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ETHICS AND PROFESSIONAL CONDUCT FOR TENNESSEE CPAS (COURSE #4810B/QAS4810B)

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CHAPTER 1: THE CODE OF PROFESSIONAL CONDUCT

<u>Objectives</u>: After completing this chapter, you will be able to:

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

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

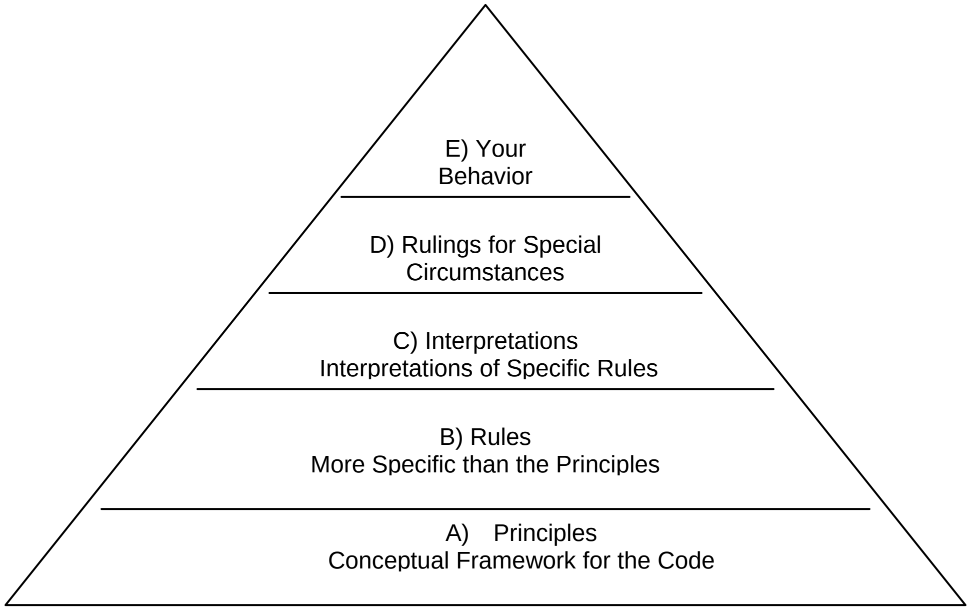
A member of the AICPA also must be aware of Interpretations of the AICPA Rules of Conduct. After public exposure, Interpretations of the AICPA Rules of Conduct are published by the Executive Committee of the Professional Ethics Division. Interpretations are not intended to limit the scope or application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

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

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

OBSERVATION: *In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the Public Company Accounting Oversight Board (PCAOB), and the U.S. Securities and Exchange Commission (SEC) if the member's report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member's report will be filed with the DOL, the AICPA SEC Practice Section (SECPS) if the member's firm is a member of the SECPS, the Government Accountability Office (GAO) if law, regulation, agreement, policy or contract requires the member's report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member's engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.*

AICPA ETHICS PYRAMID



The AICPA ethics pronouncements can be thought of as a pyramid.

A) Principles
The six principles of the Code of Professional Conduct provide the conceptual framework for the code. They are the cornerstone of ethical behavior.

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

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

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

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

PRINCIPLES

The Principles of the Code of Professional Conduct:

I. Responsibilities

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

II. The Public Interest

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

III. Integrity

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

IV. Objectivity and Independence

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

V. Due Care

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

VI. Scope and Nature of Services

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

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

RULES

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

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

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

Professional services - Professional services include all services performed by a member while holding out as a CPA.

Below is a listing of the applicable rules followed by a discussion of each rule:

Rule 101	Independence
Rule 102	Integrity and Objectivity
Rule 201	General Standards
Rule 202	Compliance with Standards
Rule 203	Accounting Principles
Rule 301	Confidential Client Information
Rule 302	Contingent Fees
Rule 501	Acts Discreditable
Rule 502	Advertising and Other Forms of Solicitation
Rule 503	Commissions and Referral Fees
Rule 505	Form of Organization and Name

Rule 101 - Independence

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

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

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

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

Rule 102 - Integrity and Objectivity

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

Rule 102 is very broad on purpose. The Code of Professional Conduct could not possibly proscribe every action that is to be avoided. Thus, Rule 102 could cover a variety of misconduct.

Rule 201 - General Standards

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

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

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

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

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

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

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

Rule 202 - Compliance with Standards

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

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

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

Rule 203 - Accounting Principles

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

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

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

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

Rule 301 - Confidential Client Information

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

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

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.

NOTE: An auditor should have access to a variety of information held by the client if the engagement is to be successful. The client will grant the auditor access to sensitive files and reports only if it can expect the auditor to hold the information in confidence. The purpose of Rule 301 is to encourage a free flow of information from the client to the CPA; however, the rule makes it clear that the principle of confidentiality is not absolute. The confidentiality concept does not allow the client to omit information that is required by generally accepted accounting principles. SAS-32 (Adequacy of Disclosure in Financial Statements) reinforces this position by stating that if a client omits information that is required by GAAP, a qualified or adverse opinion must be expressed. On the other hand, SAS-32 does note that an auditor ordinarily should not make available information that is not required to be disclosed to comply with GAAP.

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

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

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

Your Laptop: Physical Security, Data Protection, and Tracking/Recovery

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

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

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

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

Industry experts estimate that one in eight laptops is at risk of theft. With such a daunting statistic, laptop users may feel resigned to being the victim of theft. However, one of the cheapest and most cost-effective solutions to deter the theft of a laptop is to attach a security cable (similar to the locks used on bicycles) to the laptop.

With cable locks, a steel clip provided by the manufacturer is installed in a security slot on the back or side of the laptop and a steel cable is threaded through the clip and wrapped around a heavy object such as a desk leg or support pole. The two ends of the cable are then secured with a locking device. If the laptop does not contain a security slot or if the desk does not provide a location for suitable anchorage, special adhesive pads containing an anchorage slot are available. Although cable locks are not infallible, they will at least make the thief work a little harder to get the laptop.

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

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

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

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

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

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

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

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

If you are running an operating system that supports proper logins (Windows NT/2000/XP or Linux), setting a password is not only a good idea, it is required. To successfully login to the computer, the user must provide a login name and password. If the information entered is incorrect, the operating system will refuse to allow the user to become an active user.

When creating a password, make sure you create a strong password. For a password to be considered strong, it must be eight or more characters (14 characters or longer is ideal); it must combine letters, numbers, and symbols; it must use a mix of uppercase letters and lowercase letters; and it should use words and phrases that are easy for you to remember, but difficult for others to guess. (**NOTE:** Avoid using your login name, your name, your birthday, anniversary, social security number, telephone number, etc., as part of your password.) Don't forget to change your passwords on a regular basis.

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

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

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

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

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

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

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

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

Until recently, luck was the determining factor in recovering a lost or stolen machine, but new technology is providing users with the ability to track stolen or lost laptops.

With tracking programs, once a computer is reported lost or stolen, the tracking company will wait for the laptop to send a location signal (sent whenever the machine is connected to the Internet). When a signal is retrieved, the program will be instructed to broadcast as much information as it can about the current connection (originating phone number, IP address, service provider, etc.). When enough information has been collected, the tracking company will notify the appropriate law enforcement agency which may be able to recover the machine.

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

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

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

Practice Pointer:
The Ethics of Outsourcing Client Tax Returns

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

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

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

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

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

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

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

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

Rule 302 - Contingent Fees

A member in public practice shall not:

1. Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the member or the member's firm performs:

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

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

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

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

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

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

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

Fees are not considered to be contingent if they are determined (1) by courts or other public authorities or (2) by judicial proceedings or governmental agencies in the case of tax matters.

Before 1991, Rule 302 prohibited contingent fees for all professional engagements (with the exception of certain fees fixed by the judicial or quasi-judicial process). In 1985, The Federal Trade Commission (FTC) challenged the position of the profession concerning contingent fees on the basis of restraint of trade. After prolonged negotiations between the AICPA and the FTC, Rule 301 (as reproduced above) was issued to modify the prior prohibition against contingent fees.

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

The period of prohibition includes the date covered by the financial statements and the period during which the attestation service (and compilation service, as described above) is performed. For example, if the CPA is auditing a client's financial statements for the year ended December 31, 2001, and the date of the auditor's report is March 12, 2002, no services could be performed on a contingent fee basis by the auditor for the period from January 1, 2001, through March 12, 2002.

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

Rule 501 - Acts Discreditable

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

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

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

Rule 502 - Advertising and Other Forms of Solicitation

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

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

Rule 503 - Commissions and Referral Fees

A. Prohibited Commissions

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

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

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

B. Disclosure of Permitted Commissions

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

C. Referral Fees

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

NOTE: A CPA cannot receive a commission for recommending a client's product or services if the CPA audits or reviews that client's financial statements or examines that client's prospective financial information. In addition, no commissions can be received when the CPA compiles a client's financial statements if the CPA believes that a third party will rely on the statements, unless any lack of independence is disclosed in the compilation report.

OBSERVATION: *When a CPA sells products that the CPA has title to directly to clients, this is not considered a commission. However, care should be exercised to ensure that the arrangement does not violate Rule 101 (Independence).*

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

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

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

Rule 504 - Incompatible Occupations (Withdrawn)

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

Rule 505 - Form of Organization and Name

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

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

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

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

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

Non CPA Ownership of CPA Firms

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

- Fifty-one percent of the ownership (as measured by financial interest and voting rights) must be held by CPAs.
- A non-CPA owner must be actively engaged in providing services to clients of the firm, and that participation must be the principal occupation of the non-CPA.
- A CPA must be ultimately responsible for all services provided by the firm that involve financial statement attestation, compilation services, and "other engagements governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services."
- A non-CPA who becomes an owner after the adoption of the AICPA resolution must have a baccalaureate degree (after 2010, the individual must have completed 150 semester hours of education).
- A non-CPA may not hold him or herself out as a CPA, but may be referred to as a(n) principal, owner, officer, member, shareholder or other title allowed by state law.
- A non-CPA owner must observe the AICPA Code of Professional Conduct.
- A non-CPA owner must complete the same number of CPE units as CPAs.

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

OBSERVATION: *Each state is responsible for determining what forms of ownership may be used to practice public accounting; however, the AICPA notes that a practitioner can practice only in a business organization form that conforms to resolutions of the AICPA Council.*

CHAPTER 1 – REVIEW QUESTIONS

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

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

1. Why does this ethics course examine the AICPA Code of Professional Conduct when membership in the AICPA is voluntary:

   a) although membership in the AICPA is voluntary, federal law requires that all CPAs adhere to the AICPA Code of Professional Conduct
   b) most state boards of accountancy pattern their laws and regulations after the AICPA Code or refer to it
   c) membership in the AICPA is not voluntary; membership is required for all CPAs and firms doing attest work
   d) most state CPA societies pattern their code of conduct after the AICPA Code, and most states require their licensees belong to their state CPA Society

2. The fundamental theme of the six principles of the Code of Professional Conduct is:

   a) to be committed to honorable behavior
   b) to sacrifice personal advantage
   c) to be committed to honorable behavior, even at the sacrifice of personal advantage
   d) to make the most money possible in the shortest possible time without violating any laws or standards of decency

3. Which of the following is true regarding Rule 102 – Integrity and Objectivity:

   a) Rule 102 is very broad on purpose
   b) Rule 102 provides a "safe harbor" against allegations of possible violations provided a CPA is following the orders of one's boss or another superior
   c) Rule 102 provides a very long list of prohibited actions, but the list does not include every possible instance of possible violations
   d) Rule 102 only applies to CPAs doing attest engagements

4. AICPA Rule 201 requires that a CPA be competent. Nash, CPA seeks to provide services to a new client in an industry that he has not previously served. Which of the following is true regarding Nash, CPA providing services to this client:

   a) Rule 201 requires that Nash, CPA have sufficient professional competence prior to accepting any engagement
   b) Rule 201 would not apply in this case since Nash is a CPA. Rule 201 only applies to non-CPA subordinates
   c) Rule 201 allows Nash, CPA to accept the engagement as long as it can be completed competently
   d) Rule 201 would require Nash, CPA to engage the services of an expert in that industry prior to accepting the engagement but would not require that Nash, CPA be competent in that area

CHAPTER 1 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. Membership in the AICPA is voluntary. Federal law does not explicitly state that CPAs must follow the AICPA Code of Professional Conduct.

   B: Correct. Most state boards of accountancy pattern their regulations on the AICPA Code of Professional Conduct and then address specific instances where their regulations differ.

   C: Incorrect. Membership in the AICPA and state CPA societies is voluntary.

   D: Incorrect. Most state CPA societies pattern their code of conduct after the AICPA Code, but state CPA society membership is voluntary.

   (See page 1-1 in the course material.)

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

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

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

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

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

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

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

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

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

   (See Rule 102 in the course material.)

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

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

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

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

   (See Rule 201 in the course material.)

CHAPTER 2: UNDERSTANDING THE CODE OF PROFESSIONAL CONDUCT

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

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

Introduction

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

Independence, Integrity, Objectivity

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

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

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

AICPA Interpretations of Rules 101 and 102

RULE 101 - INDEPENDENCE

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

A. During the period of a professional engagement a covered member:

1. Had or was committed to acquire any direct or material indirect financial interest in the client.

2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client, and

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

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

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

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

C. During the period covered by the financial statements or during the period of the professional engagement, a partner or professional employee of the firm was simultaneously associated with the client as a(n):

   1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;
   2. Promoter, underwriter, or voting trustee; or
   3. Trustee for any pension or profit-sharing trust of the client.

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

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

1. Participated on the attest engagement team or was an individual in a position to influence the attest engagement for the client when the attest engagement covers any period that includes his or her former employment or association with that client; or

2. Was otherwise a covered member with respect to the client unless the individual first dissociates from the client by:

    a. Terminating any relationships with the client described in Interpretation 101-1C;
    b. Disposing of any direct or material indirect financial interest in the client;
    c. Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation 101-5;
    d. Ceasing to participate[1] in all employee benefit plans sponsored by the client, unless the client is legally required to allow the individual to participate in the plan (for example, COBRA) and the individual pays 100 percent of the cost of participation on a current basis; and
    e. Liquidating or transferring all vested benefits in the client's defined benefit plans, defined contribution plans, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. However, liquidation or transfer is not required if a penalty[2] significant to the benefits is imposed upon liquidation or transfer.

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

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

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

1. An individual in a covered member's immediate family was employed by the client in a position other than a key position;
2. In connection with his or her employment, an individual in the immediate family of one of the following covered members participated in a retirement, savings, compensation, or similar plan that is a client, is sponsored by a client, or that invests in a client (provided such plan is normally offered to all employees in similar positions):

    a. A partner or manager who provides ten or more hours of non-attest services to the client; or
    b. Any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement.

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

> ***OBSERVATION:*** At this point, you may believe the independence rules are very complex. You may wish to skim the independence rules, paying particular attention to the observations presented throughout the chapter.

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

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

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if:

1. An individual participating on the attest engagement team has a close relative who had:

   a. A key position with the client, or
   b. A financial interest in the client that:
      i. Was material to the close relative and of which the individual has knowledge; or
      ii. Enabled the close relative to exercise significant influence over the client.

2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had:

   a. A key position with the client, or
   b. A financial interest in the client that
      i. Was material to the close relative and of which the individual or partner has knowledge; and
      ii. Enabled the close relative to exercise significant influence over the client

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

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

Grandfathered Employment Relationships

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

Other Considerations

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

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

Litigation Between Client and Member

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

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

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

[3] A failure to prepare the required documentation would be considered a violation of Rule 202, *Compliance With Standards*, of the AICPA Code of Professional Conduct. Independence would not be considered to be impaired provided the member can demonstrate that he or she did apply safeguards to eliminate unacceptable threats or reduce them to an acceptable level. [Footnote added, effective April 30, 2006, by the Professional Ethics Executive Committee.]

4. Litigation not related to performance of an attest engagement for the client (whether threatened or actual) for an amount not material to the covered member's firm[4] or to the client company[5] would not generally be considered to affect the relationship in such a way as to impair independence. Such claims may arise, for example, out of disputes as to billings for services, results of tax or management services advice or similar matters.

Litigation by Security Holders

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

1. The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the covered member's firm[6] or to the client.
2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.
3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

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

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

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

Other Third-Party Litigation

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

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member ("the plaintiff client"), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member's firm[7] or to the plaintiff client.

Effects of Impairment of Independence

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

Termination of Impairment

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

RULE 102 – INTEGRITY AND OBJECTIVITY

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

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

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

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

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

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

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

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member's firm.

- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.

- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.

- A member provides tax or PFP services for several members of a family who may have opposing interests.

- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.

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

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

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

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

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

Q: A CPA firm represents two clients. The clients have adverse interests in a controversy involving a limited partnership of which each client owns a percentage. Can the CPA continue to advise both clients? The work the CPA performs does not require independence. A: The CPA would have a conflict of interest. If the relationships are disclosed to and consent is obtained from all appropriate parties, the CPA could continue to advise both parties. However, the CPA would have to observe Rule 301: Confidential Client Information.

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

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

1. The member should consider whether (a) the entry or the failure to record a transaction in the records, or (b) the financial statement presentation or the nature or omission of disclosure in the financial statements, as proposed by the supervisor, represents the use of an acceptable alternative and does not materially misrepresent the facts. If, after appropriate research or consultation, the member concludes that the matter has authoritative support and/or does not result in a material misrepresentation, the member need do nothing further.

2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor's immediate superior, senior management, the audit committee or equivalent, the board of directors, the company's owners). The member should

consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.

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

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

OBSERVATION: *In an audit engagement, guidance established by SAS-22 (Planning and Supervision) with respect to the subordination of judgment should be observed.*

Q: Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended March 31, 2005, Steffen proposes to reduce obsolete inventory to net realizable value. The obsolete items represent a significant amount of total inventory. The CFO concurs with Steffen's position. However, he decides not to go against the CEO whose position is that reducing the inventory this quarter is a discretionary decision and the CEO would prefer to record any such reduction at year end, after Company X completes its anticipated public offering of stock later this year. What are the ethical obligations of Steffen's in this situation?

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

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

Interpretation 102-6 (Professional Services Involving Client Advocacy) A member or a member's firm may be requested by a client—

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

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

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

AICPA Interpretations of Rules 201 and 203

RULE 201 – GENERAL STANDARDS

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

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

The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. In some cases, however, additional research or consultation with others may be necessary during the performance of the professional services. This does not ordinarily represent a lack of competence, but rather is a normal part of the performance of professional services.

However, if a member is unable to gain sufficient competence through these means, the member should suggest, in fairness to the client and the public, the engagement of someone competent to perform the needed professional service, either independently or as an associate.

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

Case Study

Competency, Auditing Standards and Other Professional Standards

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

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

RULE 203 – ACCOUNTING PRINCIPLES

Interpretation 203-1 (Departures from Established Accounting Principles) Rule 203 was adopted to require compliance with accounting principles promulgated by the body designated by Council to establish such principles. There is a strong presumption that adherence to officially established accounting principles would in nearly all instances result in financial statements that are not misleading.

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

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

Examples of events which may justify departures from a principle are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances which would not ordinarily be regarded as unusual in the context of Rule 203.

Interpretation 203-2 (Status of FASB, GASB and FASAB Interpretations) Council is authorized under Rule 203 to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Statements of Financial Accounting Standards, together with those Accounting Research Bulletins and APB Opinions which are not superseded by action of the FASB, constitute accounting principles as contemplated in Rule 203. Council has also designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203. Council has also designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities to Rule 203.

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

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

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

AICPA Interpretations of Rules 301 and 302

RULE 301 – CONFIDENTIAL CLIENT INFORMATION

Interpretation 301-3 (Confidential Information and the Purchase, Sale, or Merger of a Practice) Rule 301 prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client. The rule provides that it shall not be construed to prohibit the review of a member's professional practice under AICPA or state CPA society authorization.

For purposes of Rule 301, a review of a member's professional practice is hereby authorized to include a review in conjunction with a prospective purchase, sale, or merger of all or part of a member's practice. The member must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information.

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

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

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

RULE 302 – CONTINGENT FEES

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

Definition of Terms

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

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

Examples

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

1. Representing a client in an examination by a revenue agent of the client's federal or state income tax return.

2. Filing an amended federal or state income tax return claiming a tax refund based on a tax issue that is either the subject of a test case (involving a different taxpayer) or with respect to which the taxing authority is developing a position.

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

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

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

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

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

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

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

A: Yes. These are not prohibited transactions.

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

AICPA Interpretations of Rules 501, 502 and 505

RULE 501 – ACTS DISCREDITABLE

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

Terminology

The following terms are defined below solely for use with this Interpretation:

- *Client provided records* are accounting or other records belonging to the client that were provided to the member by or on behalf of the client.

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

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

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

Interpretation

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

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

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

[8] The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.

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

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

Member's working papers are the member's property and need not be provided to the client under provisions of this interpretation; however, such requirements may be imposed by state and federal statutes and regulations, and contractual agreements.

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

- Charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client;

- Provide the requested records in any format usable by the client;[9] and

- Make and retain copies of any records returned or provided to the client.

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

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

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

[9] The member is not required to convert records that are not in electronic format. However, if the client requests records in a specific format and the member was engaged to prepare the records in that format, the client's request should be honored.

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

Interpretation 501-4 (Negligence in the Preparation of Financial Statements or Records) A member shall be considered to have committed an act discreditable to the profession in violation of Rule 501 when, by virtue of his or her negligence, such member –

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

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

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

Case Study

Acts Discreditable

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

A CPA firm was required to make contributions to the financial institution that managed the CPA firm's employee SIMPLE IRA plan no later than the close of the 30 day period following the last day of the month in which amounts would otherwise have been payable to the employee in cash. The CPA firm informed employees that SIMPLE IRA funds would not be deposited by the date required. For a period of two years, the CPA firm did not make timely contributions to the financial institution managing the SIMPLE IRA plan. When the CPA firm deposited the funds, the CPA firm also deposited interest into each employee's SIMPLE IRA plan.

Interpretation 501-6 (Solicitation or Disclosure of CPA Examination Questions and Answers) A member who solicits or knowingly discloses the May 1996 or later Uniform CPA Examination question(s) and/or answer(s) without the written authorization of the AICPA shall be considered to have committed an act discreditable to the profession in violation of Rule 501.

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

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

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

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

Members should also consult Ethics Ruling No. 94, "Indemnification Clause in Engagement Letters," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* under Rule 101, *Independence* and Ethics Ruling No. 102, "Indemnification of a Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* under Rule 101, *Independence*, for guidance related to use of indemnification clauses in engagement letters and the impact on a member's independence.

RULE 502 – ADVERTISING AND OTHER FORMS OF SOLICITATION

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

- Create false or unjustified expectations of favorable results

- Imply the ability to influence any court, tribunal, regulatory agency or similar body or official

- Contain a representation that specific professional services in current or future periods will be performed for a stated fee, estimated fee or fee range when it was likely at the time of the representation that such fees would be substantially increased and the prospective client was not advised of that likelihood

- Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

Case Study

Public Communications and Advertising

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

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

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

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

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

RULE 505 – FORM OF ORGANIZATION AND NAME

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

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

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

Firm Names

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

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

Rule 505 acknowledges this concern for continuity:

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

Fictitious Names

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

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

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

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

Interpretation 505-1 Deleted.

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

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

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

The overriding focus of the Resolution is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. The Resolution contains many requirements that were developed to ensure that responsibility. In addition to the provisions of the Resolution, other requirements of the Code of Professional Conduct and bylaws ensure that responsibility:

a. Compliance with all aspects of applicable state law or regulation.
b. Enrollment in an AICPA-approved practice monitoring program.
c. Membership in the SEC practice section if the attest work is for SEC clients (as defined by Council).
d. Compliance with the independence rules prescribed by Rule 101, Independence.
e. Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, Compliance With Standards) and all other provisions of the Code, including, Applicability.

Taken in the context of all the above-mentioned safeguards of the public interest, if the CPAs who own the attest firm remain financially responsible, under applicable law or regulation, the member is considered to be in compliance with the financial interests provision of the Resolution.

CHAPTER 2 – REVIEW QUESTIONS

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

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

1. A potential audit client is owned by the CPA's stepsister. Which of the following is true regarding Rule 101 (independence):

   a) a stepsister is considered a close relative and would impair independence
   b) a stepsister is not considered a relative and would never impair independence
   c) if the CPA's relationship to the stepsister is very close, independence may be impaired
   d) none of the above

2. A CPA represents two clients. The clients have adverse interest involving a limited partnership of which both clients own a percentage. Which of the following is true regarding Rule 102:

   a) the CPA lacks independence and may not do any work for either of the clients
   b) the CPA lacks independence and must cease working for one of the clients
   c) although the CPA has a conflict of interest, he may continue working for both clients provided: 1) the work performed does not require independence, and 2) the relationships are disclosed to and consent is obtained from all appropriate parties
   d) none of the above

Use the following fact pattern for the next 4 questions

Jim Smith, CPA (Smith) prepares tax returns for a large number of clients. Smith has prepared the Form 1040 and Schedule C for Joe Jones for the last ten years. Joe Jones (Jones) keeps no business records except for a profit/loss summary that Jones's wife prepares using Quicken. Smith has always calculated depreciation and made all other tax related adjustments to Jones's Quicken report to prepare Jones's Form 1040. Jones provides all the necessary documents to Smith and asks Smith to prepare Jones's current year tax return. Smith prepares Jones's current year tax return even though Jones still owes Smith fees for preparing last year's tax return as well as year-end tax planning. Smith does not use any type of client engagement letter since he only prepares tax returns.

3. Assume that Smith demands payment of all past due fees as well as payment for the current year tax return preparation prior to releasing the tax return to Jones. Which of the following is true regarding releasing the current year tax return to Jones under AICPA rules:

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

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

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

5. Jones decides to prepare his current year tax return himself. Jones demands that Smith provide a copy of Jones's prior year tax return and the depreciation workpapers for the current year that Smith prepared for Jones's current year tax return. Which of the following is true:

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

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

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

CHAPTER 2 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. A stepsister is not automatically considered a close relative.

   B: Incorrect. A stepsister could be a close relative.

   C: Correct. Independence is impaired only if the relationship is close.

   D: Incorrect. Independence may be impaired.

   (See Interpretation 101-1 in the course material.)

2. A: Incorrect. The clients have the adverse interest, not the CPA.

   B: Incorrect. A CPA may do work for two clients with adverse interests.

   C: Correct. The clients are better served by allowing the CPA to continue serving them both.

   D: Incorrect. The CPA has a conflict but may continue working for both clients.

   (See Interpretation 102-2 in the course material.)

3. A: Incorrect. The AICPA has extensive rules relating to CPA workpapers and the return of client records. In fact, failure to return client records is one of the most common complaints received by the AICPA ethics committee.

   B: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to demand the release of the return prior to paying fees as required by the CPA.

   C: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to pay only a portion of the fees and demand release of the tax return.

   D: Correct. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees.

   (See Rule 501 and Interpretation 501-1 in the course material.)

4. A: Incorrect. Rule 501 requires the return of all client provided records upon request. Client provided records may not be withheld pending payment of current or prior engagement fees.

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

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

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

   (See Interpretation 501-1 in the course material.)

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

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

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

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

(See Interpretation 501-1 in the course material.)

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

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

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

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

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

   (See Rule 501 in the course material.)

CHAPTER 3: TENNESSEE SPECIFIC ETHICS

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

- Identify the Tennessee Rules of Professional Conduct.
- Explain the differences between active status vs. inactive status.
- Discuss the requirements for a Firm Permit.
- Describe the Peer Review requirements and explain when Peer Review is required.
- Identify the Tennessee CPE requirements.

Introduction

The legislature passed the Accountancy Act that authorizes the Tennessee State Board of Accountancy to issue rules to regulate the practice of public accountancy. The primary purpose of the Board of Accountancy and the rules is to protect the public.

Website

The Board maintains a website at www.state.tn.us/commerce/boards/tnsba. The website contains numerous items of interest including the law and rules, recent newsletters, downloadable forms, CPE, and Peer Review information. I encourage you to bookmark this website and check it often.

Rules of Professional Conduct – Table of Contents

0020-3-.01 DEFINITIONS.

(1) For the purpose of this Chapter, unless the context otherwise requires:

(a) “Client” shall be defined as in Tenn. Code Ann. §62-1-103;

(b) “Enterprise” means any person(s) or entity, whether organized for profit or not, with respect to which a licensee performs professional services;

(c) “Firm” means a sole proprietorship, partnership, or corporation holding a permit or required to hold a permit issued under Tenn. Code Ann. §§62-1-108, 62-1-109 or corresponding prior law;

(d) “Licensee” shall be defined as in Tenn. Code Ann. §62-1-103;

(e) “Professional service” means any service performed or offered by a licensee for a client in the course of the practice of public accountancy.

0020-3-.02 APPLICABILITY.

(1) The provisions of this chapter shall apply to all professional services performed in the practice of public accountancy or in the provision of accounting services, and shall apply to all licensees except:

(a) Where the wording of a rule indicates otherwise; and

(b) That a licensee who is practicing public accountancy outside the United States will not be subject to disciplinary action by the Board for departing from any of the provisions of this chapter as long as the licensee’s conduct is in accord with the standards of professional conduct applicable to the practice of public accountancy in the country in which the licensee is practicing. However, where a licensee's name is associated with financial statements under circumstances which would entitle the reader to assume that United States practices are followed, the licensee shall comply with rules within this chapter.

(2) A licensee shall comply with the AICPA Code of Professional Conduct when these rules are silent on any matter.

Observation: It is important to understand that the Rules of Professional Conduct apply to all professional services performed, not just attest services. In addition to these rules, a licensee must also comply with the AICPA Code of Professional Conduct. This means a licensee could be disciplined for failure to comply with the AICPA Code of Professional Conduct.

0020-3-.03 INDEPENDENCE.

A licensee in the performance of professional services, including those who are not members of the AICPA, shall conform to the independence standards established by the AICPA, and where applicable, the United States Securities and Exchange Commission, the General Accounting Office and other regulatory or professional standards setting bodies.

Observation: You studied the AICPA independence standards in the prior chapters. This rule mandates compliance with the AICPA standards as well as other applicable independence standards.

0020-3-.04 INTEGRITY AND OBJECTIVITY.

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

Observation: The Tennessee rules on integrity and objectivity are patterned after AICPA Rule 102. As such, the rule is purposely very broad and does not attempt to enumerate all possible violations.

Case Study

Integrity and Objectivity

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

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

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

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

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

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

LIKELY BOARD ACTION: Violation of 0020-3-.04 Integrity and Objectivity.

0020-3-.05 CONTINGENT FEES, COMMISSIONS, AND OTHER CONSIDERATION.

(1) As used in this rule unless the context otherwise requires:

(a) “Attest” shall be defined as in Tenn. Code Ann. §62-1-103.

(b) “Audit” means an examination of financial statements of a person or entity by a certified public accountant or public accountant, conducted in accordance with generally accepted auditing standards, to determine whether, in the opinion of the certified public accountant or public accountant, the statements conform with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting.

(c) “Commission” means compensation for recommending or referring any product or service to be supplied by another person.

(d) “Compilation of a financial statement” means a presentation of information in the form of a financial statement that is the representation of any other person without the undertaking of the certified public accountant or public accountant to express any assurance on the statement.

(e) “Consideration” means compensation other than a commission, including but not limited to compensation for recommending or referring any service of a certified public accountant or public accountant to any person.

(f) “Contingent fee” means a fee established for the performance of any service pursuant to an arrangement under which a fee will not be charged unless a specified finding or result is attained, or under which the amount of the fee is otherwise dependent upon a finding or result of such service. “Contingent fee” does not mean a fee fixed by a court or other public authority, or a fee related to any tax matter which is based upon the results of a judicial proceeding or the findings of a governmental agency.

(g) “Examination of prospective financial information” means an evaluation by a certified public accountant or public accountant of a forecast or projection, the support underlying the assumptions in the forecast or projection, whether the presentation of the forecast or projection is in conformity with professional presentation guidelines, or whether the assumptions in the forecast or projection provide a reasonable basis for the forecast or projection.

(h) “Person” means any natural person, corporation, partnership, or other entity.

(i) “Review of a financial statement” means to perform inquiries and analytical procedures that permit a certified public accountant or public accountant to determine whether there is a reasonable basis for expressing limited assurance that there are no material modifications that should be made to financial statements in order for them to be in conformity with generally accepted accounting principles or, if applicable, with another comprehensive basis of accounting.

(2) A licensee shall neither pay any consideration or commission to obtain a client nor accept any consideration or commission when the licensee or the licensee's firm also performs for that client the services listed in T.C.A. § 62-1-122(a)(1) through (a)(3). This prohibition applies during the period in which the licensee is engaged to perform any of the listed services and the period covered by any historical financial statements involved in such listed services.

Commissions, Contingent Fees, and Other Consideration

Rules 002-3-.05 (2) and (5) describe the circumstances when licensees are prohibited from paying or receiving commissions, referral fees and contingent fees. The prohibitions apply when the holder of a permit or any partner, officer, shareholder, member, manager or owner of the firm performs any of the following services for a client who is also the subject of the commissions, referral fees or contingent fees:

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

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

What Is Meant By "During the Period"

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

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

(3) A licensee who is not prohibited by this rule from performing services or receiving consideration or a commission and who is paid or expects to be paid consideration or a commission shall disclose that fact, in compliance with the requirements of T.C.A. §62-1-122 and Rule 0020-3-.06, to any person to whom the licensee recommends or refers a product or service to which the commission or consideration relates.

(4) Any licensee who accepts consideration or a commission for a referral shall disclose such acceptance or payment to the client in compliance with the requirements of T.C.A. §62-1-122 and Rule 0020-3-.06.

(5) A licensee shall not receive or agree to receive a contingent fee from a client for the following:

(a) Performance of any professional services for a client for whom the licensee or person associated with the licensee performs any of the services listed in T.C.A. § 62-1-123(b)(1)(A) through (C) ; or

(b) Preparation of an original tax return.

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

(6) Any licensee who accepts or agrees to accept a contingent fee shall disclose the terms of such contingent fee to the client in compliance with the requirements of Tenn. Code Ann. §62-1-123 and Rule 0020-3-.06.

(7) Nothing in this rule shall be construed to prohibit:

(a) Payments for the purchase of all, or a part, of an accounting practice;

(b) Retirement payments to persons formerly engaged in the practice of public accountancy or payments to the heirs or estates of such persons; or

(c) Payments, including incentive or bonus payments, to employees or members of an accounting firm as compensation for their services.

0020-3-.06 DISCLOSURES.

(1) A licensee who is not prohibited from performing services or receiving consideration or a commission and who is paid or expects to be paid consideration or a commission shall disclose that fact in compliance with the requirements of this rule to any person to whom the licensee recommends or refers a product or service to which the commission relates.

(2) Any licensee who accepts consideration or a commission for a referral shall disclose such acceptance or payment to the client in compliance with the requirements of this rule.

(3) Any licensee who accepts or agrees to accept a contingent fee shall disclose the terms of such contingent fee to the client in compliance with the requirements of this rule.

(4) The disclosure must:

(a) Be in writing and be clear and conspicuous;

(b) State the amount of the consideration or commission or the basis on which it will be computed; and

(c) Be made at or prior to the time of the recommendation or referral of the product or service for which consideration or commission is paid or prior to the client retaining the licensee to whom the client has been referred for which a referral fee is paid; or

(d) Be made prior to the time the licensee undertakes representation of or performance of the service upon which a contingent fee will be charged.

(5) The following form may be used to comply with the disclosures required by this rule and Tenn. Code Ann. §§62-1-122 and 62-1-123. A form which contains additional information may be used by a licensee if the form includes the minimum disclosure requirements.

STATEMENT OF DISCLOSURE OF COMMISSIONS, CONTINGENT FEES, AND OTHER CONSIDERATION

Certified public accountants and public accountants are required by law to disclose to clients the receipt or payment of certain commissions and contingent fees.

The purpose of this disclosure statement is to acknowledge that proper disclosure has been made and that a copy of this statement has been provided to each of the signatories thereof.

I hereby acknowledge that on this ______________ day of ______________ , 20 ___.

________________________________ has disclosed that he/she/the firm will
CPA/PA/Firm

receive/pay a commission/contingent/fee/consideration of ______________________
AMOUNT

in relation to goods or services he/she/the firm has agreed to provide or recommend.

____________________________________ ________________
Client (signature) **Date**

____________________________________ ________________
CPA/PA/Firm (signature) **Date**

0020-3-.07 COMPETENCE.

(1) A licensee shall comply with the following standards and with any interpretations thereof by bodies designated by the AICPA, or by other entities having similar generally recognized authority.

(a) Professional Competence. Undertake only those professional services that the licensee or the licensee's firm can reasonably expect to be completed with professional competence.

(b) Due Professional Care. Exercise due professional care in the performance of professional services.

(c) Planning and Supervision. Adequately plan and supervise the performance of professional services.

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

Observation: The rules on competence are generally the same as AICPA rules.

Case Study

Competence and Technical Standards

Brown prepared Client's 2006 tax returns and calculated that Client would receive a $6,000 tax refund from Arizona, owe $7,000 in taxes to Tennessee, and owe $6,500 in taxes to Internal Revenue Service. Client took tax information to another Certified Public Accountant who completed the returns and made the following determination: Client would receive a $10,000 refund from Arizona, owe $6,000 to Tennessee, and owe $5,500 to IRS.

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

LIKELY BOARD ACTION: Violation of 0020-3-.07 Competence.

Case Study

Competence – Preparation of Tax Return

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

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

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

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

LIKELY BOARD ACTION: Violation of 002-3-.07 Competence.

0020-3-.08 COMPLIANCE WITH STANDARDS.

A licensee who performs attest, management advisory, tax, or other professional services shall comply with standards promulgated by the American Institute of Certified Public Accountants or by other entities having similar authority as recognized by the Board.

Case Study

Competency and Compliance with Standards

Able Accountants, CPAs (Firm) audited XYZ Company in 2005 and 2006. XYZ Company provided investment and money management services to clients, many of which were union pension trusts and health and welfare plans. XYZ Company managed a total portfolio of about one billion dollars.

A division of Firm prepared a valuation report of XYZ Company that valued XYZ Company at just under $5 million dollars. XYZ Company's growth in fee income was fueled by a collateralized note program that was critical to Firm's valuation. The collateralized note program included loans made by XYZ Company to its affiliate ABC Company. By 2007, the collateralized note program with its affiliate ABC Company had accounted for 25% of the total assets managed by XYZ Company and 45% of the fees charged by XYZ Company.

ABC Company suffered losses during the years 2005 through 2007 and had a stockholders' deficit of $109 million at the end of September 2007. ABC Company filed for reorganization under Chapter 11 of the U.S. Bankruptcy Code. The 2007 audit report for ABC Company was prepared by another firm. The audit report expressed substantial doubt about ABC Company's ability to continue as a going concern.

Firm audited XYZ Company during calendar years 2005 and 2006 and issued unqualified opinions for both years.

LIKELY BOARD ACTION: Violations of Generally Accepted Auditing Standards in both 2005 and 2006.

Case Study

Competence and Other Professional Standards

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

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

LIKELY BOARD ACTION: Violation of 0020-3-.07 Competence; Violation of 002-3-.08 Compliance with Standards.

0020-3-.09 ACCOUNTING PRINCIPLES.

(1) A licensee shall not:

(a) Express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles; or

(b) State that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles if such statements or data contain any departure from an accounting principle promulgated by bodies designated by the AICPA to establish such principles, which departure has a material effect on the statements or data taken as a whole.

0020-3-.10 CONFIDENTIAL CLIENT INFORMATION.

(1) A licensee shall not disclose any confidential client information without the specific consent of the client.

(2) This rule shall not be construed to:

(a) Relieve a licensee of his or her professional obligations under Rules 0020-3-.08 and 0020-3-.09;

(b) Affect in any way the licensee's obligation to comply with a validly issued and enforceable subpoena or summons;

(c) Prohibit review of a licensee's professional practice by the AICPA, a state CPA society or state PA association, or the Board;

(d) Preclude a licensee from initiating a complaint with or responding to any inquiry made by a recognized investigative or disciplinary body;

(e) Prohibit a licensee from utilizing any such relevant information in the defense of a claim or reasonably anticipated claim against the licensee; or

(f) Restrict the exchange of information with a recognized investigative or disciplinary body.

(3) Licensees of a recognized investigative or disciplinary body and professional practice reviewers shall not use to their own advantage or disclose any licensee's confidential client information that comes to their attention in carrying out their official responsibilities.

Observation: The exceptions are generally the same as AICPA Rule 301.

0020-3-.11 RECORDS

(1) A licensee shall, upon request made within a reasonable time, furnish to his or her client or former client:

(a) A copy of any report or other documentation belonging to, or obtained from or on behalf of, the client, which the licensee removed from the client's custody. The licensee may make and retain copies of such documents when they form the basis for work performed by the licensee;

(b) Any accounting or other documents belonging to, or obtained from or on behalf of, the client, which the licensee removed from the client's premises or received from the client's custody. The licensee may make and retain copies of such documents when they form the basis for work performed by the licensee; and

(c) A copy of the licensee's working papers, to the extent that such working papers include records which would ordinarily constitute part of the client's books and records and are not otherwise available to the client, to include but not be limited to general ledgers, general journals, fixed asset and depreciation records. Provided, however, that nothing in this rule shall require a licensee to furnish any work product to his or her client or others before the client has made satisfactory arrangements for payment for services rendered to or on behalf of such client.

In-Depth Analysis

Client Records and Working Papers

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

Rule 0020-3-.11 requires licensees to provide to a client or former client any records belonging to or obtained from or on behalf of the client, and a copy of the licensee's working papers, to the extent that the working papers include records that would ordinarily constitute part of the client's records and are not otherwise available to the client.

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

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

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

- A client's request for return of records that is made within a reasonable time and that occurs <u>after</u> the issuance of a tax return, financial statement, report or other document prepared by a licensee: the licensee shall furnish, within a reasonable time to the client or former client:

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

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

The client may have a general ledger, but may depend on the CPA to adjust and close the general ledger. In that event, copies of both adjusting entries, with explanations and any supporting papers, and closing entries would be provided to the client.

If the client does not have a general ledger and only provides the CPA with transaction summaries that the CPA uses to prepare a working trial balance, copies of the adjusted working trial balance, transaction entries, adjusting entries with explanations and any supporting working papers, and closing entries would be provided to the client.

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

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

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

Investments	Accounts payable	Prepaid expenses
Accrued liabilities	Owner's equity	Current portion of long-term debt
Accounts receivable	Bad debts	Income tax expenses and payable

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

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

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

Case Study

Client records and working papers
Requested records

In 2007, Green decided to close her public accounting office and accept a position in private industry. Green notified clients that she was closing her office and referred clients to another Certified Public Accountant.

Client "A" received the notification from Green. In 2008, Client "A" needed a copy of her depreciation schedule to complete 2006 and 2007 tax returns. Client "A" left telephone messages for Green. Green did not return Client's calls and did not provide Client with a copy of the requested depreciation schedule.

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

POSSIBLE BOARD ACTION: Violation of 0020-3-.11 Records.

Observation: Violation of the records retention law results in more licenses being revoked than any other violation.

0020-3-.12 DISCREDITABLE ACTS.

(1) A licensee shall not commit any act that reflects adversely on the profession.

(2) A licensee or a candidate for licensure who solicits, discloses, and/or uses information obtained through violation of any nondisclosure statement of the Uniform CPA Examination shall be considered to have committed an act discreditable to the profession.

Case Study

Discreditable Acts

White, CPA prepared Smith's 2007 tax return. White offered client "Extended Tax Service" (ETS) for a fee. White explained to Smith that ETS is a guarantee to represent Smith at no additional cost if a taxing authority selected Smith's tax return for audit.

White required that clients who purchased ETS must be continuing clients to receive the benefits of ETS. White published the terms of ETS once a year in his December newsletter.

The continuing client requirement was not printed on Smith's invoice. White did not give Smith a verbal explanation of the continuing client requirement. Smith did not read White's December newsletter.

Smith paid White for ETS when she picked up her 2007 tax return. Smith knew at the time that she paid for ETS that she would not use White's services again.

Smith's 2007 tax return was selected for audit. White refused to represent Smith, because Smith was not a continuing client.

White was obligated under the terms stated on Smith's invoice to provide ETS.

POSSIBLE BOARD ACTION: Violation of 0020-3-.12 Discreditable Acts.

Case Study

Dishonesty, Fraud or Gross Negligence in the Practice of Public Accountancy

Brown, CPA obtained a power of attorney to provide financial assistance to Ms. Frail who was in a nursing home. After Ms. Frail died, the estate's executor discovered unexplained withdrawals of funds that occurred during the time that Brown held power of attorney for Ms. Frail. The executor also discovered that nursing home expenses and pharmacy bills remained unpaid during the time that Brown held power of attorney for Ms. Frail.

Brown was also appointed treasurer of a youth club. As treasurer, Brown was responsible for the club's accounting and tax reporting. When Brown was replaced with another treasurer, the successor treasurer was unable to account for approximately $60,000 that Brown reported as "cash in bank" on the club's financial statement.

The Board requested a response from Brown. Brown failed to respond to the Board communication.

POSSIBLE BOARD ACTION: Numerous violations. Please take a moment to see how many possible violations you can identify.

0020-3-.13 ACTING THROUGH OTHERS.

(1) A licensee shall not permit others to carry out on his/her behalf, either with or without compensation, any act which, if carried out by the licensee, would constitute a violation of this chapter.

0020-3-.14 ADVERTISING AND OTHER FORMS OF SOLICITATION.

(1) A licensee shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading or deceptive.

(2) Solicitation by the use of coercion, over-reaching or harassing conduct is prohibited.

Observation: The rules on advertising are similar to AICPA rules.

Case Study

Public Communications and Advertising by Firm

"A" operated as a sole proprietor from 1984 through 1999. In March 2000, "A" registered "A LLC" with the Board. In August 2004, "B" and "C" merged with "A" to form "AB&C LLC." The website for "AB&C LLC" described the firm as "established in 1984."

Stating that "AB&C LLC" was established in 1984 is a misrepresentation of fact.

POSSIBLE BOARD ACTION: Using the "established date" of 1984 is misleading and a violation of 0020-3-.14 Advertising and Other Forms of Solicitation.

0020-3-.15 FIRMS.

(1) A CPA or PA firm name is misleading under § 62-1-113(i) if, among other things, its name:

(a) Implies the existence of a corporation when the firm is not a corporation;

(b) Implies the existence of a partnership when the firm is not a partnership;

(c) Is similar to or the same as existing fictitious names within the State of Tennessee;

(d) Tends to mislead regarding the nature of the business or the affiliation of the trade name user with another business entity;

(e) Contains more than one (1) fictitious name;

(f) Includes the name of an individual whose license has been suspended or revoked by the Board;

(g) Includes the name of a person who is neither a present nor a past partner, member or shareholder of the firm; or

(h) Includes the name of a person who is not a CPA, if the title “CPAs” is included in the firm name.

(2) A fictitious CPA or PA firm name (that is, one not consisting of the names or initials of one or more present or former partners, members or shareholders) may not be used by a CPA firm unless such name has been registered with and approved by the Board, and it is not false or misleading.

Case Study

Notification of Assumed Business Name

White registered his firm as “White CPA PC.” White did not use the registered name “White CPA PC” on letterhead, business cards or when answering the telephone. Instead, White used “Accounting Services” on letterhead, business cards and when answering the telephone. “White CPA PC” did not notify the Board of the assumed business name “Accounting Services.”

LIKELY BOARD ACTION: Violation of 0020-3-.15 (2) Firms.

(3) The Board may disapprove of the use of any fictitious name that falls within one (1) of the prohibitions listed in paragraph (1) of this rule or if it determines after notice and hearing that the trade name is deceptive.

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

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

(4) A certified public accountant or public accountant may practice under his/her own name or that of inactive or deceased partners or shareholders who were certified public accountants or public accountants. A partner or shareholder surviving the death or withdrawal (unless (1)(f) applies) of all other partners or shareholders may continue to practice under the partnership or professional association name for up to two (2) years after becoming a sole practitioner.

(5) When a firm name violation is determined to exist, the firm shall have sixty (60) days after notification by the Board to come into compliance with all applicable rules and statutes.

0020-3-.16 NOTIFICATION TO THE BOARD.

(1) A licensee shall notify the Board in writing within thirty (30) days of any change of name, address and, in the case of individual licensees, change of employment.

Observation: When the Board sends renewal notices, they receive far too many “forwarding order expired” notices from the post office. These people are obviously in violation of the notification requirement. Failure to submit written notice to the Board will result in a violation.

(2) Except as otherwise provided, a licensee shall respond in writing to any communication from the Board requesting a response within thirty (30) days of the mailing of such communication by registered or certified mail to the last address furnished to the Board by the licensee.

(3) Upon the receipt of a complaint against a licensee, the Board may transmit a copy of such complaint to the licensee. Such licensee shall, within fourteen (14) days of receipt, file a written answer to the complaint with the Board, unless otherwise granted an extension of time.

Case Study

Failure to Respond to a Board Communication and Investigation

A complaint was filed against Brown. The Board notified Brown of the complaint and requested that Brown respond within 14 days. Brown did not respond within 14 days.

LIKELY BOARD ACTION: Violation of Rule 0020-3-.16 (3) Notification to the Board.

0020-3-.17 RETENTION OF RECORDS.

A licensee shall maintain copies, or other obtainable facsimile records, or computer records, in whatever manner kept, of all work papers and work product used to render or support rendering public accounting services to a client for a period of five (5) years. The five (5) year period shall commence at the end of the fiscal period in which the engagement was conducted. Premature destruction of these records shall subject the licensee to disciplinary action.

CPE

0020-5-.03 BASIC REQUIREMENTS.

(1) A license holder seeking regular biennial renewal shall, as a prerequisite for such renewal, show that he or she has completed no less than eighty (80) hours of qualified continuing professional education during the two (2) year period immediately preceding renewal, with a minimum of twenty (20) hours in each year with specifications as follows:

(a) All license holders shall complete at least forty (40) hours in the subject areas of accounting, accounting ethics, attest, taxation, or management advisory services;

(b) All license holders shall complete a board-approved four (4) hour ethics course designed to familiarize the licensee with the accountancy law and rules as well as professional ethics;

- Licensees renewing upon 12/31/07 expiration date have a two (2) hour ethics CPE requirement.
- Licensees renewing upon 12/31/08 expiration date have a four (4) hour ethics CPE requirement.

(c) License holders engaged in the attest function, shall biennially complete at least twenty (20) hours in the subject areas of attest and accounting theory and practice in fulfilling the above requirements;

(d) License holders engaged to testify in a Tennessee court(s) as expert witnesses in the areas of accounting, attest, management advisory services, or tax shall have completed, within the current or most recent renewal period, at least twenty (20) hours in the subject area(s) (as noted in this paragraph) concerning such expert testimony; and

(e) Up to twenty-four (24) CPE hours taken in excess of the eighty (80) hour requirement for each two year period may be applied to the requirement of the next succeeding two year renewal cycle. License holders must maintain a list of CPE which will be used for carry forward and must submit that listing as requested by the Board. Failure to do so will result in the disallowance of carry-forward hours.

(2) A license holder seeking to renew an initial certificate issued less than two (2) years but more than one (1) year prior to expiration must provide evidence of having completed at least forty (40) hours of continuing education, of which twenty (20) hours shall be in the subject areas of accounting, accounting ethics, attest, tax, or management advisory services. Licensees seeking to renew an initial certificate issued less than one year prior to expiration will be exempt from CPE requirements for that renewal period.

(3) Upon application supported by such evidence as the Board may require, those licensees not practicing in Tennessee, who do not perform or offer to perform for the public one (1) or more kinds of services involving the use of accounting or auditing skills, including the issuance of reports on financial statements or one or more kinds of management advisory, financial advisory or consulting services, or the preparation of tax returns or the furnishing of advice on tax matters, may be exempted from any continuing professional education requirements provided that:

(a) Licensees granted such an exemption must place the word “inactive” adjacent to their CPA title or PA title when used in any written form with the exception of their certificate or registration;

(b) Individuals exempt under this paragraph must complete eighty (80) hours of CPE in the areas of accounting, accounting ethics, attest, taxation, or management advisory services, during the twenty-four (24) month period preceding the date of their request for the reactivation of their license. The CPE hours required to reactivate a license may also be used as credit toward the renewal requirement so long as those hours are completed within the two (2) year window prior to the licensee’s next December 31 renewal date.

(4) Licensees who surrender their licenses in good standing may reactivate a license by complying with this subsection.

(5) Upon application supported by such evidence as the Board may require, licensees age seventy (70) and over, disabled for more than six (6) months or in active military service may be exempted from payment of a license renewal fee and/or CPE requirements so long as they do not practice public accountancy or offer accounting services to the public.

(6) An applicant for renewal whose license has lapsed as set forth under Rule 0020-1-.08(8) shall complete no less than eighty (80) hours of CPE in the areas of accounting, accounting ethics, attest, taxation, or management advisory services, during the six (6) month period preceding the date of reapplication. The CPE hours required to reinstate a lapsed license are considered penalty hours and may not be used to offset the CPE hours required for renewal of a license.

(7) A non-resident licensee seeking renewal of a license in this state shall meet the CPE requirement of this rule by meeting the CPE requirements for renewal of a license in the state in which the licensee's principal office is located.

> (a) Non-resident applicants for renewal shall demonstrate compliance with the CPE renewal requirements of the state in which the licensee's principal office is located by signing a statement certifying to that effect on the renewal application of this state.
>
> (b) If the state in which a non-resident licensee's principal office is located has no CPE requirements for renewal of a license, the non-resident licensee must comply with all CPE requirements for renewal of a license in this state.

Important CPE Changes

The Board converted to an online renewal system. This makes it easier to renew your license. However, in order to use the online renewal system, the process for reporting CPE changed. There will be an increase in CPE audits and the elimination of the detailed CPE listing requirement. Deficiencies discovered through the CPE audit process will be forwarded to the complaint coordinator.

As many of you know, NASBA has expanded its fields of study subject codes for CPE. Specialized Knowledge seems to be a very popular field of study. The Board has received numerous calls and has adopted a new policy concerning this. The licensee is responsible for making the determination if a specialized knowledge CPE course qualifies as technical subject matter. If a CPE audit reveals that the course is a non-technical subject, the licensee shall have the right to present evidence to the Board to support their determination of the course. The appeal will be presented to the Board, who will make the final determination.

A link to the NASBA registry of approved CPE sponsors is on the Board website. To view the CPE registry for live CPE courses or the QAS registry for self-study courses, go to www.state.tn.us/commerce/boards/tnsba and look under the CPE section to find the links.

There is a rule which went into effect in 2006 and once again allows carry forward CPE hours. In order to claim up to 24 carry forward hours, the licensee must maintain a listing of the CPE that is being carried forward. If the licensee cannot substantiate the carry forward hours, they cannot be claimed to meet the CPE reporting requirements. As always, carry forward hours cannot be used to meet the 20 hour yearly minimum, the 20 attest or expert witness testimony hours, or the 40 hour technical requirement.

Peer Review

Selected rules and articles follow to help you understand Tennessee's Peer Review requirements.

0020-6-.02 PURPOSE.

The purpose of the Peer Review Program (Program) is to improve the quality of financial reporting and to assure that the public can rely on the fairness of presentation of financial information on which licensees issue reports. Appropriate educational programs or rehabilitation procedures will ordinarily be recommended or required where professional services do not comply with applicable professional standards; however, when a licensee is unwilling or unable to comply with such standards, or a licensee's professional services are so egregious as to warrant disciplinary action, such action may be taken as the appropriate means of protecting the public interest.

0020-6-.04 BASIC REQUIREMENTS.

(1) Each firm location required to hold a permit to practice under Tenn. Code Ann. § 62-1-108, which performs attest services, shall be covered by a peer review at least once every three (3) years with a report of that review to be submitted to the Committee. However, the initial review must be completed by August 31 of the next calendar year following the initial date of issuance of the firm permit.

(2) Each firm location that performs one (1) or more audit engagement(s) shall have an on-site peer review. Firm locations that perform only compilations or reviews in accordance with SSARS shall have either an on-site or off-site peer review.

(3) Each firm is responsible for having the review(s) performed at its own cost by a reviewer approved by the Committee or in the alternative, submitting proof of compliance with an approved peer review program.

(4) Failure of a firm location to be included in a peer review performed in a timely manner may result in the denial of the renewal of the location's permit to practice.

(5) Firms with multiple locations may submit a single peer review report covering all locations.

(6) Firm locations not providing attest services shall not be required to undergo a peer review

(7) The Peer Review Program of the Board does not provide for reviews of Audits of Governmental Grant Recipients, Publicly Traded Companies, or Financial Institutions. Those reviews must be obtained through one (1) of the other approved peer review programs.

(8) Firms receiving peer reviews under the PCAOB program will also be required to have a peer review under an approved peer review program that covers the portion of the firms' practice not regulated by the U.S. Securities and Exchange Commission.

0020-6-.06 PEER REVIEW RESULTS.

(1) If the results of a peer review reveal that the professional services of a firm location are in general conformity with applicable professional standards, and the Committee concurs, the firm shall be notified of the acceptance of the review.

(2) If the results of a peer review reveal significant or certain departures from applicable professional standards, and the Committee concurs, the Committee may:

(a) Require the firm location to undergo an additional on-site or off-site review;

(b) Require any individual licensee who had responsibility for the professional services in question to successfully complete specific courses or types of continuing education as specified by the Committee;

(c) Require that the firm location responsible for the professional services submit all or specified categories of its engagements for a preissuance review in a manner and for a duration prescribed by the Committee; and/or

(d) Inform the Board that the firm is not in compliance with the Peer Review Program if it appears that the firm location is unwilling or unable to comply with the Program, or the departures from professional standards are so serious as to warrant consideration of possible disciplinary action.

(3) The costs of the remedial requirements imposed under subparagraphs (2)(a), (b) and (c) shall be borne by the firm.

(4) The results of any remedial requirements imposed under this rule are subject to review and approval by the Committee or the Board's staff.

INSTRUCTIONS FOR FIRMS HAVING A PEER REVIEW UNDER THE TNSBA PEER REVIEW PROGRAM.

General

- An on-site peer review is required for all firms that perform one or more audits of historical or prospective financial statements because of the public interest in the quality of such audits and the importance to the accounting profession of maintaining the quality of those services. Firms that issue only compilations or review reports may have an off-site peer review. The TNSBA Peer Review Program is not approved by GAO for Yellow Book audits or by REA for audits of that program.

- It is the reviewed firm's responsibility to contract with a qualified reviewer to perform the review. Your firm is responsible for these costs.

Prior to the Review

- Agree with the reviewer on the date the review will be performed. The date established must meet the deadline established by the TNSBA Peer Review Committee.

- Notify the TNSBA Peer Review Committee of the name of the approved reviewer and the date the review is scheduled to begin.

- All engagements to be reviewed will be selected by the approved reviewer.

During the Review

- Make sure firm personnel will be available for discussion with the reviewer(s) as necessary. The reviewers will endeavor to have these discussions and interviews without disrupting the firm's operation.

- The firm is required to respond to the reviewer and to the Board regarding any determinations and recommendations noted by the reviewer.

After the Review

- Prior to issuing the schedule of determinations and recommendations, the reviewer must communicate its findings to the reviewed firm in an "Exit Conference." This may be via telephone. If the firm disagrees with any of the reviewer's determinations and recommendations, this is the appropriate time for discussion and suggestions.

- Within 15 days of the date of completion of the review, the reviewer should supply the reviewed firm and the Board office with a copy of the schedule of determinations and recommendations signed by both the reviewer and the reviewed firm.

- If the reviewed firm does not agree with the schedule of determinations and recommendations, it should submit a response letter to the TNSBA Peer Review Committee within 15 days of receipt of the schedule.

- The TNSBA Peer Review Committee will notify the reviewed firm of acceptance and/or of any required follow-up actions to be taken by the firm resulting from the peer review.

- The results of the firm's peer review are confidential and shall not be made available to the public.

FREQUENTLY ASKED QUESTIONS ABOUT PEER REVIEW

Question: When is my Peer Review due and what is the procedure for having one completed and approved by the Board?

> **Answer:** All Tennessee registered firms that perform attest functions (audits, review, compilations or agreed upon procedures) must have a peer review completed once every three years. The initial review is due during the next calendar year following registration or the issuance of the firm's first attest report.
>
> **Answer:** All firms in the TSBA Peer Review Program must complete its peer review by **August 31** of its assigned due date year to comply with the Board's law and rules. The TNSBA Peer Review Manual and a list of Board approved reviewers are provided on the Board's website. Once the review is completed, Form 700-701 of the TNSBA Peer Review Manual must be submitted, along with any letters of comment/response to the Board. The Board's Peer Review Oversight Committee will meet to review and approve the peer reviews performed under the TNSBA program. Letters of acceptance or follow-up will be issued to the reviewed firm.
>
> **Answer:** If your firm is enrolled in the AICPA/TSCPA Peer Review Program, the TSCPA will provide the Board with the information regarding your enrollment in or withdrawal from their peer review program, the due date for your review, and the date of completion. If your firm is enrolled in the AICPA Peer Review Program through a state other than Tennessee, you must provide the Board with proof of current enrollment in the peer review program.

Note: If you have any questions regarding the Board's Peer Review Program, please contact Leona Johnson, Firm Permit Coordinator at (615) 741-2550. If you have questions concerning the AICPA/TSCPA's Peer Review Program, please contact their Peer Review Coordinator at (615) 377-3825.

Question: If I perform mostly write up work, is my firm subject to a peer review?

> **Answer:** Yes, the issuance of a financial statement requires a minimum of a compilation report unless it is a SSARS 8 engagement; therefore your firm is due a peer review. If you render only SSARS 8 engagements, you are not subject to a peer review.

Question: If I am a sole proprietor and have a permit to practice, do I still have to have a registered firm?

Answer: Yes, every individual practicing public accounting in the state of Tennessee should be practicing through a registered office or firm. This would include individuals practicing as sole proprietors.

Question: If I want to do tax returns part-time, do I need to register myself as a firm? If so, will I be subject to a peer review?

Answer: If you plan to do any side work, including tax returns, as a CPA you must register as a firm. You will not be subject to a peer review as long as you do not perform any write-up work including financial statements, compilations, review, or audits.

Question: If my practice consists mainly of tax or consulting work and I perform just one review for someone applying for a contractor's license, will I be subject to peer review?

Answer: Yes, if you perform any attest work including financial statements, compilations, review, or audits, even it it's just one, you will be subject to peer review.

Question: If I have a CPA firm in which I am the only CPA owner and/or employee but I form my firm as a PC with the Secretary of State, can I include "& Associate(s)," "Company," or "Group" in the name of my firm?

Answer: No, a firm with only one CPA owner and/or employee may not use the terms "& Associate(s)," "Company," or "Group" in the name of the firm. Accountancy law prohibits the use of names that are false and misleading. A firm must have more than one CPA owner or employee to use such terms. Firm names should be approved by the Board prior to registration with the Secretary of State's office.

WHAT IS A COMPILATION?

Type of Financial Presentation	Is this a Compilation?	Is Peer Review Required?
Balance Sheet	Yes	Yes
Income Statement	Yes	Yes
Comprehensive Income Statement	Yes	Yes
Retained Earnings Statement	Yes	Yes
Cash Flow Statements	Yes	Yes
Changes in Owners' Equity Statement	Yes	Yes
Statement of Assets and Liability	Yes	Yes
Statement of Revenue and Expenses	Yes	Yes
Statement of Financial Position	Yes	Yes
Statement of Activities	Yes	Yes
Statement of Operations	Yes	Yes
Statement of Operations by Product Lines	Yes	Yes
Statement of Cash Receipts and Disbursements	Yes	Yes
Trial Balance, without subtotals	No	No
Working Trial Balance, without subtotals	No	No
Adjusted Trial Balance, without subtotals	No	No
Listing of General Ledger Accounts	No	No

WHEN DO I NEED TO FILE FOR A FIRM PERMIT?

Section 62-1-108 of the Tennessee Code Annotated requires that each firm or branch office maintained by each sole proprietor, partnership or professional corporation of certified public accountants or licensed public accountants engaging in the practice of public accountancy in this state shall register annually with the State Board of Accountancy. An annual permit fee of $50.00 is required and should accompany your Firm Permit Application or Renewal when returned to this office.

Firm permit applicants must have a resident manager who is an active CPA/PA licensee certified by the Tennessee State Board of Accountancy. The Board will approve firm names which are not false or misleading. If the firm wants to use the terms "and Associates," "Group," "Company," or any similar type wording in its name, the firm must have multiple CPAs employed. Questions regarding firm permits should be directed to the Board office in writing since telephone conversations are not considered binding.

Under Rule 0020-1-.11, applications must be signed by the resident manager of the office location and disclose the following information:

(a) The name of the firm;

(b) The firm's organizational structure;

(c) The address of the office location;

(d) The name and address of each individual with an equity or voting interest in the firm;

(e) A listing of the percentage of equity ownership and voting rights of each owner of the firm;

(f) The percentage of the firm's normal business hours that each non-CPA owner spends working at the firm;

(g) The name, address, and certificate number of each certified public accountant or public accountant employed at the office location;

(h) The name, address, and certificate number of the resident manager of the office location;

(i) The name and certificate number of each person responsible for supervising or providing attest services as contemplated by T.C.A. § 62-1-108(c)(2). The firm's initial application must include a completed experience affidavit for each of these individuals; and

(j) The type of peer review program in which the firm participates along with proof of compliance in a manner acceptable to the Board.

ACTIVE STATUS VS. INACTIVE STATUS

Only active licensees may practice public accountancy. Changing from active to inactive status requires filing a notarized affidavit that is available on the Board's website. A discussion of license status changes from a Board newsletter is reprinted below.

License Status Changes

CPAs can request a status change on their biennial renewal form or by submitting an affidavit. The affidavit may be downloaded from the Board's website under the forms and applications link.

Status options are as follows:

Inactive – Prohibited from performing public accounting services and continues to pay renewal fee. Must put "Inactive" after CPA credential.

Retired over 55 – Retired from public accounting practice and continues to pay the renewal fee. Must put "Retired" after CPA credential.

Retired over 70 – Retired from public accounting practice and does not pay a renewal fee. Must put "Retired" after CPA credential.

Disabled – Unable to perform public accounting services for longer than six months. Must submit a written request to the Board and provide documentation from physician to obtain a waiver of renewal fee and CPE requirement.

Active Military – Must provide the Board with a written request and copy of military orders to obtain a waiver of renewal fee and CPE requirement.

Active – To convert back to active status, must send a written request to the Board and provide documentation of 80 hours of technical CPE completed within the immediately preceding 24-month period.

Closed – No longer considered a CPA, must request change prior to license expiration date and must return wall certificate to the Board. Can reinstate at later date by paying renewal fee and submitting 80 hours of technical CPE completed within the immediately preceding 24-month period.

How to Renew Your License

0020-1-.08 RENEWAL OF LICENSES.

(1) Each holder of a certificate as a certified public accountant or a registration as a public accountant shall be required to renew such certificate or registration biennially.

(2) An individual or firm choosing not to renew his, her, or its license shall notify the Board of his, her, or its intention prior to the expiration of that license, and shall surrender the license to the Board immediately upon its expiration.

(3) Applications for the renewal of certificates and registrations pursuant to the Act shall be made on a form provided by the Board and shall be filed no later than the expiration date set by these rules. Applications will not be considered filed until the applicable fee prescribed in these rules is received.

(4) Applications for renewal of certificates or registrations shall be accompanied by evidence satisfactory to the Board that the applicant has complied with the continuing professional education requirements under T.C.A. § 62-1-107(d) and Chapter 0020-5 of the Board's rules.

(5) The Board may request additional evidence from licensees for continuing professional education requirements including continuing professional education audits (which require CPE course completion documentation). Listings of CPE courses on renewal forms are required; however, the listings are not considered evidence for this rule.

(6) Licensees that renew more than thirty-one (31) days but less than three (3) months following their expiration date will be assessed a late penalty.

(7) Licensees that renew more than three (3) months but less than one (1) year after their expiration date will be assessed an additional late penalty.

(8) Licenses not renewed within (1) year of the expiration date shall be deemed to have lapsed. Any individual desiring to reinstate a lapsed license shall comply with the requirements of paragraph four (4) of this rule and paragraph six (6) of rule 0020-5-.03. The CPE hours required to be completed to reinstate a lapsed license are considered penalty hours and may not be used to offset the CPE hours required for renewal of a license.

Q: If I am licensed and residing in another state, what do I do with my Tennessee CPA license?

A: Before you make a decision about what to do with your Tennessee CPA license, contact the State Board of Accountancy in your state of residence to find out requirements they may have. If your state of residence requires you to maintain your Tennessee license, you will need to continue to renew your CPA license, pay the biennial renewal fee, submit CPE to the Tennessee State Board of Accountancy, and pay the annual Professional Privilege Tax to the Tennessee Department of Revenue. If your state of residence does not require you to maintain your Tennessee license and you do not practice accounting in Tennessee or for Tennessee clients, then you may change your CPA status using one of the affidavits available on the Board's website at www.state.tn.us/commerce/boards/tnsba/formsandapps.html.

Complaint Information

The Accountancy Act authorizes the Tennessee State Board of Accountancy to respond to complaints filed against licensees for possible violations of the Accountancy Act and allegations of unprofessional conduct. Complaints generally come from consumers, other state agencies and other CPAs. The most common allegations in a complaint are unauthorized use of the term accountant, unprofessional conduct in preparing tax returns, and the issuance of substandard financial statements.

Conduct and Ethics

The mission statement of the TNSBA is to protect the public welfare by ensuring that only qualified persons are certified, permitted or licensed and once licensed, these persons who are licensed uphold the highest professional standards of practice, independence, and competency. To this end, a CPA should be aware of and understand state law and rules regarding licensing requirements, maintain independence of thought and action, endeavor to continually improve professional skills, observe generally accepted accounting principles and auditing standards, promote sound financial reporting, uphold the dignity and honor of the accounting profession, and maintain high standards of professional conduct.

The Rules of Professional Conduct adopted and enforced by the Board cover a broad range of behaviors, but do not cover every possible unethical act. These rules include the issues of integrity, contingent fees, disclosures, competence, compliance with standards, and confidential client information.

Finally, it is important to note that the CPA is not only responsible for his or her compliance with these rules, but is also responsible for ensuring that partners, shareholders, or employees under his or her supervision comply with the rules.

Frequently Asked Questions Regarding Complaints

Q: How do I file a complaint?

A: The complaint form is a form that asks for information pertinent to the complaint. You may download the form. If you do not have access to download the form, office staff can mail or fax you the complaint form. Be sure to include all documentation that supports your allegation such as the nature of the complaint, copies of relevant paperwork, and the address of the person or firm you are filing the complaint against.

Q: Can I file a complaint anonymously?

A: Yes, you can. However, we will still need the documentation that supports the allegation.

Q: How do I know if a complaint has been filed against me?

A: Board staff will send written notification when a complaint is filed against you. Upon receiving a notice of complaint, you should respond in writing to the Board within fourteen days.

Q: What happens after I file a complaint?

A: The respondent is sent a copy of the allegation and is requested to send in a written response to the complaint. If the charges are serious in nature, such as embezzlement, the complaint is forwarded to our legal counsel for an immediate investigation. Depending on the nature of the response, additional information from all parties may be requested. All documentation is then sent to legal counsel to determine the next course of action. Legal counsel then reviews the complaint file and makes a recommendation to the Probable Cause Committee as to what type of action should be taken on the complaint.

Q: What happens to me if the allegations in the complaint are unfounded?

A: If the allegations are unfounded, the complaint will be dismissed. You will have a clean slate with the Board.

Q: What happens to me if the allegations in the complaint are true?

A: The Board's legal counsel and the Probable Cause Committee will review your entire complaint file. The committee can take into consideration past complaint history, the severity of the violation, and the risk of harm to the public. Disciplinary action can include consent orders with assessed civil penalties, licensee suspensions, informal conferences and formal hearings. The most severe form of disciplinary action is a revocation of your CPA license and firm license.

Q: Is disciplinary action available to the public?

A: Yes. After the Probable Cause Committee has reviewed the complaint and agrees to a disciplinary action, the Board attorney enforces the action through the issuance of a consent order, formal hearing, etc. Once all stipulations of the action have been met, the complaint file is closed. Board staff then issues a disciplinary report to The Department of Commerce & Insurance's Public Information Officer. Disciplinary action is then posted on The National Association of the State Boards of Accountancy's Web site and the Board's online newsletter.

Q: Will the action taken against me by the state of Tennessee affect my license standing with other state boards or professional accounting organizations?

A: It could. Most states require that licensees disclose disciplinary action taken against them by other state licensing boards and professional accounting organizations. Each state has its own law and rules. The decision to file a complaint against a licensee for past disciplinary action is solely made by the other states or professional organizations.

Q: I am a CPA who has an active reciprocal license in Tennessee. I do not reside in Tennessee. Am I subject to following Tennessee's Accountancy law and rules?

A: Yes. Please read section 62-1-117 and pay particular attention to paragraph 3.

Q: What if I have other questions about the disciplinary process?

A: Contact our office at: TNSBA Davy Crockett Tower, 2nd Floor, 500 James Robertson Parkway, Nashville, TN 37243-1141.

CHAPTER 3 – REVIEW QUESTIONS

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

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

1. Which of the following is the primary purpose of the Board of Accountancy:

    a) promoting the CPA profession
    b) protecting the general public
    c) setting minimum competency standards
    d) collecting CPA permit fees

2. Which of the following is true regarding the AICPA's Code of Professional Ethics and Tennessee CPAs:

    a) AICPA rules are voluntary guidelines
    b) AICPA ethics rules need not be followed by non AICPA members
    c) the AICPA does not have a Code of Professional Ethics
    d) a Tennessee CPA must generally comply with the AICPA Code of Professional Ethics when Board rules are silent on any matter

<u>Use the following fact pattern for the next 4 questions.</u>

Jim Doe, CPA (Doe) prepares tax returns for a large number of clients. Doe has prepared the Form 1040 and Schedule C for Joe Plumber for the last ten years. Joe Plumber (Plumber) keeps no business records except for a profit/loss summary that Plumber's wife prepares using Quicken. Doe has always calculated depreciation and made all other tax related adjustments to Plumber's Quicken report to prepare Plumber's Form 1040. Plumber provides all the necessary documents to Doe and asks Doe to prepare Plumber's current year tax return. Doe prepares Plumber's current year tax return even though Plumber still owes Doe fees for preparing last year's tax return as well as year-end tax planning. Doe does not use any type of client engagement letter since he only prepares tax returns.

3. Assume that Doe demands payment of all past due fees as well as payment for the current year tax return preparation prior to releasing the tax return to Plumber. Which of the following is true regarding releasing the current year tax return to Plumber:

    a) Doe may withhold releasing the current year tax return until all current and past due fees are paid
    b) Doe may withhold releasing the current year tax return pending the payment of past due fees but may not demand payment of current year fees prior to issuing the tax return
    c) Doe must release the current year tax return regardless of the status of unpaid fees
    d) neither the Board of Accountancy nor the AICPA have any rules relating to releasing client records

4. Plumber refuses to pay any of the current or past due fees and demands a copy of all of Doe's workpapers as well as the return of all documents provided to Doe. Which of the following is true:

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

5. Plumber decides to prepare his current year tax return himself. Plumber demands that Doe provide a copy of Plumber's prior year tax return and the depreciation workpapers for the current year that Doe prepared for Plumber's current year tax return. Which of the following is true:

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

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

   a) nothing; problems like this occur in business and are simply a fact of life
   b) use an engagement letter
   c) communicated with each other before the problem arose
   d) both b and c would have helped

CHAPTER 3 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. The CPA societies try to promote the profession.

   B: Correct. A secondary objective is to set competency standards.

   C: Incorrect. Setting competency standards is a secondary purpose.

   D: Incorrect. All fees collected are used in the regulation of the profession.

   (See the Introduction in the course material.)

2. A: Incorrect. Tennessee CPAs must comply with AICPA standards when the state specific rules are silent on any matter.

   B: Incorrect. Tennessee CPAs must comply with AICPA standards when the state specific rules are silent on any matter.

   C: Incorrect. Tennessee CPAs must comply with AICPA standards when the state specific rules are silent on any matter.

   D: Correct. This includes any changes in the rules and interpretations.

   (See Rule 0020-3-.02 in the course material.)

3. **A: Correct.** Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees.

   B: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to pay only a portion of the fees and demand release of the tax return.

   C: Incorrect. Prior to being released, the completed tax return is considered to be part of the CPA's workpapers and is the property of the CPA. Accordingly, the tax return need not be released to the client. The CPA may set the terms for releasing the tax return. Such terms may include receiving payment for some or all fees. The client has no right to demand the release of the return prior to paying fees as required by the CPA.

   D: Incorrect. Both the Board of Accountancy and the AICPA have extensive rules relating to CPA workpapers and the return of client records. In fact, failure to return client records is one of the most common complaints received by the Board of Accountancy.

   (See Rule 0020-3-.11 in the course material.)

4. A: Incorrect. Rule 0020-3-.11 requires the return of all client records upon request. See Rule 0020-3-.11.

   B: Correct. Rule 0020-3-.11 requires the return of all client records upon request. In addition, the licensee must provide a copy of the working papers to the extent that such working papers include records that would ordinarily constitute part of the client's records and are not otherwise available to the client. However, the licensee may demand payment prior to releasing the work papers.

   C: Incorrect. Rule 0020-3-.11 requires the return of all client records upon request. In addition, the licensee must provide a copy of the working papers to the extent that such working papers include records that would ordinarily constitute part of the client's records and are not otherwise available to the client. The depreciation records are part of Doe's workpapers but are also considered part of the client's records and must be made available to the client but only after payment of fees.

   D: Incorrect. Rule 0020-3-.11 requires the return of all client records upon request. In addition, the licensee must provide a copy of the working papers to the extent that such working papers include records that would ordinarily constitute part of the client's records and are not otherwise available to the client. The depreciation records are part of Doe's workpapers but are also considered part of the client's records and must be made available to the client. Doe has no obligation to provide access to any workpapers that are not considered client records.

   (See Rule 0020-3-.11 in the course material.)

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

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

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

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

   (See Rule 0020-3-.11 in the course material.)

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

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

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

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

   (See Rule 0020-3-.11 in the course material.)

CHAPTER 4: ETHICS FOR INDUSTRY CPAs

- Discuss AICPA guidance for Management Accountants.
- Identify ethical guidance promulgated by the Institute of Management Accountants (IMA).
- Compare and contrast the guidance issued by IMA and the AICPA.

Introduction

Although all CPAs begin their careers in public practice, many soon migrate to positions in industry. Many will join the Institute of Management Accountants (IMA). Some of those who join the IMA will also get the Certified Management Accountant (CMA) designation. Many will retain their membership in the AICPA. Both the AICPA and IMA are voluntary member organizations – only members are required to follow their respective ethical guidelines. However, these guidelines were designed in furtherance of the CPA's role as trusted business advisers. Accordingly, these guidelines should be followed by members and non-members alike.

AICPA GUIDANCE

Rule 102 – Integrity and objectivity has particular importance to CPAs in industry. Rule 102 is very broad in its dictate that "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."

Following are summaries and discussion of the AICPA Rule 102 Interpretations relating to Management Accountants.

Interpretation 102-2 (Conflicts of Interest) A conflict of interest may arise when a member performs a professional service for a client or employer and has a "significant relationship" with another party. For example, the firm may provide investment advice for a client but may have a relationship with a financial product that is sold to the client. This situation is not prohibited if the client is informed of the relationship. In making the disclosure to the client the member should make sure that Rule 301 (Confidential Client Information) is not violated. The disclosure and consent option is available only for conflicts of interest. Impairments of independence cannot be so eliminated.

Interpretation 102-3 (Obligations of a Member to His or Her Employer's External Accountant) When a member who is not in public practice communicates with his or her employer's external accountant, the member "must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts." This guidance applies, for example, to written representations requested by the employer's external accountant.

Interpretation 102-4 (Subordination of Judgment by a Member) During the performance of a professional service (all services performed by a member while holding out as a CPA), a member should not subordinate his or her judgment to the position taken by a supervisor. Specifically, if there is a disagreement about the preparation of financial statements or the recording of a transaction, the member should observe the following guidelines.

- Determine whether the position taken by the supervisor is consistent with an acceptable alternative accounting principle. If the principle is generally acceptable, the member does not need to take additional action.

- If the member determines that the alternative accounting principle is not acceptable, the member should communicate the disagreement to an "appropriate higher level(s) of management with the organization." This higher level could include the supervisor's supervisor, members of senior management, or the audit committee.

- If, after the appropriate higher level(s) of management was informed of the disagreement, appropriate action was not taken, the member should consider whether to continue as an employee and whether there is any responsibility to notify appropriate regulatory agencies or the employer's current or former external accountant. Consultation with legal counsel may be appropriate before communicating with external parties.

Cindy Steffen is a CPA and the controller of Company X Inc. In preparing the financial statements for the quarter ended September 30, 200X, Steffen proposes to reduce obsolete inventory to net realizable value. The obsolete items represent a significant amount of total inventory. The CFO concurs with Steffen's position. However, he decides not to go against the CEO whose position is that reducing the inventory this quarter is a discretionary decision and the CEO would prefer to record any such reduction at year end, after Company X completes its anticipated public offering of stock later this year. What are the ethical obligations of Steffen's in this situation?

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

The member should be aware of obligations established under Interpretation 102-3.

The AICPA has also issued one ruling of interest to CPAs in industry. When may an industry CPA use the CPA designation? The AICPA believes it is proper for the CPA to use the CPA designation provided it is not done in a manner that implies the CPA is independent of the employer.

Following are questions asked by AICPA members. The answers are from the AICPA Professional Ethics division:

1. A member is hired by a company as the chief financial officer. The member later discovers that, prior to his or her employment, material false and misleading entries were recorded in the books and records of the company. If he or she fails to record a correcting entry, is the member in violation of the AICPA Code of Professional Conduct?

Yes. Rule 102 requires that in the performance of any professional service, a member shall not knowingly misrepresent facts. Interpretation 102-1 states that a member shall have knowingly misrepresented facts if he or she knowingly fails to correct an entity's financial statements or records that are materially false and misleading when the member has the authority to record such an entry.

2. A member is the controller of a company. The company's external auditors request, and the member provides them with, copies of documents relating to the company's revenue-recognition policy. However, the member does not disclose the existence of other documents that would reveal the company is improperly and prematurely recording revenue which has a material impact on the company's financial statements. Is the member in violation of the AICPA code?

Yes. Under Interpretation 102-3, when dealing with his or her employer's external accountant, a member must be candid and not knowingly misrepresent facts or fail to disclose material facts.

3. A supervisor instructs a member to record a transaction that would result in a material misstatement of the financial statements. If, after appropriate research and consultation, the member determines that the transaction cannot be recorded using an acceptable alternative, should he or she comply with the supervisor's instructions?

No. Interpretation 102-4 prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. If the member concludes that the financial statements could be materially misstated, he or she should discuss the concerns with the appropriate higher level(s) of management and consider documenting his or her understanding of the facts, the accounting principles involved, the application of the accounting principles to the facts and the parties with whom the matters were discussed. If the member then concludes that appropriate action was not taken, that member may wish to consider his or her continuing relationship with the employer and any responsibility to communicate the matter to third parties, including the employer's external accountants. The member also may wish to consult with legal counsel.

4. A member in industry is assigned by his or her employer to facilitate a transaction between two entities. During this process, the member creates false and misleading documents that are presented to one of the entities. Is the member in violation of the AICPA code?

Yes. Rule 102 requires that, in the performance of any professional service, a member shall not knowingly misrepresent facts.

5. A member employed as the controller of a company is directed by its president to record a sale material to the company's financial statements. The member records the sale without obtaining the necessary documents to determine whether the transaction is in compliance with GAAP. It is later discovered that the sale occurred after the reporting period and resulted in materially overstated earnings in the financial statements. Is the member in violation of the AICPA code?

Yes. Under Interpretation 501-4, if the member, by virtue of his or her negligence, makes, or permits or directs another to make, materially false or misleading entries in the financial statements or records of an entity, he or she shall be considered to have committed an act discreditable to the profession.

6. A member who is a CFO has been asked to sign a management representation letter stating that the company's financial statements are in conformity with GAAP when he or she is aware of a material departure from an established accounting principle. Should the member sign the letter?

No. Rule 203 provides that a member shall not state affirmatively that the financial statements are in conformity with GAAP if such financial statements contain any departure from an established accounting principle that has a material effect on them. In addition, Rule 102 requires that in the performance of any professional service a member shall not knowingly misrepresent facts.

STANDARDS OF ETHICAL CONDUCT FOR MANAGEMENT ACCOUNTANTS[1]

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

Members shall abide by the more stringent code of ethical conduct, whether that is the standards widely practiced in their country or IMA's Standards of Ethical Conduct. In no case will a member conduct herself or himself by any standard that is not at least equivalent to the standards identified for members in IMA's Standards of Ethical Conduct.

COMPETENCE

Management accountants have a responsibility to:

- Maintain an appropriate level of professional competence by ongoing development of their knowledge and skills

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- Perform their professional duties in accordance with relevant laws, regulations, and technical standards

- Prepare complete and clear reports and recommendations after appropriate analyses of relevant and reliable information.

CONFIDENTIALITY

Management accountants have a responsibility to:

- Refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to do so

- Inform subordinates as appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that confidentiality

- Refrain from using or appearing to use confidential information acquired in the course of their work for unethical or illegal advantage either personally or through third parties.

INTEGRITY

Management accountants have a responsibility to:

- Avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict

- Refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically

- Refuse any gift, favor, or hospitality that would influence or would appear to influence their actions

- Refrain from either actively or passively subverting the attainment of the organization's legitimate and ethical objectives

- Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity

- Communicate unfavorable as well as favorable information and professional judgments or opinions

- Refrain from engaging in or supporting any activity that would discredit the profession.

OBJECTIVITY

Management accountants have a responsibility to:

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

RESOLUTION OF ETHICAL CONFLICT

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

- Discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level.
- If the immediate superior is the chief executive officer, or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with the superior's knowledge, assuming the superior is not involved.
- Clarify relevant concepts by confidential discussion with an objective adviser to obtain an understanding of possible courses of action.
- If the ethical conflict still exists after exhausting all levels of internal review, the management accountant may have no other recourse on significant matters than to resign from the organization and to submit an informative memorandum to an appropriate representative of the organization.

After resignation, depending on the nature of the ethical conflict, it may also be appropriate to notify other parties.

The author believes that all CPAs in industry should adhere to both the AICPA and IMA guidelines regardless of membership.

Case Study

Integrity and Objectivity

CPA, Director of Finance for a publicly owned company, made journal entries to adjust second and third quarter 200X financial statements according to a model developed and used by the company. When CPA made the adjustments to the second and third quarter financial statements, CPA did not report to senior management or to the external auditors that the adjustments could result in a misstatement of the financial statements. CPA reported the unsupported journal entries on the fourth quarter financial statements.

CPA made journal entries that were not in compliance with Generally Accepted Accounting Principles. CPA did not discharge the duty owed to the general public when CPA allowed incorrect second and third quarter financial statements to be issued.

FOREIGN CORRUPT PRACTICES ACT

Congress enacted the Foreign Corrupt Practices Act in 1977. This Act was passed because of disclosures by the Office of the Watergate Special Prosecutor and the Securities and Exchange Commission (SEC) of the use of U.S. corporate funds for domestic political contributions and for the bribery of foreign government officials. Some of these payments were clearly illegal and others questionable, while some payments appeared to have been made by avoiding internal control systems. To prevent these problems from occurring in the future, the Act requires a publicly traded company (it does not apply to privately held companies) to keep in reasonable detail “books, records and accounts” that accurately and fairly reflect its transactions and disposition of assets, and maintain an adequate system of internal controls. The control system must have the following attributes:

- Transactions must occur under the authorization of management
- Transactions must be properly recorded
- There must be reasonable controls over access to assets
- There must be periodic reconciliations of recorded to actual assets, with an investigation of any differences.

This Act is particularly applicable to multinational organizations, so the controllers of these organizations must be aware of it and its ramifications for enhanced control systems. To be in compliance with the Act, a controller should be particularly mindful of the adequacy of company control systems, as well as of subtle changes in financial results that may indicate the presence of control problems.

The penalties for violation of this act are fines of up to $2,000,000 for any concern convicted of the violation. In addition, individuals involved in such illegal payoffs are subject personally to fines up to $100,000 and prison for up to five years.

INTERNAL AUDITORS

The Institute of Internal Auditors has issued an exposure draft to revise its code of ethics. It would require compliance by all internal auditors not just Institute members.

COOK THE BOOKS & GO TO JAIL

In a sign of a widening crackdown, the Securities and Exchange Commission said it plans to work more closely with criminal prosecutors to attack corporate accounting fraud.

The high-level warning came from Richard H. Walker, the SEC's director of enforcement, who said in a speech that the agency continues "to see an unacceptably high number of busted audits."

To reduce corporate bookkeeping frauds, Mr. Walker said, the agency plans to work more closely with U.S. attorneys' offices across the country to pursue criminal charges against executives involved in such fraudulent behavior. The SEC's top enforcement official said an "increasing number of our cases are also accompanied by criminal charges," and cited the success of a so-called "SWAT-team approach" the agency executed in conjunction with U.S. attorneys in New York in a fraud case against executives of Livent, Inc., the Canadian producer of Broadway shows.

"Cook the books, and you will go directly to jail without passing Go," Mr. Walker said.

MANAGEMENT ACCOUNTANTS SHOULD HEED THE ABOVE WARNING

One of the most common schemes is the bill-and-hold sales transaction. While it's not necessarily a GAAP violation, it's often associated with financial frauds and calls for deeper investigation. The SEC says that all of the following conditions must be met for revenue recognition to be appropriate:

- The risks of ownership must have passed to the buyer.
- The customer must have a commitment to purchase, preferably in writing.
- The buyer must request the bill-and-sale transaction and substantiate a business purpose for it.
- A fixed delivery date must exist.
- The seller must not retain any significant specific performance obligations.
- The goods must be complete and ready for shipment and not subject to being used to fill other orders.

THE ENRON CASE

Enron had one of the most pervasive impacts on the accounting profession and the investment community since the Depression. The largest bankruptcy in American history has called into question the effectiveness of auditors and the integrity of the accounting profession, as a whole. In the post-Enron era, dramatic reforms have been passed, several of which have impacted the ability of the accountants to continue as a self-regulated profession.

Other players in the Enron saga, including financial analysts and lawyers, will also feel the effects of Enron's demise, which will likely result in sweeping reforms in independence, conflict of interest rules and liability limits.

It will take years to sort out the criminal and tort litigation that is a byproduct of Enron's failure. On a short-term basis, Congress is quickly forcing dramatic changes as the public watches and demands accountability for the billions lost by Enron shareholders and creditors. Some of the changes that Congress will make will be positive and constructive, while others will be window dressing. Oddly enough, the changes by Congress will bring Washington's hypocrisy to the forefront. Many of the same Congressmen who now demand changes to the accounting rules were lobbied to oppose those same changes when proposed by the FASB years ago.

SARBANES-OXLEY CORPORATE RESPONSIBILITY ACT OF 2002

Title III of the Sarbanes-Oxley Act deals with making corporations more responsible for the financial statements they issue. Some of the major changes affect audit committees and are designed to make them more independent. In particular, the Act vests the audit committee of an issuer with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It also requires committee members to be a member of the board of directors of the issuer, and to be otherwise independent.

Title IX of the Sarbanes-Oxley Act amends Federal criminal law to increase criminal penalties for: 1) conspiracy to commit offense or to defraud the United States, including its agencies; and 2) mail and wire fraud.

IMA ETHICS HOTLINE NOW OPEN TO ALL FINANCIAL PROFESSIONALS

In response to the need for businesses to maintain the highest ethical standards, the Institute of Management Accountants announced that financial professionals can now get free, confidential guidance on ethical issues through the IMA Ethics Hotline.

Since Enron and other corporate accounting scandals, ethics programs and hotlines are fast becoming an unofficial requirement for businesses. Confidential hotlines, in particular, are gaining popularity to protect an employee from being labeled a "whistleblower."

Financial professionals can call the hotline toll-free at 1-800-638-4427 x 1662, or send their inquiry via e-mail to ethics@imanet.org. The IMA does not record phone numbers or e-mail addresses. Those who contact the hotline can be provided with a numerical code for identification, to maintain confidentiality.

FEDERAL SENTENCING GUIDELINES

Under the newly revised sentencing guidelines, there are five things you can do to change the culture of your company and reduce your firm's potential exposure.

1. Create a formal, written ethics policy.
2. Require managers to monitor ethics compliance.
3. Screen potential employees carefully before hiring.

4. Develop incentives to promote compliance.
5. Encourage employees to speak up when they encounter problems.

Companies that embrace the five items above will receive lighter sentences in the event they are convicted of wrongdoing.

STOCK OPTION BACKDATING

In 2006 and 2007, there was a flurry of controversy over stock option backdating. This controversy is the direct result of an ethical breakdown in corporate America. While it may take years to sort out the full impact of this dubious practice, here are a few of the possible impacts excerpted from articles written by the experts in employee ownership at the National Center for Employee Ownership (www.NCEO.org):

1. **Shareholder Litigation:** Backdating will be a field day for securities lawyers for a number of reasons. If a company said it was issuing options at fair market value, but really didn't, shareholders could sue because they never approved such a plan. Furthermore, IRS rules make shareholder approval a condition of tax-qualified incentive stock option plans.

2. **SEC Enforcement:** Lawyers still haven't quite sorted out all the violations that could be involved with backdating. If an executive got options timed just before the release of data that would affect the stock price, that's potentially insider trading. If the options were granted in a way not in accordance with the plan, that could mean that proper disclosures from the executive to the SEC had not been made. If the two-day rule for reporting grants was effectively violated (because the grant date was pushed back more than two days over what the company actually claimed it was), then the securities laws are violated again.

3. **Corporate Taxes:** It's not entirely clear how the new rules on the taxation of deferred compensation will apply to backdated options issued before the effective date of the new deferred compensation rules under Internal Revenue Code Section 409A, which says that certain kinds of deferred compensation will be heavily taxed unless the recipient specified well in advance when the award would be paid. Options generally do not require such an advance election (you can exercise whenever you like once they are vested until they expire; that's why they are so appealing). Option grants at fair market value are not covered by Section 409A, but discounted options are. More clear is that if the options were incentive stock options, then the backdating would disqualify the option as an incentive option, and the executive would owe big-time back taxes on the exercised award, even if the stock had not yet been sold. If the exercise date is bogus, that means the company has underwithheld taxes on the exercise, and that means it owes the government, with penalties and interest. Failure to withhold payroll taxes on non-qualified options can result in the denial of the corporate tax deduction for the compensation element of the stock option award. This alone could result in hundreds of millions of dollars in unpaid corporate income taxes.

4. **Financial Statements and Restatements:** Rules for recording the impact of options expenses have changed, but under both the old rules and the new rules, pretending the awards were granted at a price they were not requires companies to go back and restate earnings.

5. **Excess Compensation:** Companies can take tax deductions for compensation to top executives over $1 million only if it is performance-based. Backdated options are not, so there may well be tax penalties.

6. **The Alternative Minimum Tax:** Employees who have incentive stock options do not have to pay any tax when they exercise the option, only when they sell the stock (provided they hold the shares for one year after exercise and two years after grant). At sale, they only would pay capital gains taxes, but they may be subject to the alternative minimum tax (AMT) requiring them to count the spread on the option at exercise as a “preference” item. Many employees (especially executives) would have held on to the stock after exercise for at least a year and paid the AMT. But backdated options cannot be incentive options because incentive options must be issued at fair market value. So, that means they now owe regular tax on the exercise of the option from years ago.

7. **Changes to Option Programs:** This scandal could force companies to reduce or eliminate the granting of options. Why risk the hassle? Just cancel the plan.

GREED

Excessive executive compensation seems to be an issue that just won’t go away. The theory seems to be that a good CEO is worth any price a company will pay. Any gain a company makes is assumed to be the sole result of the extraordinary wisdom of this one very special person, not the collective efforts of hundreds or thousands of employees. Despite all the editorials, all the accounting rule changes, and all the new laws, nothing much seems to change except the particular manner in which so many executives get overpaid. Chances are this particular practice will now go away, but another one will surface all too soon. The question is – How will you react to the next scandal? Will you have the courage to question and stop the practice? Check out the latest at www.NCEO.org.

CHAPTER 4 – REVIEW QUESTIONS

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

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

1. Smith is a member of the AICPA and is the controller for a large wholesale distribution company. In the current year, sales were down 10% from the prior year. The Vice President of Finance has instructed Smith to “keep the books open” for a few days in January so that some anticipated large orders could be booked in the prior year. What should Smith do?

   a) determine if “leaving the books open” for a few days is an acceptable alternative accounting principle
   b) communicate the disagreement to the appropriate higher level of management
   c) if higher level management fails to take action, Smith should consider quitting employment
   d) all of the above

CHAPTER 4 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. He must do more than simply analyze the circumstances.

   B: Incorrect. While a proper second step, claiming, "I was only following orders" is not acceptable.

   C: Incorrect. Quitting may be required, but it is not the only requirement.

   D: Correct. A CPA should take all of the above steps.

   (See Interpretation 102-4 in the course material.)

CHAPTER 5: ETHICAL DILEMMAS AND THE CPA

<u>Objectives</u>: After completing this chapter, you will be able to:

- Discuss how the growth in the CPA profession has been accomplished by performing a wider variety of services.
- Explain the concept of "third party liability" as evidenced by the John P Butler Accountancy Corp. case.
- Discuss the Ibanez v. Florida Board of Accountancy case.
- Discuss how Texas sought to regulate when CPAs can use the CPA title.
- Identify increasing SEC scrutiny of public companies and their auditors.

Introduction

When the accountancy act was first enacted, the services offered by CPAs were very limited. These services typically fell into the "attest" area. Soon the public perception of the CPA was one of trust and respect. Naturally, clients who felt comfortable with the quality of services offered by their CPA would seek the CPA's help or opinion in other areas. Slowly, as the business world grew in size and complexity, the CPA began to offer new services to his clients. Contrary to popular belief, this expansion of services did not occur solely in the last twenty years. It is only the rapid pace of this expansion of non-attest services in the last twenty years that has captured the spotlight. It has been most visible with the "Big 4" and national firms that have greatly expanded their non-attest services. This expansion has been both internal and through hiring managers experienced in these new fields to create an instant presence in these areas.

Having worked for a "Big 6" firm from 1985 – 1990, I witnessed this explosion of new services. These new services included:

Appraisal – Cost segregation for investment tax credit, rehabilitation tax credit and property tax appeal purposes. Identification and valuation of intangible assets such as customer lists, deposit base, work force in place, etc. for amortization purposes. Valuation of entire companies for purposes of making a Section 338 election to treat a stock purchase as if it were an asset purchase.

Personal Financial Planning – Advising executives and wealthy individuals on all phases of their investments.

Estate Planning – Reducing estate taxes through the effective use of trusts.

Litigation support – provide expert testimony for court and arbitration proceedings.

Most of the services above which were "discovered" by the large firms in the 1980's were services that very small clients were receiving from sole practitioners and small firms for many years. My father was a practicing CPA in the Mid 1960s specializing in income tax preparation. During this annual tax interview with these small clients he would be barraged with all sorts of questions such as:

- Why is my property tax bill so high?
- Should I do a will?
- Will purchasing a house reduce my tax liability?
- Can I gift ownership of my business to my children?

Obviously, the types of questions asked of a sole practitioner are much less difficult than those asked of a “Big 4” firm. However, the concept is the same. Clients want their CPA to provide a greater menu of services because they trust the CPA.

Most of the non-attest services above can be performed by individuals without any type of license. However, the attest services can only be performed by a duly licensed CPA. The trust that CPAs have earned carries over to their non-attest management advisory services. Accordingly, the CPA designation is an important asset whether CPAs work in public practice or industry. Many CPAs wish to use their reputation as honest hard working financial experts to capitalize on these high growth areas before other professionals capture the market. Still, some purists wish to limit the use of the CPA designation solely to the performance of public accounting. The CPA profession must ask itself, “How will the public be best served?” The vitality of the profession ultimately depends on how the public is served.

Following is a discussion of cases addressing who can use the CPA title.

INTERNATIONAL MORTGAGE COMPANY v. JOHN P. BUTLER ACCOUNTANCY CORP.

John P. Butler Accountancy Corporation (Butler) entered into an agreement with Westside Mortgage, Inc. (Westside) to audit Westside’s financial statements for the year ending December 31, 1978. Butler completed its audit and issued unqualified audited financial statements on March 22, 1979.

Westside is a mortgage company that arranges financing for real property. It accepts loan applications, screens qualified buyers, obtains real estate appraisals, and then either lends the funds requested or finds outside lenders. The loans are then sold to other mortgage bankers.

Westside provided a copy of its audited financial statements to International Mortgage Company (IMC) in October 1979. Subsequently, Westside defaulted on a loan from IMC.

IMC alleged two causes of action against Butler: negligence and negligent misrepresentation, based on Westside’s financial statements of December 31, 1978, which Butler had audited and issued without qualification. It allegedly relied on the defective financial statements in deciding to do business with Westside.

It was admitted Butler had no knowledge of IMC at the time of the audit, nor did IMC contact Butler to verify the financial statements' accuracy. Further, Butler was unaware of IMC's receipt of, and reliance upon, Westside's financial statements.

The court ruled that an innocent party who foreseeably relies on an independent auditor's unqualified financial statement should not be made to bear the burden of the professional's malpractice.

The principal to be understood here is that we CPAs owe a duty not only to our clients but also to those who ultimately use our product – the public.

Note: The above case is somewhat muted under 1995 Federal Securities Law Reform. However, it shows the extent of the reliance placed on CPAs.

The next case deals with something as old as the public accounting profession – how to best showcase your talents and expertise in order to differentiate yourself from your competitors.

IBANEZ v. FLORIDA BOARD OF ACCOUNTANCY

Ibanez was a CPA, CFP and attorney. She was proud of her hard work and accomplishments. She wished to inform the public of these accomplishments by putting all three designations on her business cards, stationery and in her yellow page advertising. Her practice was primarily legal and she did not perform any work which would require a CPA license.

The Florida Board of Accountancy believed that Ibanez was practicing public accountancy solely by using the "CPA" designation. Accordingly, the board felt that she was subject to all of the provisions of the Public Accountancy Act, including those restricting advertising.

In 1994, the U.S. Supreme Court ruled that the Constitutional protection of free speech extended to informing the public of one's CPA designation. Thus, Ibanez could continue to include both attorney and CPA on her business cards and in her advertising.

The fact that this case went to the Supreme Court is important because it stresses how valuable, in the public's eye, the CPA title is. Here, an attorney sought professional credibility beyond that afforded bar members. She had worked hard for that CPA title and obviously felt that it benefited her legal career to proclaim herself to be a CPA.

TEXAS STATE BOARD OF PUBLIC ACCOUNTANCY v. AMERICAN EXPRESS TAX AND BUSINESS SERVICES, INC.

American Express is a diversified financial services company. It operates American Express Tax & Business Services in an attempt to provide a complete menu of services to small business clients. These services include personal and business tax preparation as well as compiling financial statements.

In the aftermath of the *Ibanez* case, Texas amended its CPA licensing rules in order to protect the public. The new Texas requirements are: 1) An individual CPA can use the CPA designation regardless of where they work; 2) Public accounting (audits, reviews, compilations) may only be performed by registered CPA firms which must be 100% owned by CPAs; 3) If an employee of a non-CPA commercial entity makes a disclosure that he is a CPA then the CPA's employer must disclose that it is not a CPA firm by using the following disclaimer, "Not qualified to register with the Texas State Board of Public Accountancy in Texas".

Thus, a CPA working for AMEX could put the designation "CPA" after his name but would have to also include the disclaimer, "Not qualified to register with the Texas State Board of Public Accountancy in Texas" on their AMEX business card. Needless to say, most affected CPAs did not want the words "not qualified" on their business cards. In 1995 the Board of Accountancy filed suit against AMEX for the practice of public accountancy without a license.

The court ruled that CPAs working for non-CPA firms such as AMEX could prepare tax returns but not compilation reports. Both AMEX and the Board of Accountancy immediately issued press releases touting their victory.

On July 30, 1997 the Federal Appeals Court ruled in favor of AMEX in a similar case in the state of Florida. The Eleventh Circuit Court of Appeals ruled that a Florida accountancy statute violates the First

Amendment by barring CPAs working for the unlicensed company from using their designation. Florida appealed this decision to the U.S. Supreme Court, which declined to grant certiori.

The decision frees AMEX to advertise in Florida that it employs CPAs and permits CPAs working for the company to use their designation. Florida has responded with unique and revolutionary ideas. Florida will now allow CPA Firms with no CPA owners. At the same time, the new law regulates audit firms at a new and higher level as a licensed audit firm. Meanwhile, other firms which provide no attest work, could opt for so called "basic regulation" and handle all other CPA-type services.

AMEX received help in mid 1997 when the AICPA and NASBA (National Association of State Boards of Accountancy), who initially opposed the company's position, changed their policies.

The issues regarding the use of the CPA title as well as when a CPA must conform to prescribed standards when performing non-attest functions will continue to confront practitioners. Recently the AICPA and NASBA joined forces to propose a uniform set of laws regulating CPAs. This "national certification" seeks to alleviate some of the issues above. The AICPA is also wrestling with allowing CPAs to issue "plain paper" financial statements that do not carry the name or designation of a CPA.

SEC Scrutiny Increases

The Securities and Exchange Commission adopted new rules on what constitutes improper professional conduct by accountants, following an appeals court ruling that its standards were unfathomable. But SEC Commissioner Norman Johnson warned that the standards could chill relationships between accountants and clients.

Negligent conduct would also violate SEC rules if it presents a substantial risk of making a document materially misleading, or if repeated violations demonstrate incompetence. "Let me assure you that the commission has no intention of sanctioning those who merely make a simple, harmless mistake," said SEC Chairman Arthur Levitt.

But Mr. Johnson said that if negligence were accepted as a standard, accountants may shun consulting on difficult issues for fear of personal liability. Violators would be suspended or barred from performing many public auditing functions.

The amended rule now reads:

"With respect to persons licensed to practice as accountants, 'improper professional conduct' under 201.102(e)(1)(iii) means:

"(A) Intentional or knowing conduct, including reckless conduct, that results in a violation of applicable professional standards; or

(B) Either of the two types of negligent conduct:

(1) A single instance of highly unreasonable conduct that results in a violation of applicable professional standards in circumstances which an accountant knows, or should know, that heightened scrutiny is warranted.

(2) Repeated instances of unreasonable conduct, each resulting in a violation of applicable professional standards that indicate a lack of competence to practice before the commission.

SEC Attacks "Eroding" Financial Reporting

On the heels of adopting a rule clarifying "improper conduct" on the part of accountants, U.S. Securities and Exchange Commission Chairman Arthur Levitt has called for a governmental "action plan" to stem what he called the "eroding" financial reporting in corporate America.

Levitt and other SEC officials warned accountants and auditors that five shell-game accounting practices that companies employ will be scrutinized more closely by the government in the future.

The five areas of scrutiny are:

- "Big Bath" restructuring charges
- Creative Acquisition Accounting
- "Cookie Jar" reserves against poor quarters of performance
- "Immaterial" misapplications of accounting principles.
- Premature recognition of revenue

In part, this is a reaction to companies trying to meet or beat Wall Street earnings projections in order to grow market capitalization and increase the value of stock options. “Too many corporate managers, auditors and analysts are participants in a game of nods and winks”, Levitt said.

SEC Censures PWC

In 1999, the SEC censured PriceWaterhouseCoopers for failing to adequately supervise its own personnel and to follow up on its own policies. In a probe of the Tampa, Florida office, the SEC found 45 instances in which Coopers’ retirement plan owned stock in audit clients, 31 cases of partners and managers who owned stock in firm clients, and four examples of CPAs who owned stock in companies that they personally audited.

SEC Issues Rules on Independence

The Securities and Exchange Commission has adopted rule amendments regarding auditor independence. The amendments modernize the commission’s rules for determining whether an auditor is independent. Some of the rules were effective in 2001.

The amendments do the following:

- Reduce the number of audit firm employees and their family members whose investments in audit clients are attributed to the auditor for purposes of determining the auditor’s independence.

- Decrease the number of family and former firm personnel whose employment impairs independence.

- Identify non-audit services that impair independence.

- Provide limited exceptions for certain inadvertent independence impairments.

- Require most public companies to disclose in their annual report fee paid to their auditor for non audit services.

OBSERVATION: *These rules apply only to public companies. The rules have almost no impact for firms with no SEC registrant clients. If you have no SEC clients, you may skip the following material.*

The following is an unofficial comparison of AICPA rules for non public companies and SEC rules (public companies).

	AICPA's Rules for Non Public Companies	SEC's Rules
Bookkeeping and Related Type Services	These are permitted, provided management approves all adjustments and provides the coding.	These are not permitted.
Financial Information Systems Design and Implementation	This is permitted.	This is permitted, under certain conditions.
Appraisal or Valuation Services and Fairness Opinions	These are permitted if the client approves all significant judgments about the services and can make an informed judgment on the results of your firm's services.	Generally, these are not permitted, however, there are a few exceptions.
Actuarial Services	These services are permitted, provided the client approves all significant judgments and can make an informed judgment on the results of your service.	These are permitted, but are more restrictive.
Internal Audit Services	These are permitted, provided you do not act or appear to act in a management capacity. You may not have custody of assets, make decisions on the client's behalf, nor may you report to the board or audit committee on management's behalf. The client must designate competent management to oversee the function, determine the scope, risk, and frequency of the activity, and evaluate the result and the adequacy of the procedures.	These are limited to not more than 40% of the I/A services; however, there is a small client exception.
Investment Advisory Services	You are permitted to make recommendations about suitable investments, keep investment records, and analyze performance. However, you may not make investment decisions, execute transactions or take custody of a client's assets.	You are not permitted to offer these services.

CHAPTER 5 – REVIEW QUESTIONS

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

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

1. The *International Mortgage Corporation v. John P. Butler Accountancy Corp.* case is important because:

   a) the court found the defendant "criminally negligent" in an accounting case
   b) the court enforced the California Accountancy Act for an audit that occurred in a foreign country
   c) the case set forth the concept that CPAs owe a duty of care to those who foreseeably may rely on the independent auditors unqualified opinion
   d) the case demonstrated that a CPA operating in the corporate form was not immune from liability for negligent actions the CPA did while an employee of his wholly owned corporation

2. In Ibanez v. Florida Board of Accountancy, the court found:

   a) an individual may not be both an attorney and CPA at the same time
   b) an attorney may inform the public that she is a CPA by using the CPA title in advertisements for her practice of law
   c) the Florida Board of Accountancy has regulatory authority over attorney/CPAs
   d) CPAs owe a duty of care only to their clients

3. In the *Texas State Board of Accountancy v. American Express* case the court ruled:

   a) CPAs working for AMEX could prepare tax returns
   b) all AMEX employees could prepare compilation reports
   c) CPAs working for AMEX could prepare compilation reports
   d) more than one of the above are correct

CHAPTER 5 – SOLUTIONS AND SUGGESTED RESPONSES

1. A: Incorrect. This was a civil case, not a criminal case.

   B: Incorrect. All audit activity took place in California.

   C: Correct. CPAs must stand behind their work.

   D: Incorrect. Professional corporations do not protect the owner from his own negligence as an employee.

   (See the International Mortgage Corporation case in the course material.)

2. A: Incorrect. A CPA may also hold other professional licenses.

   B: Correct. Advertising one's credentials is not prohibited.

   C: Incorrect. The Board does not regulate attorneys.

   D: Incorrect. The duty of care was not an issue in this case.

   (See the Ibanez case in the course material.)

3. **A: Correct.** CPAs working for AMEX could prepare tax returns.

   B: Incorrect. The case did not involve the work of non CPAs.

   C: Incorrect. The case did not allow the preparation of compilation reports.

   D: Incorrect. The case only permitted the preparation of tax returns.

   (See the Texas State Board of Public Accountancy case in the course material.)

GLOSSARY OF ETHICS TERMS

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

TERM	DEFINITION
Alternative Practice Structures (APS)	A nontraditional structure for the practice of public accounting in which a traditional CPA firm engaged in auditing and other attestation services might be closely aligned with another organization, public or private, that performs other professional services (e.g., tax and consulting).
American Institute of Certified Public Accountants (AICPA)	The national professional organization for all certified public accountants (CPAs).
Client's records	Any accounting or other records belonging to the client that were given to the member by, or on behalf of, the client.
Close relative	Close relatives are the member's nondependent children (including grandchildren and stepchildren), brothers and sisters, grandparents, parents, and parents-in-law. Spouses of any of the above are also close relatives. The SEC definition of close relatives expands the above to include a spouse's brothers and sisters and their spouses.
Code of Professional Conduct (the Code)	The Code was adopted by the membership of the AICPA to provide guidance and rules to all members on various ethics requirements. The Code consists of: 1) Principles, 2) Rules, 3) Interpretations, and 4) Ethics Rulings.
Conflict of interest	A conflict of interest may occur if a member performs a professional service for a client or employer, and the member or his or her firm has a relationship with another person, entity, product, or service that could, in the member's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the member's objectivity.
Consulting process	The analytical approach applied in performing a consulting service. The process typically involved some combination of the following: • Determining the client's objective • Fact-finding • Defining problems or opportunities • Evaluating alternatives • Formulating proposed actions • Communicating results • Implementing • Following up

Consulting services	Professional services that use the practitioner's technical skills, education, observations, experiences, and knowledge of the consulting process.
Contingent fee	A fee for performing any service in which the amount of the fee (or whether a fee will be paid) depends on the results of the service.
Direct financial interest	A direct financial interest is created when a member invests in a client entity.
Disqualifying services	Term used to refer to the following services, which when performed for a client prohibit the member from accepting a contingent fee or commission: a. An audit or a review of a financial statement. b. An examination of prospective financial information. c. A compilation of a financial statement expected to be used by third parties except when the compilation report discloses a lack of independence.
Ethics Rulings	Part of the Code of Professional Conduct. Rulings summarize the application of rules and interpretations to a particular set of factual circumstances.
Firm	A form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof.
Former practitioner	A proprietor, partner, shareholder or equivalent of a firm, who leaves by resignation, termination, retirement, or sale of all or part of the practice.
Holding out as a CPA	Includes any action initiated by a member, whether or not in public practice, that informs others of his or her status as a CPA.
Independence in appearance	If there are circumstances that a reasonable person might believe are likely to impair independence, the CPA is not independent in appearance. To be recognized as independent, the auditor must be free from any obligation to or interest in the client, its management, or its owners.
Independence in fact	To be independent in fact (mental independence), the CPA must have integrity and objectivity. If there is evidence that independence is actually lacking, the auditor is not independent in fact.
Indirect financial interest	An indirect financial interest is created when a member invests in a nonclient entity that has a financial interest in a client.
Integrity	An element of character fundamental to professional recognition. It is the quality from which public trust derives and the benchmark against which a member must ultimately test all decisions.

Internal audit outsourcing	Internal audit outsourcing involves performing audit procedures that are generally of the type considered to be extensions of audit scope applied in the audit of financial statements. Examples of such procedures might include confirming receivables, analyzing fluctuations in account balances, and testing and evaluating the effectiveness of controls.
Interpretations of rules of conduct	Part of the Code of Professional Conduct. Interpretations are pronouncements issued by the AICPA's Division of Professional Ethics to provide guidelines concerning the scope and application of the rules of conduct.
Joint closely held business investment	An investment that is subject to control by the member, or the member's firm, client or its officers, directors, or principal stockholders, or any combination of the above.
Joint Ethics Enforcement Program (JEEP)	The AICPA and most state societies cooperate in the Joint Ethics Enforcement Program (JEEP) in bringing enforcement actions against their members.
Member	In its broadest sense, "member" is a term used to describe a member, associate member, or international associate of the AICPA. All members must adhere to the AICPA's Code of Professional Conduct. For the purposes of applying the independence rules, the term "member" identifies the people in a CPA firm and their spouses, dependents, and cohabitants who are subject to the independence requirements.
Multidisciplinary practices (MDP)	Arrangements in which CPAs share fees with attorneys or other professionals.
National Association of State Boards of Accountancy (NASBA)	A voluntary organization composed of the state boards of accountancy. It promotes communication, coordination, and uniformity among state boards.
Objectivity	The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Objectivity is a state of mind, a quality that lends value to a member's services.
Period of professional engagement	The period of engagement starts when the member begins the service requiring independence and ends upon termination of the relationship (by the member or the client) or, if later, when the report is issued. The period does not stop when the report is issued and restart with the beginning of the next engagement. The period of engagement typically covers many periods.

Practice of public accounting	According to the Code of Professional Conduct, the practice of public accounting consists of the performance for a client, by a member or a member's firm, while holding out as CPAs, of the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements on Standards for Tax Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Engagements. However, a member or member's firm, while holding out as CPAs, is not considered to be in the practice of public accounting if the member or the member's firm does not perform, for any client, any of the professional services described in the preceding paragraph.
Principles	Positive statements of responsibility in the Code of Professional Conduct that provide the framework for the rules, which govern performance.
Professional services	Includes all services performed by a member while holding out as a CPA.
Rules	Broad but specific descriptions of conduct that would violate the responsibilities stated in the principles in the Code of Professional Conduct.
Securities and Exchange Commission (SEC)	A federal government regulatory agency with responsibility for administering the federal securities laws.
State boards of accountancy	State government regulatory organizations. Each state government issues a license to practice within the particular state under that state's accountancy statute.
State societies of CPAs	Voluntary organizations of CPAs within each individual state.
Statements on Standards for Tax Services (SSTS)	SSTS superseded and replaced the AICPA's Statements on Responsibilities in Tax Practice (SRTP). They are enforceable standards of conduct for tax practice under the Code of Professional Conduct.
Unpaid fees	Fees for: 1) audit, and 2) other professional services that relate to certain prior periods that are delinquent as of the date the current year's audit engagement begins, if the client is an SEC registrant, or the date the audit report is issued for non-SEC clients (i.e., AICPA rule).
Yellow Book	Governmental Auditing Standards issued by the Government Accountability Office.

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