the right and wrong action are clear and unmistakable. More often, we are faced with shades of gray where one or more choices have pros and cons. Our challenge as CPAs is to use good judgment in ascertaining which are the best of these choices. This judgment must be free of biases, must be objective and independent of any client demands that are in contravention to an individual's personal principles, the Code of Professional Conduct and any other accounting rules to which a CPA is subject.

Secondly, it is not enough to know what is the right thing to do with respect to our own conscience and the rules; the more difficult task is taking action on what we have determined to be the best course of action. Most people know what is the right thing to do in any given situation; it is DOING IT where many individuals fall short. Here, courage, determination and accountability can be helpful tools in "getting the job done." If a person has internalized his or her values and always strives to act in the most ethical manner possible, when challenges come he or she will tend to fall back on their instincts and training and it will not be as much of a struggle to choose to do the right thing. In addition, CPAs must consider removing any barriers in doing the right thing, which include having back up plans in case it becomes necessary to leave a job or fire a client.

Third, be aware that ethical traps are present all day, every day. Many individuals, whom we would categorize as being "a good person" have made bad decisions and have found themselves far down the slippery slope of moral compromise. CPAs who are sensitive to the presence of these pitfalls will be far more careful of their decisions and are more likely to avoid ethical dilemmas.

PART III: TEST YOUR KNOWLEDGE

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

We recommend that you answer each question and then compare your response to the suggested solutions on the following page(s) before answering the final exam questions related to this chapter (assignment).

1. **Which of the following is a sign than an organization is on the verge of an ethical collapse:**

A. management is unreasonably obsessed with analysts' expectations and are pressuring the accountants to "do what it takes" for the financial statement to match external metrics

B. the Board of Directors is either closely related to the CEO or is easily intimidated

C. management has shown a willingness to fire or demote employees who raise questions or concerns

D. all of the above

2. **When do ethical conflicts arise:**

A. when the CPA experiences obstacles to following an appropriate course of action due to internal or external pressures

B. when the CPA has the duty to maintain client confidentiality, but has just discovered evidence that criminally fraudulent acts are being committed

C. both A and B above

D. none of the above

3. **The course materials discuss action steps a person can take to rebuild moral character. Which of the following are parts of these steps:**

A. recognize what is wrong

B. feel remorse and resolve to change

C. plan new behavioral intentions and demonstrate improved moral behavior

D. all of the above

THIS PAGE INTENTIONALLY
LEFT BLANK.

PART III: SOLUTIONS AND SUGGESTED RESPONSES

Below are the solutions and suggested responses for the questions on the previous page(s). If you choose an incorrect answer, you should review the pages as indicated for each question to ensure comprehension of the material.

1.	**A.** Incorrect. This is true, however, signs of ethical collapse also include a closely related or easily intimidated Board of Directors and a management willing to fire or demote employees who raise questions or concerns. **B.** Incorrect. This is true, however, signs of ethical collapse also include management that is unreasonably obsessed with analysts' expectations or is willing to fire or demote employees who raise questions or concerns. **C.** Incorrect. This is true, however, signs of ethical collapse also include management that is unreasonably obsessed with analysts and a closely related or easily intimidated Board of Directors. **D.** CORRECT. All of the above items are included in Marianne Jennings' "The Seven Signs of Ethical Collapse." *(See page 60 of the course material.)*
2.	**A.** Incorrect. This is true, however, an ethical conflict would also include the situation when the CPA has the duty to maintain client confidentiality, but has just discovered evidence that criminally fraudulent acts are being committed. **B.** Incorrect. This is true, however, an ethical conflict would also include the situation when the CPA experiences obstacles to following an appropriate course of action due to internal or external pressures. **C.** CORRECT. An ethical conflict would encompass both answers above per ET §§ 1.000.020/2.000.020 **D.** Incorrect. An ethical conflict would include both A and B above per ET §§ 1.000.020/2.000.020. *(See page 62 of the course material.)*

3.	**A.** Incorrect. Action steps a person can take to rebuild moral character also include to feel remorse and resolve to change, plan new behavioral intentions and demonstrate improved moral behavior. **B.** Incorrect. Action steps a person can take to rebuild moral character also include to recognize what is wrong, plan new behavioral intentions and demonstrate improved moral behavior. **C.** Incorrect. Action steps a person can take to rebuild moral character also include to recognize what is wrong and feel remorse and resolve to change. **D.** **CORRECT**. According to the Cherrington paradigm, all of these steps are part of the process to improve moral character. *(See page 65 of the course material.)*

GLOSSARY

Adverse interest threat: The threat that a member will not act with objectivity because the member's interests are opposed to the interests of the employing organization.

Advocacy threat: The threat that a member will promote an employing organization's interests or position to the point that his or her objectivity is compromised.

Applied ethics: The philosophical examination, from a moral standpoint, of particular issues in private and public life which are matters of moral judgment. It is thus the attempts to use philosophical methods to identify the morally correct course of action in various fields of everyday life.

Consequentialism: The doctrine that the morality of an action is to be judged solely by its consequences.

Credit default swaps (CDSs): A financial contract whereby a buyer of corporate or sovereign debt in the form of bonds attempts to eliminate possible loss arising from default by the issuer of the bonds.

Deontology: The normative ethical position that judges the morality of an action based on rules.

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

Golden Rule: The principle of treating others as one would wish to be treated oneself.

Hedonism: The ethical theory that pleasure (in the sense of the satisfaction of desires) is the highest good and proper aim of human life.

Management participation threat: The threat that a member will take on the role of client management or otherwise assume management responsibilities.

Mortgage-backed securities (MBSs): A type of asset-backed security that is secured by a mortgage or collection of mortgages.

Nepotism: The practice among those with power or influence of favoring relatives or friends, especially by giving them jobs.

Normative ethics: The study of ethical action. It is the branch of philosophical ethics that investigates the set of questions that arise when considering how one ought to act, morally speaking.

Rationalization: The action of attempting to explain or justify behavior or an attitude with logical reasons, even if these are not appropriate.

Self-interest threat: The threat that a member could benefit . . . from an interest in. . . the employing organization or persons associated with the employing organization.

Self-review threat: The threat that a member will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the member.

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

Utilitarianism: An ethical theory that states that the best action is the one that maximizes utility. "Utility" is defined in various ways, usually in terms of the well-being of sentient entities, such as human beings and other animals.

Virtue ethics: One of three major approaches in normative ethics. It may, initially, be identified as the one that emphasizes the virtues, or moral character, in contrast to the approach that emphasizes duties or rules (deontology) or that emphasizes the consequences of actions (consequentialism).

INDEX

About the Speaker and Author

Allison M. (Yee) McLeod, LL.M., JD, CPA, is currently a Senior Lecturer at the University of North Texas in Denton, Texas. She received Bachelor of Business Administration and Juris Doctor degrees from Baylor University, and a Master of Legal Letters (LL.M.) degree specializing in Taxation from the Southern Methodist University School of Law. Professor McLeod has also studied British and Art History at the University of Sussex, England.

Prior to joining the UNT faculty in 2010, Professor McLeod held the position of Director of Tax Planning and IRS Audits for Lehigh Hanson North America, a major manufacturer of cement, aggregates and other building materials. Her practice included both federal and international tax planning. Professor McLeod also spent thirteen years specializing in Tax Planning with the JCPenney Corporation, Inc., and two years with Deloitte & Touche in Dallas.

Professor McLeod teaches at the university level graduate classes on Ethics, Tax Research and Corporate Income Tax. She also lectures in Financial Accounting and Individual Taxation on an undergraduate level. Since 2011, Professor McLeod has been honored to present live and on-line ethics CPE classes to CPAs across the nation. She also serves as an expert witness in accounting malpractice cases and maintains a small private practice serving individuals and small businesses.

Professor McLeod is licensed to practice law by the State Bar of Texas since 1992 and has been a Certified Public Accountant since 1993.

THIS PAGE INTENTIONALLY
LEFT BLANK.