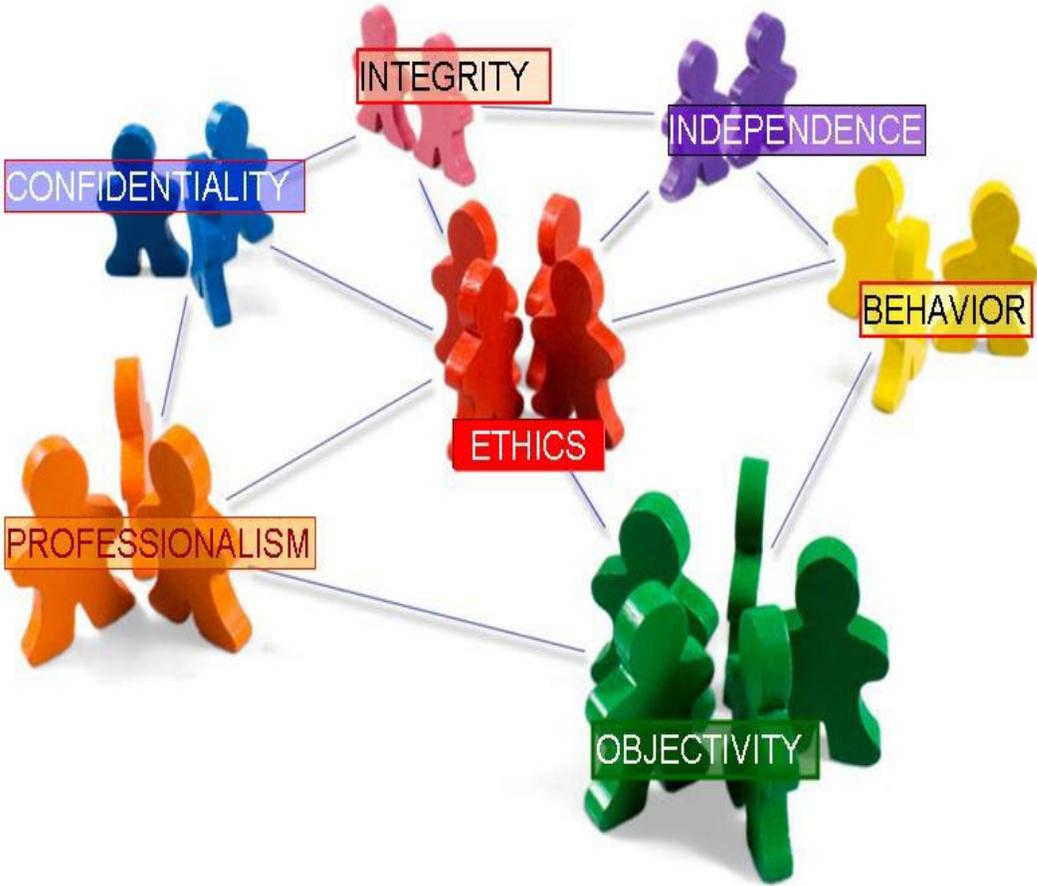


# ACCOUNTING ETHICS



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## **Course Objective**

1. To educate Texas Certified Public Accountants in ethical standards and issues associated with the practice of accounting within the State of Texas. As part of the education process, this course will:
  - a. aid Texas CPAs in applying ethical judgment when interpreting the various standards and rules applicable to the practice of public accountancy within the State of Texas.
  - b. encourage Texas CPAs to place primary importance in ethical decision-making on public rather than self-interest when evaluating their ethical decisions even at the loss of position or client.
2. To help Texas CPAs to develop more than a technical understanding of the various applicable Rules of Professional Conduct when involved in the performance of professional accounting services/work. Within this context, this Course will review and encourage open discussion of the Rules of Professional Conduct and their implications for persons in a variety of practices, including:
  - a. attest and non-attest services for Texas CPAs in public practice.
  - b. internal accounting and auditing services for those Texas CPAs in industry.
  - c. education or government service.

## **Course Sequence:**

<b><u>Module</u></b>	<b><u>Activity</u></b>	<b><u>Duration</u></b>
1	Culture and Ethical Attitudes	50 minutes
2	Ethical Aspects of Organizational Governance, Fraud and Bribery	50 minutes
3	Ethical Behavior	50 minutes
4	Ethical Philosophies	50 minutes
5	Codes of Conduct	50 minutes

## Accounting Ethics Program

This course satisfies the requirements for the required 4-hour ethics training required by the Texas State Board of Public Accountancy.

It is conducted at an **intermediate level** for practicing CPAs who already have backgrounds in tax, financial accounting, auditing, and managerial accounting.

The course takes a different approach to ethical attitudes and focuses on identifying ethical behavioral components. To accomplish this, the course is divided into 5 Modules intended to help CPAs to identify and reach satisfactory conclusions about ethical issues in their practice.

1. Module 1 examines the role of geographic as well as generational culture on our ethical attitudes.
2. Module 2 investigates ethical aspects of Corporate Governance and Fraud in association with managerial ethical attitudes and behavior.
3. Module 3 considers ethics from a human behavioral standpoint to help participants understand the various “pulls and tugs” that are inherent in our human nature.
4. Module 4 focuses on ethical philosophies with emphasis on ethical thinking and analysis, including references to existing research in ethical philosophies associated with ethical processing.
5. Module 5 will review the current Codes of Professional Conduct applicable to practice in Texas, including the current Texas and AICPA Codes of Professional Conduct.

# **Module 1 - Ethics & Culture**

## **Module 1 Objectives:**

After reviewing Module 1 you should be able to better understand the relationship between generational and geographic culture and ethical behavior and attitudes.

**[Back to Start](#)**

# **Module 1**

## **Tab 1 – Slides and Notes**





GENERATION Z:  
CONNECTED FROM BIRTH.  
Born mid-1990s to 2010.



- 20% of the workforce;
  - Pressure to succeed; but
  - Self-assured.
  - Conservative spending...With a
- Different concept of "community" (global and facebook/twitter).
- They want (not need) instant gratification in **feedback and rewards**
  - Want mentors/coaches, not managers;
    - Some companies have hired "celebration assistants" to administer reward programs to younger workers. [Wall Street Journal]
  - Early career promotions [Deloitte, 2018 survey].



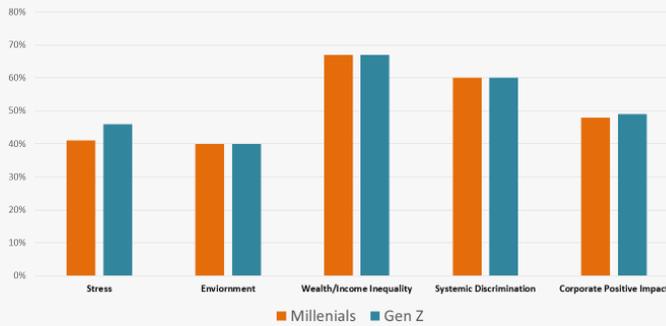
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### Generational Divide

- Over the first 10 years in the workforce, young workers will
  - Change jobs an average of **7** times;
  - Change **careers** an average of **3** times. [Crumpacker, 2007; Topal & Ward, 1988; Morrison, et al, 2006; Martin, 2005]
- Make long-term commitments to an organization of an average of **1** year.
  - Job Surfing.
- Progressive inability to self-evaluate. [Twenge, 2019]
  - More likely to blame external circumstances/persons for mistakes or failures. [Twenge, 2004, 2019]

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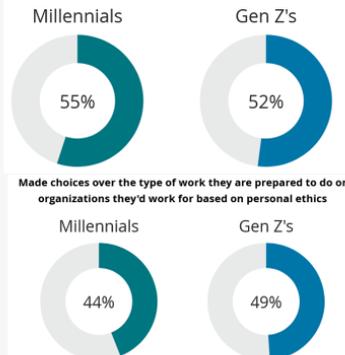
### Millennials/GenZ – Causes for Concern (Deloitte 2021 Global Survey)



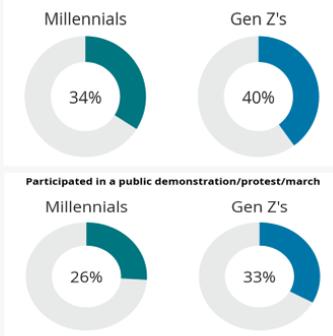
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### Millennials Deloitte 2021 Survey

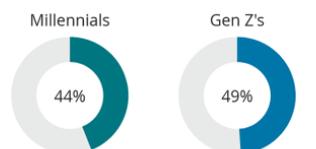
Donated to charities



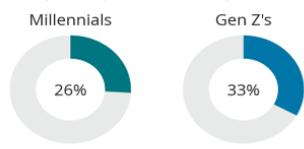
Created social media content relating to an environmental, human rights, political or social issue



Made choices over the type of work they are prepared to do or organizations they'd work for based on personal ethics



Participated in a public demonstration/protest/march



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### Cultural Variables and Ethical Attitudes



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### Cultural Priorities

<u>United States</u>	<u>Japan</u>	<u>Middle East Countries</u>
1. Freedom	1. Belonging	1. Family security
2. Independence	2. Group harmony	2. Family harmony
3. Self-reliance	3. Collectiveness	3. Parental guidance
4. Equality	4. Age/seniority	4. Age
5. Individualism	5. Group consensus	5. Authority
6. Competition	6. Cooperation	6. Compromise
7. Efficiency	7. Quality	7. Devotion
8. Time	8. Patience	8. Patience
9. Directness	9. Indirectness	9. Indirectness
10. Openness	10. Go-between	10. Hospitality

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### Cultural Gaffes

- When **Kentucky Fried Chicken** entered the **Chinese** market, they discovered that their slogan “finger-lickin’ good” came out as “eat your fingers off”
- **Coke** tried to twist their trademark into Ke-kou-ke-la to get it to sound the same. The result, after printing thousands of signs and banners, was that their slogan meant either “bite the wax tadpole” or “female horse stuffed with wax”.
  - Coke now uses “ko-kou-ko-le” which roughly means “happiness in the mouth”
- When **Pepsi** entered the **Chinese** market, they tried to translate their slogan “Pepsi brings you Back to Life” into Chinese.
  - The translation promised more than they could deliver - they found it translated to “Pepsi Brings your ancestors back from the Grave”
- In **Italy**, **Schwepps Tonic Water** translated into “Schwepps Toilet Water”.
- In **Mexico**, **Parker Pens** tried to market their pens as “It won’t leak in your pocket and embarrass you” translated into “it won’t leak and make you pregnant”.
- When entering the **US** market, **Japan’s** second-largest tourist agency found it would have to change it’s name – **Kinki Nippon** Tourist Company.

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### International Scandals

- Parmalat (Italy) - \$10 Billion;
- Australia;
  - Harris Scarfe – \$160 Million (PwC).
  - HIH (Insurance) – 2.7 Billion.
    - Guess who was their auditor?
- SK Global (Korean Trading Firm) - \$1.3 Billion;
- YGX (China – Eco-Agriculture) - \$92 Million;
- Vivendi (France - Telecom) - \$47 Billion;
- Satyam (India – Computer Services) – \$1.47 Billion.

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### Hofstede's Model of Culture

- Power/distance (PD)
  - Individual equality with a culture.
- Uncertainty avoidance (UA)
  - A culture's willingness to change.
- Collective vs. Individualistic (IND)
  - Does the culture value individual or group (however defined) activities.
- Achievement Orientation (MAS)
  - Focuses on whether a culture measures success in terms of achievements (that were, at the time, considered to be masculine characteristics) or nurture.
- Societal Orientation (LTO)
  - How forward-looking is a culture. How far out do they plan.
- Self-Restraint (IND)
  - A recent addition, this marker tries to evaluate how much a culture is willing to restrain immediate gratification.

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### Citizen Equality - Power Distance (PD)

- A **High PD** culture allows/accepts power/wealth inequalities.
  - System hinders significant upward mobility.
  - Permits corruption.
  - People in such a culture
    - Show less pride in work.
    - Feel disconnected from the benefits of their efforts.
      - As a result, their ethics are "external".
        - » They will rigidly follow relevant codes of conduct; and
        - » Sacrifice others at the expense of organizational attitudes (whether ethical or not).
    - Believe corruption is an integral part of their society
- A **Low PD** culture de-emphasizes power and wealth differences between citizens.

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### Citizen Equality Throughout the Globe



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Self-Restraint (IND)

- **INDULGENT cultures** want immediate gratification.
- **Restrained** Cultures (less IND) are
  - willing to **postpone gratification** and/or
  - **regulate** it through social standards.



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# **Module 2**

## **Ethical Aspects of Organizational Governance, Social Responsibility Fraud & Bribery**

Module 2 Objectives:

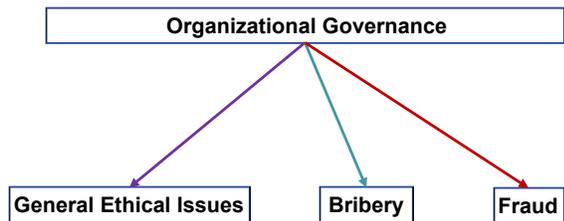
After reviewing Module 2 you should be able to:

- Understand the impact and role of organizational governance and social responsibility in ethical behavior and attitudes; and
- integrate Module 1 into how fraud, social obligations and bribery impact ethical attitudes and behavior.

**[Back to Start](#)**

# **Module 2**

## **Tab 1 – Slides**



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## GENERAL ETHICAL ISSUES

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### Organizational Governance – Behavior

- **Money and addictive substances** affect similar pathways in our brain.
  - These are **not** the same pathways as occur with natural rewards, such as food and water.
  - Are activated **just by the discussion or thought of money.**  
[Potenza, 2004; Tancredi, 2015]
- **Gamblers** (like fraudsters) have been shown to have abnormally low serotonin levels in areas of the brain that are associated with impulse control.  
[Tancredi, 2015; Thut, 1997]
  - Low impulse control correlates to potential fraud tendencies.

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## ORGANIZATIONAL ACCOUNTABILITY AND IT'S IMPACT ON FRAUD AND ETHICAL ATTITUDES

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### Organizational Governance - Accountability

#### •Take it Outside

##### – Externally-administered

- reporting channel with associated training
- Offsets group, obedience (Milgram), and power (Stanford) issues. [Mesmer-Magnus, 2005; Near & Miceli, 1996; Gao, Greenberg, Wing, 2015; Dworkin & Baucus, 1998; Wier, Achilles, 2015; Zhang, 2009]

#### •Fraud Losses



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## TRUST AND COMPENSATION

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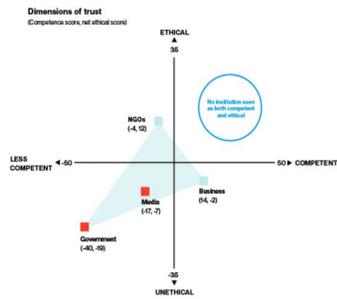
## Edelman – Organizational Trust

- Capitalism as it exists today does more harm than good

28%

56%

- Competence and Ethics




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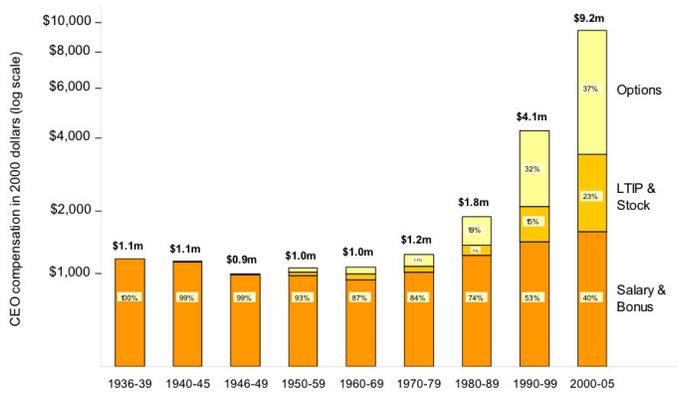
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## Organizational Governance – Executive Compensation




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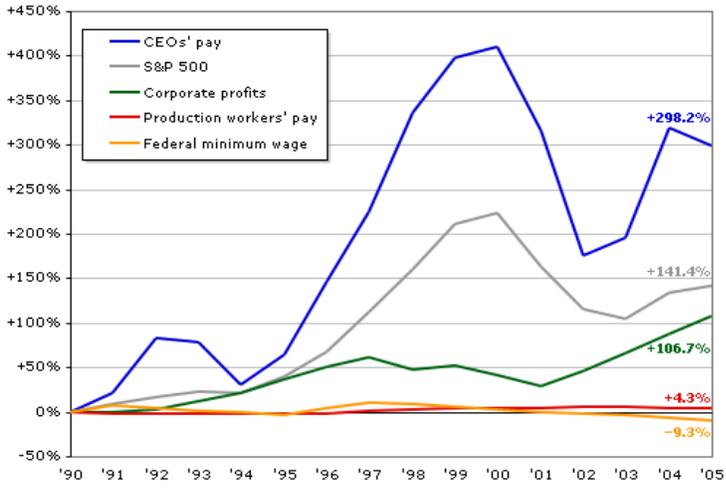
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## Corporate Governance - Executive Compensation




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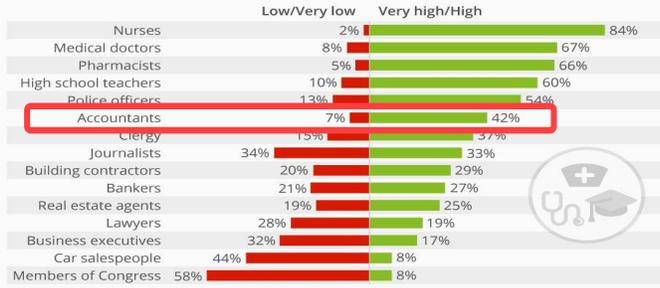
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Public Confidence in Professionals

America's Most & Least Trusted Professions

Rating of selected U.S. professions in terms of honesty and ethical standards in 2018



© StatistaCharts n=1,025 U.S. adults Source: Gallup

Forbes statista



Fraud and Financial Reporting

- **PCAOB report** - auditors fail to effectively modify their standard audit procedures in response to fraud risk.
- **Nearly 1/3 of SEC enforcement actions cite auditor failure to consider a client's fraud potential.** Allegations include **failure to**
  - gather sufficient competent audit evidence (73%);
  - exercise **due professional care** (67%);
  - exhibit adequate level of **professional skepticism** (60%);
  - obtain adequate **evidence** related to **management representations** (54%);
  - express an **appropriate audit opinion** (47%).

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BRIBERY AND CORRUPTION

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**Bribery's Economic Effect**

- The World Bank estimates that more than \$1 Trillion dollars is actually paid in bribes annually.
- Reduced corruption (Chile, Costa Rica, Slovenia) significantly increases per capita income ([www.worldbank.org](http://www.worldbank.org)).
- 96% of top executives list bribery as the most likely form of corruption.
- Incidences of bribery has increased from 10.9% in 2020 to 17% in 2020.

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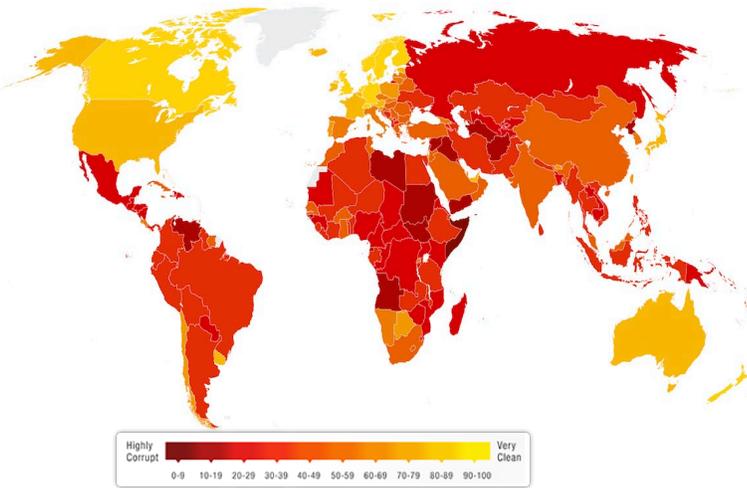
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**Transparency International Corruption Perception**



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**FRAUD COSTS/PENALTIES**

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Fraud Overview [ACFE 2020]

- Median loss is \$\$116,200.
  - Nearly 1-in-4 frauds cost at least \$1 million (~5% of gross revenue).
- One in 7 companies may be committing corporate fraud this year.
- Shareholder cost:
  - Overall - 22% of enterprise value in fraudulent firms;
  - 3% of enterprise value in ALL firms.

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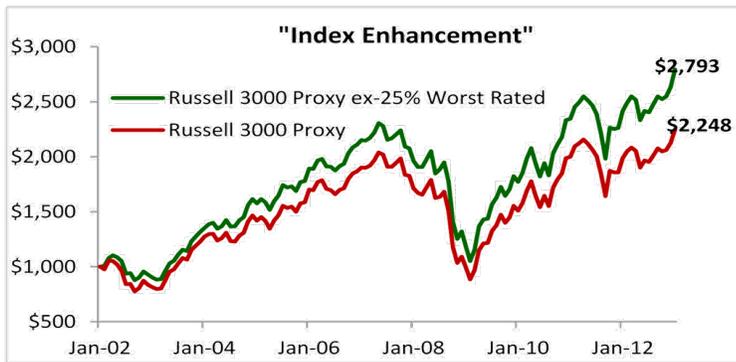
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Fraud's Market Penalty

- \$1 of inflated stock value → \$3.08 of loss when the fraud is detected;
  - \$0.36 due to expected legal penalty;
  - \$2.72 due to loss of reputation.



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ANATOMY OF A FRAUDSTER

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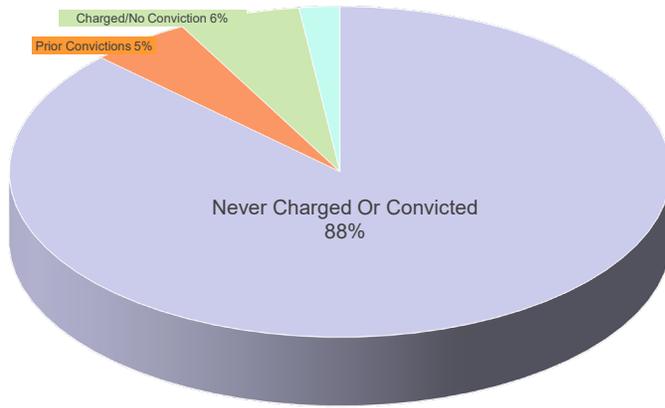
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## Anatomy of a Fraudster

“When compared between criminals and college students, the personality and demographics of someone likely to commit fraud more closely resembled the college students than the criminals.”



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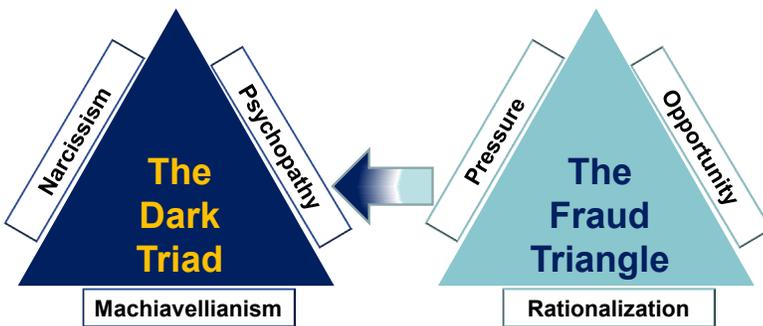
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**Fraud by Age**



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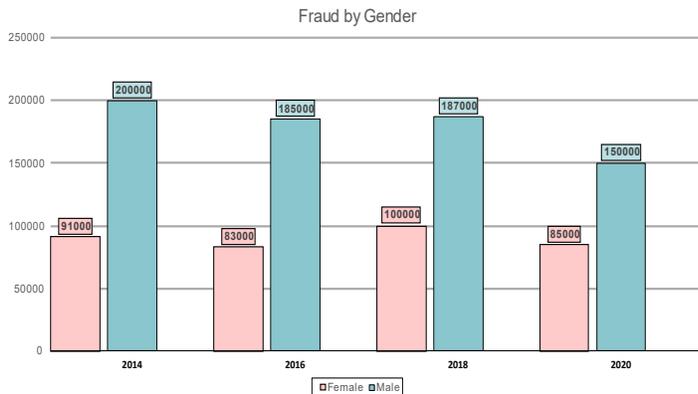
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**Fraud by Gender**



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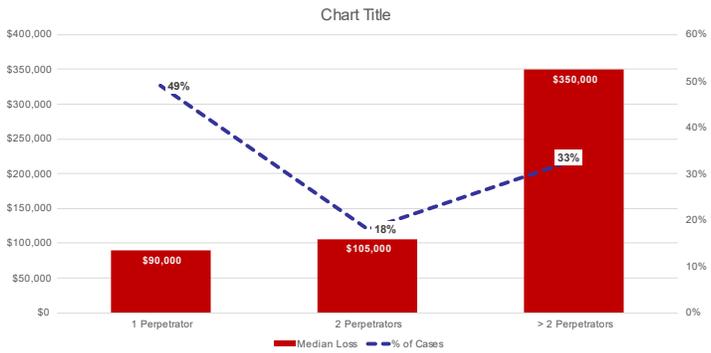
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**Fraud - Groups - Collusion**



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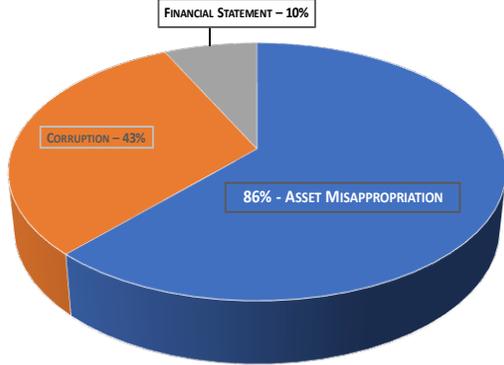
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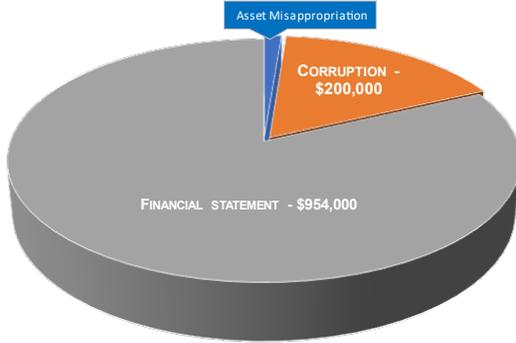
Fraud By Category



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Fraud By Average Amount



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**FRAUD  
THOUGHTS ON HOW TO LIMIT A  
FRAUDSTER'S OPPORTUNITIES**

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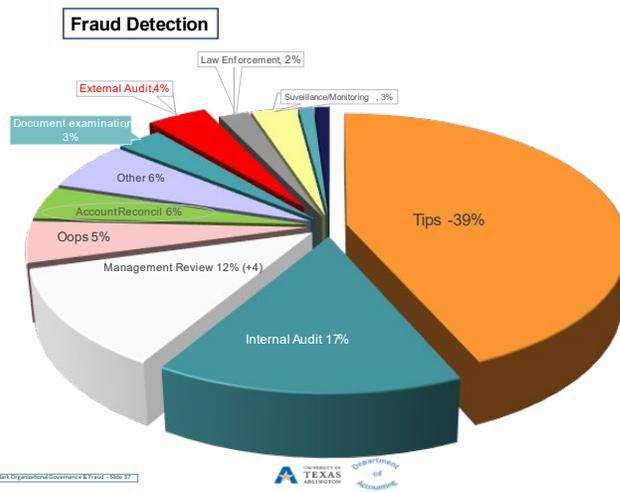
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Corporate Governance – Federal Sentencing Guidelines

- **Purpose:**
  - provide supposed incentives to self-govern by providing reduced criminal sanctions when corporations establish effective ethics and compliance programs.
  - Fines can be reduced by up to 95% if an organization can show that it has an *effective* ethics and compliance program in place.
- **Effective Change?**
  - Some evidence that training has **negative to neutral** effect on ethical attitudes.
  - Recent evidence that the training’s effectiveness
    - dissipates over time (e.g., 2 years) or
    - is replaced by **moral inconsistencies**.

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Fraud and Financial Reporting<sub>2</sub>

- **International auditing standards** now encourage auditors to consider “organizational attitudes” toward fraud when making their fraud assessment.
- **EU** now has regulatory guidance requiring auditors to address bribery mitigation, detection, and disclosure.
- Considerable evidence that **Corruption** can be offset through
  - Extensive disclosure requirements;
  - Auditor “incentives” to identify & disclose corruption
    - Lower the burden of proof in litigation vs auditors.

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## Global Fraud and Corruption

- **Kroll Corruption Index**
  - <http://fraud.kroll.com/interactive-map/>
- **Transparency International Corruption Perception Index**
  - [https://www.transparency.org/news/feature/corruption\\_perceptions\\_index\\_2017](https://www.transparency.org/news/feature/corruption_perceptions_index_2017) World Bank Group Corruption Index
- **PWC – Global Economic Crime Report.**
  - <https://www.pwc.com/gx/en/services/advisory/forensics/economic-crime-survey.html>
- **Edelman Trust Barometer**
  - <https://www.edelman.com/trust-barometer>

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# **Module 2**

## **Tab 2 – Cases and Discussion Material**

## Discussion Summary of Recent Frauds #2 (Forbes):

Company	When Scandal Went Public	Allegations	Investigating Agencies	Latest Developments	Company Comment
<b>Adelphia Communications</b> (otc: <a href="#">ADELA</a> - <a href="#">news</a> - <a href="#">people</a> )	April 2002	Founding Rigas family collected \$3.1 billion in off-balance-sheet loans backed by Adelphia; overstated results by inflating capital expenses and hiding debt.	SEC; Pennsylvania and New York federal grand juries	Three Rigas family members and two other ex-executives have been arrested for fraud. The company is suing the entire Rigas family for \$1 billion for breach of fiduciary duties, among other things.	Did not return repeated calls for comment.
<b>AOL Time Warner</b> (nyse: <a href="#">AOL</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	As the ad market faltered and AOL's purchase of Time Warner loomed, AOL inflated sales by booking barter deals and ads it sold on behalf of others as revenue to keep its growth rate up and seal the deal. AOL also boosted sales via "round-trip" deals with advertisers and suppliers.	SEC; DOJ	Fears about the inquiry intensified when the DOJ ordered the company to preserve its documents. AOL said it may have overstated revenue by \$49 million. New concerns are afoot that the company may take another goodwill writedown, after it took a \$54 billion charge in April.	No comment.
<b>Arthur Andersen</b>	November 2001	Shredding documents related to audit client Enron after the SEC launched an inquiry into Enron	SEC; DOJ	Andersen was convicted of obstruction of justice in June and will cease auditing public firms by Aug. 31. Andersen lost hundreds of clients and has seen massive employee defections.	Did not return repeated calls for comment.
<b>Bristol-Myers Squibb</b> (nyse: <a href="#">BMY</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	Inflated its 2001 revenue by \$1.5 billion by "channel stuffing," or forcing wholesalers to accept more inventory than they can sell to get it off the manufacturer's books	SEC	Efforts to get inventory back to acceptable size will reduce earnings by 61 cents per share through 2003.	Bristol will continue to cooperate fully with the SEC. We believe that the accounting treatment of the domestic wholesaler inventory buildup has been completely appropriate.
<b>CMS Energy</b> (nyse: <a href="#">CMS</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Executing "round-trip" trades to artificially boost energy trading volume	SEC; CFTC; Houston U.S. attorney's office; U.S. Attorney's Office for the Southern District of New York	Appointed Thomas J. Webb, a former Kellogg's CFO, as its new chief financial officer, effective in August.	No comment.
<b>Duke Energy</b> (nyse: <a href="#">DUK</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	Engaged in 23 "round-trip" trades to boost trading volumes and revenue.	SEC; CFTC; Houston U.S. attorney's office; Federal Energy	The company says an internal investigation concluded that its round-trip trades had "no	Although the effect [of these trades] on the company's financial statements

			Regulatory Commission	material impact on current or prior" financial periods.	was immaterial, we consider improper trades in conflict with the company's policies. To address this we have made changes to our organization, personnel and procedures. Dynegy believes that it has not executed any simultaneous buy-and-sell trades for the purpose of artificially increasing its trading volume or revenue. There have been no allegations or accusations, only requests for information. The company has confirmed in multiple affidavits that it did not engage in "round-trip" trades to artificially inflate volume or revenue.
<b>Dynegy</b> (nyse: <a href="#">DYN</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Executing "round-trip" trades to artificially boost energy trading volume and cash flow	SEC; CFTC; Houston U.S. attorney's office	Currently conducting a re-audit. Standard & Poor's cut its credit rating to "junk," and the company said it expects to fall as much as \$400 million short of the \$1 billion in cash flow it originally projected for 2002.	
<b>El Paso</b> (nyse: <a href="#">EP</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Executing "round-trip" trades to artificially boost energy trading volume	SEC; Houston U.S. attorney's office	Oscar Wyatt, a major shareholder and renowned wildcatter, may be engineering a management shakeup.	
<b>Enron</b> (otc: <a href="#">ENRNQ</a> - <a href="#">news</a> - <a href="#">people</a> )	October 2001	Boosted profits and hid debts totaling over \$1 billion by improperly using off-the-books partnerships; manipulated the Texas power market; bribed foreign governments to win contracts abroad; manipulated California energy market	DOJ; SEC; FERC; various congressional committees; Public Utility Commission of Texas	Ex-Enron executive Michael Kopper pled guilty to two felony charges; acting CEO Stephen Cooper said Enron may face \$100 billion in claims and liabilities; company filed Chapter 11; its auditor Andersen was convicted of obstruction of justice for destroying Enron documents.	No comment.
<b>Global Crossing</b> (otc: <a href="#">GBLXQ</a> - <a href="#">news</a> - <a href="#">people</a> )	February 2002	Engaged in network capacity "swaps" with other carriers to inflate revenue; shredded documents related to accounting practices	DOJ; SEC; various congressional committees	Company filed Chapter 11; Hutchison Telecommunications Limited and Singapore Technologies Telemedia will pay \$250 million for a 61.5% majority interest in the firm when it emerges from bankruptcy; Congress is examining the role that company's accounting firms played in its bankruptcy.	No comment.
<b>Halliburton</b> (nyse: <a href="#">HAL</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Improperly booked \$100 million in annual construction cost overruns before	SEC	Legal watchdog group Judicial Watch filed an accounting fraud lawsuit against Halliburton and its	Halliburton follows the guidelines set by experts, including GAAP (generally

		customers agreed to pay for them.		former CEO, Vice President Dick Cheney, among others. The California State Teachers' Retirement pension fund, which lost \$9 million on a Homestore investment, has filed suit against the company.	accepted accounting principles).  No comment.
<b>Homestore.com</b> (nasdaq: <a href="#">HOMS</a> - <a href="#">news</a> - <a href="#">people</a> )	January 2002	Inflating sales by booking barter transactions as revenue.	SEC		
<b>Kmart</b> (nyse: <a href="#">KM</a> - <a href="#">news</a> - <a href="#">people</a> )	January 2002	Anonymous letters from people claiming to be Kmart employees allege that the company's accounting practices intended to mislead investors about its financial health.	SEC; House Energy and Commerce Committee; U.S. Attorney for the Eastern District of Michigan	The company, which is in bankruptcy, said the "stewardship review" it promised to complete by Labor Day won't be done until the end of the year.	Did not return repeated calls for comment.
<b>Merck</b> (nyse: <a href="#">MRK</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	Recorded \$12.4 billion in consumer-to-pharmacy co-payments that Merck never collected.	None	The SEC approved Medco's IPO registration, including its sales accounting. The company has since withdrawn the registration for the IPO, which was expected to raise \$1 billion.	Our accounting practices accurately reflect the results of Medco's business and are in accordance with GAAP. Recognizing retail co-payments has no impact on Merck's net income or earnings per share.
<b>Mirant</b> (nyse: <a href="#">MIR</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	The company said it may have overstated various assets and liabilities.	SEC	An internal review revealed errors that may have inflated revenue by \$1.1 billion.	This is an informal inquiry, and we will cooperate fully with this request for information.
<b>Nicor Energy, LLC</b> , a joint venture between <b>Nicor</b> (nyse: <a href="#">GAS</a> - <a href="#">news</a> - <a href="#">people</a> ) and <b>Dynegy</b> (nyse: <a href="#">DYN</a> - <a href="#">news</a> - <a href="#">people</a> )	July 2002	Independent audit uncovered accounting problems that boosted revenue and underestimated expenses.	None	Nicor restated results to reflect proper accounting in the first half of this year.	Our focus now is to stabilize this venture and put some certainty to its financial results. The company is evaluating its continued involvement in this venture.
<b>Peregrine Systems</b> (nasdaq: <a href="#">PRGNE</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Overstated \$100 million in sales by improperly recognizing revenue from third-party resellers	SEC; various congressional committees	Said it will restate results dating back to 2000; slashed nearly 50% of its workforce to cut costs; is on its third auditor in three months and has yet to file its 2001 10-K and so, consequently, is in danger of being delisted from the Nasdaq.	We have been and will continue to cooperate with the SEC and the Congressional committee.
<b>Qwest Communications International</b> (nyse: <a href="#">Q</a> - <a href="#">news</a> - <a href="#">people</a> )	February 2002	Inflated revenue using network capacity "swaps" and improper accounting for long-term deals.	DOJ; SEC; FBI; Denver U.S. attorney's office	Qwest admitted that an internal review found that it incorrectly accounted for \$1.16 billion in sales. It will restate results for 2000, 2001 and 2002. To raise funds, Qwest says it is selling its phone-directory unit for \$7.05 billion.	We are continuing to cooperate fully with the investigations.

<b>Reliant Energy</b> (nyse: <a href="#">REI</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Engaging in "round-trip" trades to boost trading volumes and revenue.	SEC; CFTC	Recently replaced Chief Financial Officer Steve Naeve with Mark M. Jacobs, a managing director of Goldman Sachs and a Reliant adviser.	We're cooperating with the investigations.
<b>Tyco</b> (nyse: <a href="#">TYC</a> - <a href="#">news</a> - <a href="#">people</a> )	May 2002	Ex-CEO L. Dennis Kozlowski indicted for tax evasion. SEC investigating whether the company was aware of his actions, possible improper use of company funds and related-party transactions, as well as improper merger accounting practices.	Manhattan district attorney; SEC	Said it will not certify its financial results until after an internal investigation is completed. The Bermuda-based company is not required to meet the SEC's Aug. 14 deadline. Investors looking to unseat all board members who served under Kozlowski may launch a proxy fight to do so.	The company is conducting an internal investigation and we cannot comment on its specifics, but we will file an 8-K on the initial results around Sept. 15.
<b>WorldCom</b> (nasdaq: <a href="#">WCOEQ</a> - <a href="#">news</a> - <a href="#">people</a> )	March 2002	Overstated cash flow by booking \$3.8 billion in operating expenses as capital expenses; gave founder Bernard Ebbers \$400 million in off-the-books loans.	DOJ; SEC; U.S. Attorney's Office for the Southern District of New York; various congressional committees	The company stunned the Street when it found another \$3.3 billion in improperly booked funds, which will bring its total restatement up to \$7.2 billion, and that it may have to take a goodwill charge of \$50 billion. Former CFO Scott Sullivan and ex-controller David Myers have been arrested and criminally charged, while rumors of Bernie Ebbers' impending indictment persist.	WorldCom is continuing to cooperate with all ongoing investigations.
<b>Xerox</b> (nyse: <a href="#">XRX</a> - <a href="#">news</a> - <a href="#">people</a> )	June 2000	Falsifying financial results for five years, boosting income by \$1.5 billion	SEC	Xerox agreed to pay a \$10 million and to restate its financials dating back to 1997.	We chose to settle with the SEC in April so we can put the matter behind us. We have restated our financials and certified our financials for the new SEC requirements.



# **Module 3 - Ethical Behavior**

## **Module 3 Objectives:**

After reviewing Module 3 you should be able to:

- Understand how our human behavior and attitudes affect and control our ethical consideration; and
- Integrate Modules 1 and 2 into how our internal attitudes impact ethical attitudes and behavior.

**[Back to Start](#)**

# **Module 3**

## **Tab 1 – Slides and Notes**

## Public Interest

### Integrity

Fundamental Element of Character  
Candid and honest  
Measured in terms of what is right and just  
Used to decide which part of the public to respond to.

### Objectivity

State of Mind  
Impartial  
Intellectually Honest  
Free of *appearances of* Conflicts of Interest  
Don't subordinate judgment

### Due Care

Best Interest of Client *consistent* with Public Interest  
Competence through **experience** & education  
Diligence  
Ignore pressures (*threats*) from those in a position of authority [2.170.010]



### Independence

Reasonable Third Party

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Slide 1

Leslie Caldwell, formerly lead prosecutor on the Enron/Andersen case remarked that most corporate criminals are not bad people. Rather, they succumb to pressures (and/or ego) and begin a slide down a slippery slope.



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Slide 2



**Conscious....?**  
**Subtle and Unconscious?**  
**Both?**

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Slide 3

## Thinking & Leaps of Irrationality - Integrity and Objectivity

### Default Setting - Stage 1



- Quick resolution to the situation/issue
  - Uses
    - habits,
    - experiences and
    - beliefs
  - Ignores facts
- Makes Irrational connections to help quickly resolve situation

### Slow and Rational - Stage 2



- Slow;
- Conscious;
- Effortful;
- Reliable;
- Deliberate and Complex.

- Either Stage leaves us with internal "blind spots" that can impact and adjust our ethical behavior and objectivity and integrity
  - Often, these "blind spots" are difficult if not impossible to be changed.
- Either Stage also leaves us with internal attitudes and biases that prejudices our moral compass (e.g., we don't start at a purely objective point in our evaluations); and
  - our evaluations as well as our decisions.
- External factors and influences can also adjust our ethical objectivity and adjust our biases.

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## Our Biased Objectivity - Can you Ask For a Second Chance?

- Some of our biases affect our objectivity. For instance:  
*You've been asked to evaluate the quality of internal controls for a division that has a number of complex responsibilities and activities. You've decided to spend some time at the division itself to review its operations. Will you be thorough and objective in your review? Will you be able to objectively "get the big picture" for the division? Maybe not.*
- As you consider the question, review the following video.  
[Insert hyperlink at "review the following video" to the Gorilla Experiment on next page]
- Did you see the gorilla? If you're viewing the video for the first time, you have a 50/50 chance of missing the gorilla. Here's the point - once you've seen the video, you most likely don't miss the gorilla. This is an instance when we can improve our objectivity with experience.

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## Selective Attention - Gorilla Experiment



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### Out Biased Objectivity - Do-Overs Won't Matter

- Unlike the previous situation, there are times when our mind just won't accept what we know is in front of us. Take a look at this video. [Insert link to checkboard video at "Take a look at this video"]
- Want to try another? Do you think you always objectively hear what's being said? Review the first 90 seconds this video. [Insert link to selective hearing video at "video"]

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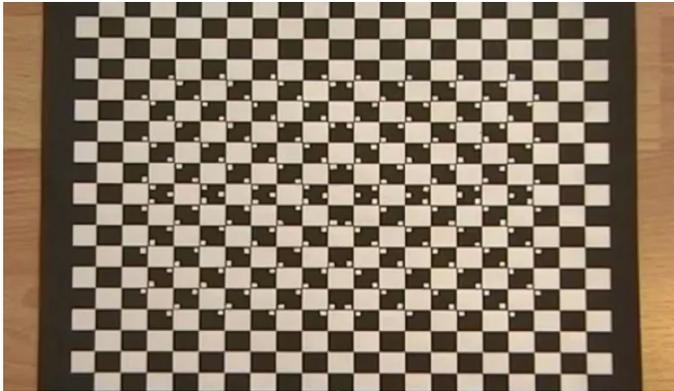
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### Checkboard Video



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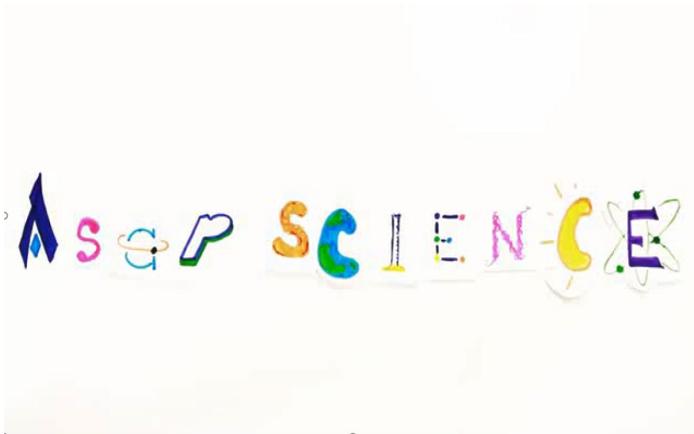
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### Selective Hearing



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# Internal and External Biases

- Okay, so I hope that I've at least got you thinking about the fact that we don't view (or hear) external situations objectively. Now let's look at some of the internal and external "pulls" on our ability to act
  - Objectively; and
  - With integrity.

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## Setting Our Ethical Compass - Some Beginning Considerations

"We are professionals that follow our code of ethics and practice by the highest moral standards. We would never be influenced by our own person financial well being." [AICPA testimony to Congress]

"Consistent with decades of research in social psychology, each of these three conditions (of the Codes of Conduct (e.g., objectivity, integrity and independence) makes independence a farce." [Bazerman, Gino, 2015]

- We seem to want to be just unethical enough to be able to still feel good about ourselves. [Allingham & Sandmo, 1972; Becker, 1968; Gino, Ayal & Ariely, 2009; Gino, Gu, Zhong, 2009]

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## Biases - Some Beginning Considerations

### Internal Biases



Feelings and Emotions



- Background, Attitudes and Experiences
- Anchors
- Outside Biases
  - Surroundings
  - Perceptions and Framing
  - Stress and Time

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## Primal Emotions



- Primal Emotions can change our ethical attitude to people and situations.



When we're disgusted we

- Stay **emotional** (Stage 1);
- Transfer those feelings to the offending person(s);
- Physically & Emotionally distance ourselves from the person(s) [Tiedens & Linton, 2001]



When we're happy or sad or feeling guilty we

- Behave **more rationally** (Stage 2);
- Feel **better** about ourselves;
- More **aware BUT tolerant** of other's unethical actions. [Labroo & Patrick 2009]



When we're ashamed we

- Feel **inferior**;
- Behave **less ethically**;
- Studies indicate that, when ashamed, accountants are more likely to falsify data. [DeHooghe, Breugelmanns et al, 2008; DeHooghe, 2010, 2011]

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## Biases and Internal Accounting

You are looking forward to going to a concert. You've already spend \$100 on the ticket and are carrying \$100 in your wallet for purchases during the event. When you arrive at the event after driving for 2 hours, you find that you've lost your ticket. You can purchase another ticket at the office for the same price by using the \$100 in your wallet. Will you?

You are looking forward to going to a concert. You plan on buying the ticket at the event. So, you put two, \$100 bills in your wallet, one to purchase the ticket and the other for purchases during the event. When you arrive at the event after driving for 2 hours, you find that you've lost one of the \$100 bills only have \$100 in your wallet. Will you still to the concert?

- Easy ≠ True Vinyl Records are selling better than downloaded songs. ✓

*Vinyl Records are selling better than downloaded songs.* ✗

- First Trading Day for Stock



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## Externals That Can Affect our Ethical Behavior

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## Priming - Bias and Input

- Vacation;
- Concert;
- Family;
- Summer;
- Picnic.



- Retirement,
- Social Security,
- Senior Citizen,
- Assisted Living,
- Adult Community

- In a study, college students shown either shown
  - words conveying normal activities; or
  - Words that conveyed old age
 As they left, the students actually began to act and react older just by viewing the words.
- People rewarded for remembering the 10 commandments were 3 times less likely to cheat than those asked to remember 10 favorite songs.
- College students asked to read (or be read) and sign an Honor Code are 50% less likely to cheat on exam.

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## Bias Based on Input

- Your mind may make different evaluations based on where you're asked (e.g. the framing) to start on the decision. For instance:
  - If I ask you whether George Washington died before or after age 140? , your answer will be, on average, much higher than
  - If I ask you whether George Washington died before or after age 9.
- Now consider what effect this may have if, instead, I ask you before an audit whether you'll test revenue fluctuations only if they're above 10%?
  - What if I changed the fluctuation to 4%?
  - Should the change make a difference to your objectivity?
- Would you rather buy ice cream that is 15% fat or 85% fat free?

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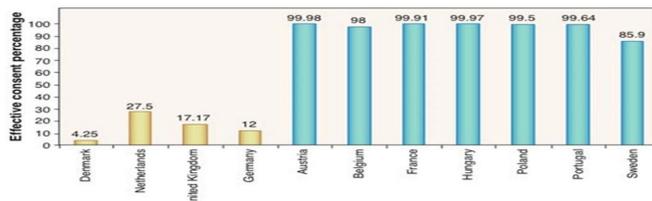
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## Bias Based on Input

- Look at the graph below. It shows the number of people in various countries who have agreed on their driver's licenses to be organ donors.



Based on the above information, one could conclude that the people in the first 4 countries were more "miserly" about their organ donations.

In fact, the difference depends on how the check-box is worded:

- In the first 4 countries, the check-box asks people to check if they "do" want to be an organ donor;
- In the other countries, the check-box asks people to check if they "don't" want to be an organ donor.

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### Bias Based on Input

- You are asked by a client to review information about a proposed complex merger. The client would like you to advise them about how to proceed.
- A review of the accountant's assessment showed that they
  - **unconsciously biased** their evaluation of the information in favor of their client and
  - **ignored** (e.g. failed to include in their evaluation) information about the target that was **objectively** relevant but unfavorable to their client's interest.
  - **were unable to adjust** their thinking even after monetary rewards were included that should have adjusted their analysis. [Bazerman, Loewenstein, Moore, 2002]
  - What if you were told that you'd have to testify for
    - The client?
    - The other party to the merger? [Murrie, 2013]

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## The Effect of Time and Stress

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### Bias and Experience - Integrity and Objectivity

- You're asked to perform a review of the tax return for a client's company. You've know the client for a decade and find her to be very honest and ethical.
  - Will you examine the company's records objectively?
  - Likely not – you may ignore inconsistencies in the return in favor of the client. [O'Donnell, Schultz, 2005]
- You're meeting with your largest tax client about their upcoming tax return.
  - **If the return hasn't been filed**, what would you say are their audit chances?
  - **If the return was filed yesterday**, what would you say are their audit chances? [Knox&Inkster, 1968; Bullens, 2013]
    - It's likely that you would be more optimistic **after** the return is filed rather than before.

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## Time - Future and Present

- When considering the previous examples, keep in mind that we analyze future situations based on how “familiar” they are
  - When our minds can’t use Stage 1 experiences, it move (slows down) to Stage 2.
  - At Stage 2, we evaluate new situations by
    - projecting to a series of solutions,
    - assigning risk factors to the solutions,
    - doing probability analysis,
    - picking a result.
  - Our implicit risk factors depend on the “frame” for the issue.
    - Losses are assigned higher risk (e.g., higher return required) than gains (factor of 20-30%);
    - Small risks of loss are overweighted by a factor of 2. [Khaneman, Thaler]

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## Stress & Time



- Stress
  - Keeps us emotional (Stage 1)
  - Uses up our “ethical” reservoir.
  - Causes us to ignore ethical issues **unless reminded**. [Gino et. al 2011; Welsh & Ordonez, 2011]

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Groups



THE MAGNET NEAR OUR MORAL COMPASS

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### Moral Accounting - Groups

- We really want to be part of a group –so we'll find any minimal reason to join.
  - Clothing (such as T-shirt);
    - We'll behave **more ethically** if the actor is **not** part of the "group".
  - Similar name;
  - Common confusion;
  - Same birthday;
  - Same culture or mindset.
- We depend on our group to set our ethical consensus.
  - Excuse unethical behavior if it benefits the group.
  - Sync our primal emotions to the group.
    - Pain;
    - Embarrassment;
    - Joy.

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### Leaving with a Positive Attitude



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# **Module 4**

## **Ethical Philosophies And Behavior**

### **Module 4 Objectives:**

After reviewing Module 4 you should be able to:

- Understand and integrate the various ethical philosophies into ethical issue identification in professional activities; and
- integrate Modules 1 through 3 into how the various ethical philosophies frame both our internal as well as external group attitudes toward ethics.

**[Back to Start](#)**

# **Module 4**

## **Tab 1 – Forsyth Questionnaire**

**Ethics Position Questionnaire****Instructions:**

Below you will find a series of general statements. Each of the statements represents a commonly held opinion and *there are no right or wrong answers*. You will probably disagree with some items and agree with others. Use the questionnaire to indicate the **extent** to which you agree or disagree with each of the statements.

Please read each of the statements carefully and then indicate the extent to which you agree or disagree by placing in front of the statement the number that best indicates your feelings about the statement, where:

- |                            |                               |                      |
|----------------------------|-------------------------------|----------------------|
| 1 = Completely disagree    | 4 = Slightly disagree         | 7 = Moderately agree |
| 2 = In Large Part disagree | 5 = Neither agree no disagree | 8 = Largely agree    |
| 3 = Moderately disagree    | 6 = Slightly agree            | 9 = Completely agree |

- \_\_\_\_\_ 1. A person should make certain that their actions never intentionally harm another even to a small degree.
- \_\_\_\_\_ 2. Risks to another should never be tolerated, irrespective of how small the risks might be.
- \_\_\_\_\_ 3. The existence of potential harm to others is always wrong, irrespective of the benefits to be gained.
- \_\_\_\_\_ 4. One should never psychologically or physically harm another person.
- \_\_\_\_\_ 5. One should not perform an action which might in any way threaten the dignity and welfare of another individual.
- \_\_\_\_\_ 6. If an action could harm an innocent other, then it should not be done.
- \_\_\_\_\_ 7. Deciding whether or not to perform an act by balancing the positive consequences of the act against the negative consequences of the act is immoral.
- \_\_\_\_\_ 8. The dignity and welfare of people should be the most important concern in any society.
- \_\_\_\_\_ 9. It is never necessary to sacrifice the welfare of others.
- \_\_\_\_\_ 10. Moral actions are those that closely match ideals of the most “perfect” action.
- 
- \_\_\_\_\_ 11. There are no ethical principles that are so important that they should be a part of any code of ethics.
- \_\_\_\_\_ 12. What is ethical varies from one situation and society to another.
- \_\_\_\_\_ 13. Moral standards should be seen as being individualistic; what one person considers to be moral may be judged to be immoral by another person.
- \_\_\_\_\_ 14. Different types of moralities cannot be compared as to “rightness”.
- \_\_\_\_\_ 15. Questions of what is ethical for everyone can never be resolved since what is moral or immoral is up to the individual.
- \_\_\_\_\_ 16. Moral standards are simply personal rules, which indicate how a person should behave, and are not to be applied in making judgments of others.
- \_\_\_\_\_ 17. Ethical considerations in interpersonal relations are so complex that individuals should be allowed to formulate their own individual codes.
- \_\_\_\_\_ 18. Rigidly codifying an ethical position that prevents certain types of actions could stand in the way of better human relations and adjustment.
- \_\_\_\_\_ 19. No rule concerning lying can be formulated; whether a lie is permissible or not permissible totally depends upon the situation.
- \_\_\_\_\_ 20. Whether a lie is judged to be moral or immoral depends up on the circumstances surround the action.
-

# **Module 4**

## **Tab 2 – Slides**



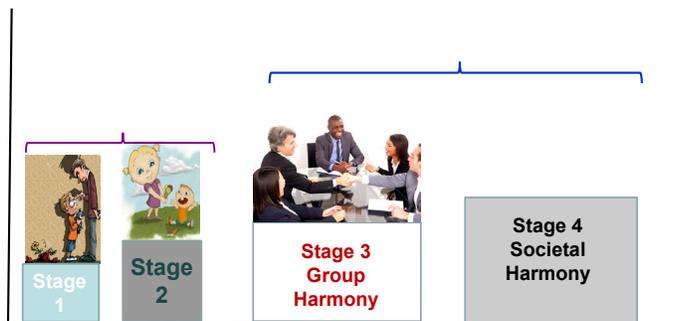
## Kohlberg Ethical Development Stages

- Kohlberg proposed to measure ethical development through a series of responses to cases.
  - Development is typically measured by scoring responses to the case by using what is called a Defining Issues Test (DIT).
  - Higher DIT score = higher ethical development.
- Kohlberg's concept was that people progressed through the stages sequentially.
  - In short, we never regressed in our ethical development.
  - Age and gender were considered to be immaterial.
  - Both of those have been since proven to be questionable, as we'll see in the following slides.
- Each of the next slides reviews Kohlberg's various ethical stages of development.

DSX\_C24 Module 4: Ethical Philosophy & Codes of Conduct

Slide 1

## Ethical Development – Kohlberg's First 4 Stages



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Slide 2

## Ethical Development – Kohlberg's Pre-Conventional Stages

At Pre-Conventional Stages our ethics are based on whether our actions result in  
- Punishment (Stage 1); or  
- Reward (Stage 2).  
Note that both of these Stages are internal and personal.



DSX\_C24 Module 4: Ethical Philosophy & Codes of Conduct

Slide 3

## Kohlberg's Conventional Stages – Group Harmony



Stage 3  
Group  
Harmony



Stage 4  
Societal  
Harmony

At the **Conventional stages** our Ethics are based on whether our actions are in harmony with  
- Our Group's standards (Stage 3);  
- Society's standards (Stage 4).

These are the stages where most adults "settle". Improvement is slow and infrequent after these stages.

Various groups of people as well as professionals have been measured over the decades using the Kohlberg standards. The next slide gives you an idea of where each of the groups test out.

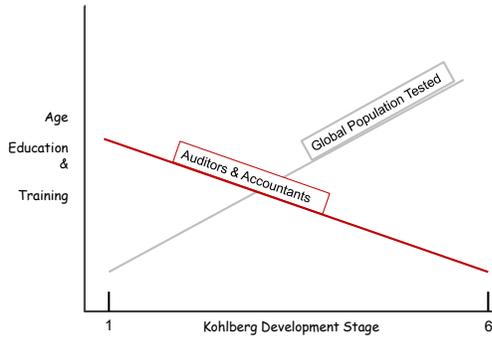
DSX\_C24 Module 4: Ethical Philosophy & Codes of Conduct

Slide 4



### Ethical Development - Accountants

One other bothersome result from the Kohlberg evaluations is that the number of accounting professionals at the higher stages of ethical development actually decline as they progress through their career.



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Slide 13

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### Kohlberg and Accountants

- Beginning accountants score higher on ethics tests than do managers or partners.
  - Ethical development seems to increase to supervisor level;
  - Then sharply decreases from manager to partner. (Ponemon)
- Ethical development is related to an accountant's practice activities and adjusts for
  - The more sensitivity to management the lower the Kohlberg score in competence and integrity (Ponemon 1993)
  - Ability to resist management pressure to misstate financial statement equates to a higher Kohlberg score; (Tsui and Gul 1995);
  - The higher the Kohlberg score, the more propensity there is to whistle-blow (Ponemon 1990);
  - Billable time management equates to higher Kohlberg scores (Ponemon 1993);
  - Higher Overall objectivity means higher Kohlberg scores (Ponemon 1995);
  - Practice area counts. Tax scores lowest on Kohlberg vs financial or audit (with tax on a lower ethical level).

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Slide 14

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### Kohlberg Scores (what we say) and actual performance (what we do)

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Slide 15

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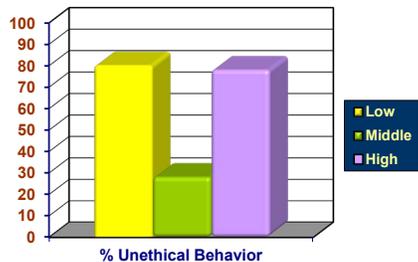
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### Kohlberg Scores and Related Unethical Behavior

What the graph below shows is that men who tested using Kohlberg's scoring were likely to act inconsistently with their ethical Stage. For instance, those men who tested highest in the Kohlberg Stages (the "high" Stage 5 or 6) were just as likely to behave unethically as those that scored in the lowest Kohlberg Stages (the "low" Stage 1 or 2)



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Slide 16

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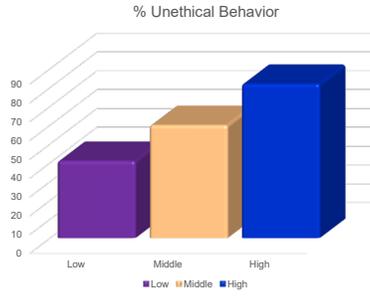
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### Kohlberg Scores and Related Unethical Behavior

Similarly, women who were tested using Kohlberg's scoring were also likely to act inconsistently with their ethical Stage. Women who tested highest in the Kohlberg Stages (the "high" Stage 5 or 6) were **more likely to behave unethically** as those that scored in the lowest Kohlberg Stages (the "low" Stage 1 or 2)



ETH 101 Module 4: Ethical Philosophy & Codes of Conduct

Slide 11

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### Kohlberg Scores

- Why the difference between men and women?
  - Researchers believe that it may be due to the fact that the DIT is structured toward a **justice orientation** rather than a **caring orientation** for women. (Gilligan 1982; Reiter 1996).

ETH 101 Module 4: Ethical Philosophy & Codes of Conduct

Slide 12

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## Utilitarianism - The dilemma

ETH 101 Module 4: Ethical Philosophy & Codes of Conduct

Slide 13

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The Trolley Problem and Utilitarianism - Courtesy of YouTube and "The Good Place"



ETH 101 Module 4: Ethical Philosophy & Codes of Conduct

Slide 14

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### Ethical Philosophies – Utilitarianism

- Recent studies show that we tend to “shift” philosophies based on whether the situation is “impersonal” or “personal”
  - We are utilitarian when our actions are impersonal – we don’t personally cause harm to others;
  - We become
    - non-utilitarian when our actions are personal – we’re asked to cause harm to others. (Schnitzler & Young, 2013)
    - Lose our empathy.
    - About 90% **won’t** take affirmative **personal** action to injure another person even if it would be for the best of the “group”.
      - The 10% referenced above that **would take personal action** to injure another were shown to have personalities that were psychopathic, Machiavellian or put a low value on life. (Dornes and Parnis)

101\_024 Module 4, Ethical Philosophy & Codes of Conduct

Slide 21

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### Forsyth Ethical Dimensions - Idealism

- **Idealists** work for positive results for everyone
  - ethically alert;
  - Recognize and make better ethical decisions;
  - Evaluate ethical behavior based on outcomes, not actions or actor;
  - intolerant of questionable budgetary practices;
  - Condone unethical actions (e.g. lie) if the act itself helps others.

101\_024 Module 4, Ethical Philosophy & Codes of Conduct

Slide 22

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## Power, Authority and Unethical Action

101\_024 Module 4, Ethical Philosophy & Codes of Conduct

Slide 23

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### The Milgram Experiment



101\_024 Module 4, Ethical Philosophy & Codes of Conduct

Slide 24

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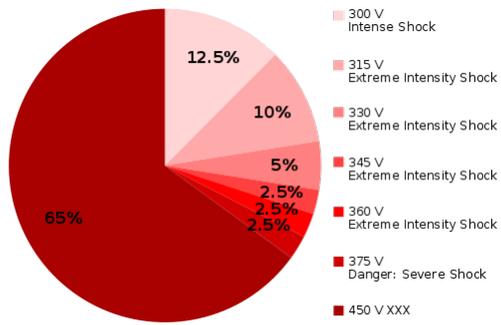
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### Milgram Experiment Results



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### Stanford Prison Experiment



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# **Module 4**

## **Tab 3 – Cases and Discussion Material**

**Discussion Question 1:**

Of the three ethical philosophies, which do you believe is most often applied to

- business settings?
- In accounting?
- In auditing?

Are ethical philosophies relevant to the practicalities of Global business? If not, why not?

Examine your answer in relation to your understanding of the basic ethical philosophies.

## Case Studies

### Case 1

A woman is near death from a rare type of cancer. There is one drug that her doctors think might save her. The drug was developed by a physician in the area. After going through clinical trials and getting government approval, the physician has set up a manufacturing facility and has begun selling the drug at approximately 100 times its actual cost. Appropriate treatment with the drug consists of one shot every month for at least 24 months.

Raj, the sick woman's husband, has gone to everyone he knows to borrow the money needed to get his wife the injections that they and the doctors believe will save her life. Raj has already mortgaged their home to its maximum extent. In addition, Raj has tried every other legal means available, including lawsuits and asking the government to help. His efforts are in vain. Raj and his wife are only able to scrap together ½ of the amount needed for even 1 shot. In a final effort, Raj approaches the physician who developed the drug and asks him to sell it to him at a reduced price or to let him pay the costs over a period of time. The physician's response is that "No, I've developed and discovered the drug and I'm going to make a large profit from it." In a final fit of desperation, Raj is considering breaking into the physician's office to steal the drug for his wife.

### Questions

1. Should Raj steal the drug?
2. In your opinion, is it actually wrong or right for him to steal the drug?
3. Do you think Raj has an ethical or moral duty or obligation to steal the drug?  
Does it matter that Raj doesn't love his wife?  
Would it matter that they've been divorced for 20 years and haven't seen each other for the last 10 years?  
What if it were a pet rather than a person?
4. Is it important for people to do everything they can to save another's life?
5. Does it matter in this instance that stealing is against the law?
6. In thinking over Raj's dilemma, what would you advise Raj to do?

### Case 2

Raj does break into the physician's office. He stole the drug and gave it to his wife. The following day, the local newspapers carry an account of the robbery. Mr. Brown, a police officer who knows Raj, reads about the robbery. He remembers seeing Raj running from the physician's office and believes that it was Raj who stole the drugs. Mr. Brown is now wondering whether he should report his suspicions to his superiors at the police department.

### Questions

7. In your opinion, does Mr. Brown have a duty or obligation to report his suspicions to his superiors?
8. Would it make any difference to you that Mr. Brown is Raj's neighbor and best friend?

### Case 3

Mr. Brown does report Raj and he's arrested and brought to court. A jury is selected, Raj's trial occurs and the jury finds Raj guilty. The judge in the case will decide Raj's sentence.

### Questions

1. You have been appointed to be the judge in Raj's case. Because of its importance, both the local and national media have covered the case and will be covering your decision live. You have already been interviewed by 60-minutes and other news programs.  
Your appointment as judge is a lifetime appointment with no possibility of removal or firing. You have the option of giving Raj a sentence that can range from a "suspended sentence", to a fine, to 10 years in jail.  
Would it make a difference if your appointment as judge is an elected position?

## Case 4 – ABC Company

Andrea is an experienced CPA who is employed by a local firm that has been in practice for many years. Andrea is the “in charge” accountant on several auditing engagements at any particular point in time. During a specific year, Andrea is assigned by her firm to audit the Portia Company as well as the Venice Company. While Andrea is friendly with both of the company’s top officers, neither of the companies is aware that Andrea is doing both of their audits.

In the course of her audits, Andrea discovers that Portia and Venice do business with each other. Specifically, Andrea discovers that Portia sells one of its product (schlock) to Venice that Venice considers critical in the assembly of its final output.

In recent years, Portia has acquired all of the other vendors that produced schlock in order to corner the market and maximize profits. Last year, Portia greatly increased the price of schlock. This increase caused resulted in enormous profits to Portia. Because Venice needs schlock to make its products, it has been forced to pay Portia’s price for schlock. The result, for Venice, has been that its current year financial statements show a large loss, primarily because of the increased purchasing costs for schlock. In fact, Venice is considering bankruptcy.

Because of the access to each of the company’s financial information, Andrea knows that Portia is pricing schlock well above its typical profit margin. In addition, Andrea is well aware, after having audited Venice’s books, of the hardship the price of schlock is causing to Venice.

### Questions

2. Andrea has come to you for advice. She is wondering whether she should advise her firm of the situation?
3. Do you believe that Andrea’s professional and personal ethical obligations are any different? If so, what do you believe is the difference?
4. Do you see any conflicts for Andrea in this case?

### Case 4B

In addition to the above information, you know:

- of an plant that is for sale that makes enough schlock to keep Venice going.
- Andrea is attending Portia’s shareholder meeting and overhears Portia’s CFO brag about cornering the schlock market. He said “..it was my idea to corner the schlock market...after all, customers like Venice will either pay the price or get out of the business.” In the course of this conversation, the CFO brags about his shrewd maneuvers to block Venice’s vertical expansion and says that he has given Venice verbal assurances of steep price cuts that he intends to honor only as long as it takes to buy the independent schlock plant discussed above.

### Questions

5. Does this new information change Andrea’s ethical and professional obligations in any way?
  - a. Venice finds out that Andrea was aware of Portia’s tactics and sues Andrea and the firm for not revealing the situation to them. The case is brought before an arbitration board and, of course, you’re the head of the arbitration panel.
  - b. Presume that Andrea does tell Venice and Portia finds out and sues Andrea and the firm. In hindsight, would you have made any different recommendation to Andrea?
6. In either event, what should be the penalty for Andrea and the firm if they’re found guilty?

## Case Studies

### Case Study #1:

**Situation 1:** Individual in control of a trolley car in San Francisco that is heading down one of the largest hills in SF. Trolley has on a single track that branches to the right at the bottom of the hill. Individual now can see that if s/he goes straight (e.g. follows the main track), the trolley will strike and possibly kill/injure a group of tourists trapped in a bus that is stalled on the track. S/he can also see that if s/he turns onto the branch track, there are two workmen at the end of the track who may be injured/killed.

There is no time to warn the workmen, move the tourist bus or otherwise stop the trolley.

What do you do and why? Would your actions depend on your philosophical outlook?

**Situation 2** (modified from 1): Individual is now not in the trolley but watching it from alongside the tracks. Notices that there is no one in the trolley but otherwise the situation is the same *except* that s/he notices that right next to him/her on the street is a lever that would allow him/her to direct the trolley to the side track.

What do you do and why? Would your actions depend on your philosophical outlook?

**Situation 3** (modified from 2): Individual is again on the side of the tracks watching the trolley speed down the hill with no one inside. In this case there is no lever but the individual has been continually annoyed by a person in a large, bulky, loud, and garish yellow chicken outfit (call this person our “chicken guy”). Our individual can see that because of the bulk of the chicken suit, if s/he pushes the chicken guy onto the tracks it will stop the trolley and no one else will be injured.

What do you do and why? Would your actions depend on your philosophical outlook?

## **Case Study #2:**

A salary of \$85,000 plus options to buy 30,000 shares of common stock -- it sounded like a reasonable deal to Leanne Gallagher. It was April 2011, and Gallagher was being recruited to join a start-up venture, MoniMed. The company, which had already been in operation for two years, made medical monitoring devices. Marc Cornwall, the director of engineering, who interviewed Gallagher, said the company was expected to go public within the year.

If Gallagher took the job, she would be joining the 30-person firm as a senior software engineer. She had been working at an established corporation for 15 years and had recently completed her master's degree. Now she felt ready for a more demanding challenge. Of course, she was currently making \$105,000 a year, but she was willing to risk the salary differential on stock in what looked like a viable concern. MoniMed had a good strategy that would take advantage of imminent changes in flat panel display technology. But the company had to get its product to market within the next 12 months to exploit this niche. Gallagher thought she was just the person to kick the manufacturing arm of the company into high gear.

As far as the stock went, 30,000 options at 30 cents a share seemed like a good offer though she had no way of knowing for sure. She had asked what percentage of the total outstanding shares her options represented, but Cornwall didn't have that information. None of the employees, he said, really knew what percentage of the stock they owned, but all the IPOs had been doing so well recently that everyone assumed they would come out ahead.

Although Gallagher knew from other engineers that a failure to share financial information was not uncommon at Silicon Valley start-ups, she hoped to be a little better informed before she accepted the offer. She learned from a friend with an MBA that all corporations in California had to file certain information about their boards of directors and stock plans with the secretary of state's office. She decided to contact that office and request information on MoniMed.

She got a phone number for the secretary of state's corporate status office, which she assumed was the correct department, but when she called, she learned that it was not possible to speak to an actual human being at that number. Instead, a recorded message gave a list of documents (with fees) that could be ordered. Since Gallagher didn't know which one would have the information she needed, and since any document wouldn't arrive for two weeks, she decided to abandon that route. Instead, she decided to do some general research on the Web, reading articles about options. She saw that, as a rule of thumb, \$10 was the typical target price for the initial offering. If MoniMed followed that pattern, even after purchasing the options for the \$9,000 in her salary package, she would make \$291,000 on the stock.

That should more than make up for the salary differential. Assuming she got no raises for the four years before she was completely vested, Gallagher would lose \$80,000 in salary from the job change. But she should still come out ahead unless the stock fell below the option costs combined with her salary losses, or \$89,000. That came out to about \$3 a share, which seemed unlikely. Medical device companies often came out at \$20 a share. Besides, IPOs had been going through the roof all year. On March 30, Priceline.com rose 331 percent on its first day of trading.

Of course, MoniMed might fail: The team might not produce their initial product within the window created by the advent of the new flat panel display. They might not be able to bring the costs down enough to make it attractive. Agilent or some other competitor might even now be coming up with a better product. Those were all risks Gallagher was prepared to take because she fully believed she had the right skills and ideas to help make the company a success. She decided to take the job.

What Gallagher didn't know, because Cornwall also wasn't aware of it, was that when he interviewed her MoniMed was at a critical juncture. Barry Grantz, the founder/CEO, had enough capital left from an original investment by his father and some venture investors two years earlier to keep the company going another three months. If MoniMed could not attract some new funding soon, it was going to have to close up shop. Grantz had decided not to share this information with anyone other than the CFO because he did not want to provoke a mass exodus, and besides, he firmly believed the company would eventually succeed especially with the help of his new, more experienced hires.

When Gallagher came to work the first day, she was struck at once by the youth of her colleagues. She was one of 20 engineers. Most were newly minted bachelors of science, and MoniMed was their first foray into the business world. She was a little nervous about whether such an untried crew could bring the project in on time.

But soon Gallagher realized that what they lacked in experience, they made up in enthusiasm and diligence. Eighty-hour work weeks were common. Gallagher herself went directly from graduation ceremonies to the office and stayed past midnight. Pretty soon, she lost count of the all-nighters. During the industry tradeshow, some of her colleagues actually slept on the convention premises. They did not leave the show for a week--not even for meals.

The hours were hard on her marriage, but she considered herself one of the lucky ones. Her husband was also an engineer, and he understood the time demands. And they had no children. Many colleagues had a tougher time, with at least two divorces and one serious stress-related illness as the employees struggled to get the company ready for a public offering.

They did not receive much help from Grantz. It didn't take Gallagher long to realize that her CEO knew a lot less about biomedical devices than his staff. Of course, that wouldn't necessarily have been a problem if he had been good

on the business side. His contribution, however, seemed to be primarily a rich father, who had put MoniMed together as a sort of toy for his son.

At the same time, Gallagher liked the intellectual challenges of her job, liked figuring out successful compromises between optimal solutions, time pressures and costs. As senior engineer, she was responsible for refining the dynamic physiological monitoring capabilities. She worked closely with the director of manufacturing, who had been able to reduce the unit cost while simultaneously making it more reliable. They were able to bring the project in on time, and the improvements helped the sales manager (who had been practically starving on his commission wages) to attract a large customer Acme Biosystems.

Grantz could not have been more encouraging, calling an all-hands meeting to congratulate the staff and predict a Mercedes in all of their futures. Gallagher and her colleagues were justifiably proud when, soon after Acme signed a contract to buy 400 cardiovascular monitoring devices, the IPO was announced for January.

They were jubilant for a few weeks. Soon scuttlebutt began circulating that the IPO was on hold. It was impossible to get reliable information, but water cooler gossip said an acquisition was in the works. Two companies had expressed an interest, CV Diagnostix and Fenton Health Group. At first, Gallagher thought this wouldn't be a bad fate for the company. After all, both rumored buyers were solid companies with distribution systems and marketing infrastructure unavailable to a start-up.

Gallagher asked to talk to Grantz about the proposed deals, but she was told that he would have nothing to say while negotiations were ongoing. Still, details began to leak out. Employees heard that Fenton was offering the sweeter deal, but it came with a proviso: MoniMed would have to install a new CEO. Gallagher was equally sure that such a move would be good for the company and that Grantz would never accept it. She was right. Within days, Grantz called employees together to announce that MoniMed was being acquired by CV Diagnostix at 27 cents a share for common stock.

When the financials became public as part of the deal, Gallagher was shocked to discover that the company had not done nearly as well as the employees had been led to believe. MoniMed had raised and spent over \$14 million. It had also lost another \$12.7 million, so that when CV Diagnostix acquired the company for \$10.5 million, investors were down about \$2 million.

Any options granted prior to June 2011 (including those owned by Gallagher and all the other employees) had strike prices of at least 30 cents. That meant Gallagher and the other engineers' shares were what is colorfully described as "underwater." It would cost more to exercise them than they were worth.

Oh, there were some people who made out OK. Grantz received about \$2.5 million from the sale. Gallagher submitted her resignation the next day. In her letter to Grantz she wrote,

When I went to work for MoniMed, I knew I was taking a risk. If we hadn't been able to produce the device or if there had been no market for it, I would have accepted my losses. But we beat the odds we made a good product and attracted a large customer.

You led us to believe that the firm was doing well, but when we were acquired, you were the only person to profit. Why were the people responsible for the firm's success the biggest losers?

I went to work for you at less than my normal salary with the understanding that my stock options represented some significant ownership in the company. This deal made me a de facto investor. Beyond the monetary investment, I also put my family and health at risk through the long, demanding hours.

Didn't this at least entitle me to the basic information and protections other investors received? Shouldn't I have been told what percentage of the total stock my options represented? Didn't I have a right to know that the company was nearly out of money when I was hired? Was it fair to string me along with tales of a new Mercedes when you knew the rate at which MoniMed was burning money? Shouldn't I have been given a voice in the deal you accepted, which made my investment worthless?

1. Identify in a proper time sequence what you believe to be the **relevant** facts, omitting all other factual material. Be careful to distinguish between fact and opinions.
2. Identify and prioritize the Ethical Issues in this fact set. Structure the ethical issue sequentially – that is, what ethical issue do you need to answer before going on to the next issue, etc.
3. Use the "Facts" and "Ethical Issues" to now address each possible alternative for Leanne Gallagher in how to address her issues and offer her an opinion on which of those possible alternatives you believe is the most appropriate in her circumstance.

### **Case Study #3:**

The School Board has received a bomb threat claiming that a bomb would be detonated at noon on Monday at the high school. The threat was received by the Board at 8 pm on Sunday night. The Board met and tried to decide how to handle the threat, keeping in mind the obligations to students, parents and the public. The school board came up with three alternatives solutions:

1. Do nothing as a majority of the time bomb threats to schools are a hoax.

2. Call off school at the high school on Monday. Have an announcement made on the 10 pm Sunday news announcing that a water main is broken. (Some members of the board feel that such an announcement of the breaking water main will prevent copycat threats.)

3. Call off school at the high school on Monday. Have an announcement made on the 10 pm Sunday news announcing that a bomb threat had been received.

Discuss which ethical theory supports each alternative. Which would you choose and why?

#### **Case Study #4:**

Susie, a newly graduated BBA in accounting, has started job with the state budgeting office. Susie has been place over expense accounts. The state has a travel policy stating that a state employee may be reimbursed up to \$90 per night for a hotel room and up to \$40 per day for meals, as long as the employee turns in food receipts. On the first expense account Susie works on, the employee has a hotel receipt for \$130 a night but no food expenses.

Susie follows the state policy and processes the reimbursement for \$90. The employee becomes irate as his reading of the travel policy is that he can be reimbursed for \$130 a night for hotel and food with a receipt. The employee claims this has never been a problem in the past and has always been reimbursed \$130 a night whether for hotel only or both hotel and food.

Discuss which ethical theory supports Susie and the employee's take on the travel policy. Which would you choose and why?

# Module 5

## Codes of Professional Responsibility

Module 5 Objectives:

After reviewing Module 5 you should be able to:

- identify and apply applicable Codes of Conduct to issues and situations in our professional activities; and
- integrate the relevant Codes of Conduct into all the previous discussions in Modules 1, 2, 3 and 4.

**[Back to Start](#)**

# **Module 5**

## **Tab 1 – Slides**

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## Codes of Professional Conduct

AICPA & Texas

IMA & IIA

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Slide #1

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### Compliance [TX 501.60 and 502.62]

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- The AICPA and Texas Codes of Professional Conduct (CPC) require that all members comply with all relevant pronouncements, including
  - Other applicable country, state and local board standards;
  - Accounting and Review Services Committee;
  - Auditing Standards Board;
  - Consulting Services Executive Committee;
  - Tax Executive Committee.
  - PCAOB
  - SEC

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### Texas Rules of Professional Conduct (CPC)

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- Embedded into [Chapter 501 of the Texas Administrative Code](#) (TAC) in Subchapters A, B, C, D, and E.
  - Texas standards provide blanket coverage for all CPA activities under the same provisions. [501.51]
    - Those not in client practice of public accountancy are still responsible for all non-attest parts of the TAC. [501.53(c)]
- AICPA standards distinguish the material between
  - Concepts (Part 0)
  - Public practice (Part 1);
  - Private practice (Part 2); and
  - Government and Philanthropic (Part 3).

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**AICPA Code of Professional Conduct (CPC)**

- Conceptual Framework [0.100]
- Part 1: *Members* in public practice [1.000]
- Part 2: *Members* in business [2.000]
- Part 3: All Other *Members* [3.000]
- Only applicable in the US.
- Member is*
- Pdf version available [HERE](#)

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**CPC - Concept Threats<sub>1</sub> [1.000.010.07, 2.000.010, 3.000]**

- Identify** Threat(s) based on
  - relationship(s) and/or
  - engagement(s)/circumstances;
  - Consider, in priority
    - Standards; then
    - Rules; then
    - Interpretations. If all else fails,
    - Concept Statements.
  - Texas has no similar set of standards.

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**CPC -Threats**

- Adverse Interest** Threat [1.000.10.10]
  - Generally associated with conflicts between the client and a firm/member through:
    - Threatened litigation;
    - actual litigation that includes the client, officer, director or shareholder against the *member*;
    - Subrogation claims by a third party for insurance payments;
    - Class action suit involving both the client and member.
- Texas addresses adverse interest threats only in relation to independence. [501.

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•**Advocacy Threat** [1.000.10.11]

- promoting a client's interest at the expense of *objectivity* and/or *independence* through
  - *Investment advice*;
  - *Forensic accounting during a dispute*;
  - *Share activity through*
    - *Underwriting*;
    - *Being a registered agent*;
  - *Product endorsement*.

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•**Familiarity Threat** [1.000.10.12]

- Relationship-based between the client and member
  - Client employment of
    - Immediate family;
    - Close relative [1.400.08];
      - » Parent, sibling, non-dependent child.
    - Close friend [undefined];
    - Former partner/professional employee in a *key position* [1.400.27] with knowledge of the *firm's* policies/practices.
      - » Primary responsibility for
        - » Key components of accounting statements; or
        - » Preparing the accounting statement; or
        - » Ability to influence the account
  - Long relationship with client
  - Close business relationships with client's
    - Officer;
    - Director;
    - >10% shareholder.

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•**Self-Interest Threat** [1.000.10.14]

- Financial interest in a client that can be affected by the professional services;
- Spouse is seeking a job with a client;
- Contingent fee on a tax refund claim;
- Firm *excessive reliance* on client's revenue.

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CPC -Threats,

•Self-Review Threat [1.000.10.15]

- Effectively – losing one’s objectivity because of past judgment(s) or service(s). For instance, if a member
  - relies on firm’s work product;
  - Performed bookkeeping for the client; o
  - A partner in the member’s office used to be an officer, director, employee or contractor.

- Management Threat [1.000.10.13]

- Assuming a management role with the client during an attest engagement.

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CPC - Concept Threats<sub>1</sub> [1.000.010.07, 2.000.010, 3.000]

•Evaluate threat(s) [both qualitative and quantitative] to see if they can be

- Eliminated; or
- Reduced to acceptable level.

•Standard for threat evaluation

- Reasonable third party
  - Having all relevant information;
    - Including safeguards;
  - Would conclude that the post-safeguard threat level would not compromise a member’s compliance with the Standards and/or their Independence (if in public practice and providing attest services) [1.200.001].

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CPC - Terminology<sub>2</sub>

•Close relative – parent, sibling, non-dependent child.

•Network and network firms – association that form to enhance professional services and share:

- Name;
- Control;
  - Management or ownership.
- Business strategy;
- Professional resources;
- Required quality control procedures/policies.

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**CPC - Terminology**

- **Affiliates** [1.224.010, 1.400.02; TAM 501.52] – For attest clients
  - Direct financial interest;
  - Based on **control and influence not necessarily ownership** as well as **materiality** of the relationship to the financial statements
    - ability to exert significant influence [ASC 323-10-15] on the financial statements based on
      - horizontal (parent/sub) or
      - vertical (brother/sister) influence.
- On attest engagements – best efforts to identify all affiliates
  - If information can't be found
    - Discuss w/ those charged with governance;
    - Document results and efforts;
    - Obtain written assurance from client about lack of affiliate information.

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**CONCEPTS APPLICABLE TO ALL PARTS**

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**Public Interest**

Integrity

Fundamental  
Element of Character  
Candid and honest  
Measured in terms of what is right and just  
Used to decide which part of the public to respond to. [TAC 901.73; CPC  
0.300.040]

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Public Interest

Objectivity

State of Mind  
Impartial  
Intellectually Honest  
Don't subordinate judgment.  
Free of *appearances of* Conflicts of Interest  
Linked to Independence in Attest Engagements.

[TAC 501.73; CPC 0.300.050]

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Public Interest

Due Care

Best Interest of Client *consistent* with Public Interest  
Diligence  
Competence through **experience** & education  
Ignore pressures (*threats*) from those in a position of authority

[CPC 0.300.060.2-170.010]

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Integrity/Objectivity [TX 501.73; AICPA 1.100; 1.300.040]

- Identify and manage threats to **integrity and objectivity.**
  - Evaluation is considered in relation to conflicts of interest through
    - Professional service;
    - Relationship; and/or
    - *Matter* (undefined).
  - Don't
    - misrepresent facts;
    - Subordinating judgment.

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**Integrity/Objectivity**<sup>[1.130.020]</sup> - **Subordinating Judgment**

- Differences of professional opinion above an **acceptable threat level** must now be discussed/disclosed
  - Audit issues;
  - GAAP issues;
  - “other relevant professional standards” <sup>[undefined]</sup>
- A **threat’s** significance should be considered in light of the position’s
  - Compliance with professional standards;
  - Materially misrepresents facts; or
  - Violates laws or regulations. <sup>[1.130.020.04]</sup>

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**Integrity/Objectivity**<sup>[1.130.020; 2.130.020]</sup> - **Subordinating Judgment**

- Differences above acceptable threat level, discuss with superiors
  - Within the firm;
  - Check legal obligations to disclose;
  - Consult with legal counsel;
  - Document issue;
  - Leave. <sup>[1.130.020.05-08]</sup>
- Differences within acceptable threat level
  - discuss with those with a different position.

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**Conflict of Interest** <sup>[CPC 1.110]</sup>

- Evaluate based on the relationship(s) between
  - Member/firm and client;
  - Member/firm and multiple clients
- **Establish policies** to identify and deal with conflicts. <sup>[1.110.010.10]</sup>
- Threats can be addressed through
  - Disclosure (other than if independence is required); and
    - General; or
    - Specific.
  - Appropriate waiver.
- AICPA now uses a “reasonable third party” to assess the conflict while Texas requires the member to assess the conflict’s potential impact on objectivity. <sup>[TAC 501.73]</sup>

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## CPC Part 1 – Public Practice

- Independence
- TX 501.70
- AICPA 1.200

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### CPC – Terminology [0.400.12]

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#### • Covered member;

- For attest (Part 1) engagements;
  - On the team;
  - **Can influence the engagement** (undefined);
  - Partner/principle/manager **providing >10 hours** non-attest services;
  - Partner/principle in the **same office** as the lead engagement;
  - Firm;
  - **Any entity controlled by any of the above.**

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### CPC Part 1 – Independence [CPE 1.210.010; TAC 501.52(4)]

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- Independence is required for attest engagements for an attest client.
- Attest engagements (service) include
  - Audit
  - Review
  - Compilations where lack of independence is not disclosed for a financial statement attest client. [0.400.16]
- The standards strongly emphasize use of quality control systems (QC §10) for whether independence threats have been addressed appropriately. [1.298.010.02]

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### CPC Part 1 - Independence

- Familiarity threats can occur when a partner/principle has been a member of the engagement team “...for a prolonged period.”  
[1.210.010.14]
- Affiliates – based on *immediate family, close relatives, and relationships*.
  - Includes subsequent employment with attest client in *key position*
    - Ability to influence, control impact attest engagement.
- The engagement letter can include
  - a “hold harmless” or indemnification clause in the engagement letter if the liability is related to “knowing misrepresentations by management”.  
[1.228.010.01]
  - Alternate Dispute Resolution (ADR) rather than litigation [1.228.030]

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### CPC - Part 1 - Independence

- Threats that **cannot be made “acceptable”**
  - **Unpaid fees** over a **year old** would limit future attest functions.
    - Measured from the start date of the current year’s report. [1.230.010.02]
  - **Material Financial Interests** [1.240.010]
    - *Member, immediate family and close relative* ownership interests (equity or otherwise) of >5% in an attest client and affiliates; [1.270.100]
      - Can include control as trustee or executor
        - Threshold now goes to 10%. [1.245.010]
    - Indirect financial interests that include self-directed retirement accounts, non-diversified mutual funds (if material) and share-based compensation arrangements. [0.400.22]

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### CPC - Part 1 - Independence Threats - Non-attest services

- Advisory services;
- Appraisal, valuation, actuarial services;
- Pension plan administration
- Disbursement functions (bookkeeping, distribution, etc)
- Risk consulting
- Finance consulting
- Investment advisory or management
- Executive recruiting
- Forensic accounting
- IT
- Internal audit
- Tax

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## Conceptual Standards

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### Competence & Due Care [TAC 501.74, CPC 1.300.010, 1.300.060]

- Competence requires that the *member* have
  - Adequate information (relevant data) to reach conclusion;
  - Technical competence;
  - Ability to supervise and evaluate work;
    - Adequate planning and supervision.
  - Exercise of due professional care (includes *due care*);
  - Obtaining sufficient data to issue

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### Discreditable Acts [TAC 501.90; CPC 1.400.010]

- Discrimination & Harassment in employment practices
- Professional Attitude Toward Clients:
  - Negligence when preparing financial statements and records;
  - Repeated failure to respond to a client's inquiry within reasonable time without good cause.
- Public allegations of a client's lack of mental capacity not supported in fact.
- Causing a breach in security of the CPA examination.

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**Solicitation and Advertising** [TX 501.82, AICPA 1.400.090]

- No false, misleading or deceptive advertising. [CPC 1.600.001]
  - Includes “puffing” about skills, background, or ability to influence a court or regulatory decision. [CPC 1.600.010]
- Texas – false, *fraudulent*, misleading or deceptive.
  - Includes communication that involve coercion, duress, compulsion, intimidation, threats, overreaching, or vexatious or harassing conduct.
  - No persistent and harassing contact with a prospective client [TAC 501.82 (g)]
  - Seeking services; unless
  - Communication was “invited”.

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**False/Misleading/Deceptive Advertising** [AICPA 1.400.200]

- Setting a fee unrealistically low knowing it will have to be increased.
  - AICPA now particularly defers to any more stringent state standard.
- Any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

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**Client Records** [TAC 501.76, CPC 1.400.200]

- Texas [TX 501.76] - CPA must return *original* client records, including:
  - Original records;
  - Workpapers that include records that would be part of the client’s books and records otherwise unavailable to the client;
  - Adjusting and closing J.E.’s [and supporting details, if necessary]
  - Consolidating or combining journal entries and worksheets.
- Texas allows a *reasonable time* not to exceed 10 business days to return client records.
- AICPA [1.400.200] – *as soon as practicable or 45 day turnaround.* [1.400.200.12]
- AICPA allows work papers to be withheld for
  - Unpaid fees;
  - Litigation;
  - BUT... now also generally defers to more restrictive state standards

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**Client Records** [TAC 501.76, CPC 1.400.200]

- CPA can charge (time and costs) to furnish client with a copy of
  - Client’s tax return;
  - Any report or other published document;
  - Work papers not otherwise available to client. [TAC 501.76]
- CPA should retain attest service work papers for a **minimum of 5 years** from report date.
  - Failure to do so may be considered an admission the work papers do not comply with professional standards.
- TSBPA recommends that CPA obtain a receipt or other written documentation of records delivery to a client.

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**Contingent Fees** [TAC 501.72, CPC 1.510.005]

- No contingency fees
  - if you are also providing services requiring independence;
    - Providing an examination of *prospective financial information*;
    - Preparing tax return (original or amended).
  - Testifying as an expert.

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**Contingent Fees** [TAC 501.72, CPC 1.510.005]

- Fees are not contingent if
  - Are the **member’s** spouse and the member isn’t *significantly* involved. [1.510.030]
  - “based on the findings of governmental agencies..”
  - Revenue Agent Report representations;
  - Private Letter Ruling request;
  - Amended return for refund on a tax issue that is the subject of a non-client test case;
  - Interest/penalty refunds in assessed value proceedings. [CPC 1.510.005.03]

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**Commissions & Referral Fees** [TX 501.71, AICPA 1.520]

- Prohibited on attest engagements
  - An audit or review of financial statements; or
  - A compilation when there is a reasonable expectation that third party(ies) will use the financial statement; or
  - An examination of prospective financial information.

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**Commissions & Referral Fees** [TX 501.71, AICPA 1.520]

- Texas more broadly prohibits when services require independence.
- Referral fees are okay when non-attest client products/services are recommended to an *attest* client's
  - Officers, directors or employees.
  - Employee benefit plan of attest client if the plan is not also an attest client.
  - Disclosure. [1.520.050]
- Applies to member but not spouse as long as member
  - is not significantly involved;
  - Activities are separated. [1.520.030]

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**Advertising - Texas** [TAC 501.82, CPC 1.600]

- false, fraudulent or misleading statements;
- Reference to services accomplished by coercion, duress, compulsion, intimidation, threats, overreaching, or vexatious or harassing conduct.
  - Misrepresentation or incomplete disclosure of relevant facts;

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**Advertising - Texas** [TAC 501.82, CPC 1.600]

- NO Promotions through
  - Unjustified expectations of favorable results;
  - Background or qualifications (including testimonials or endorsements),
    - including comparisons to other accountants;
  - Fee structure that is
    - Unreasonably low; or
    - Does not disclose variables to the fees that can be charged.
  - Ability to influence a court, regulatory agency, official, etc because of special relationship(s).
  - Would cause a reasonably prudent person to misunderstand or be deceived.

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**Advertising - Texas** [TAC 501.82, CPC 1.600]

- Keep mailing lists for 36 months (from the date of last distributions)
  - A list of persons to whom advertising was sent.
  - not required if the CPA did not make first contact
    - A client, or
    - Sought out the CPA whether or not another CPA was providing services.

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**Advertising** [TAC 501.82, CPC 1.600]

- AICPA – considered by whether it is a *threat* that a reasonable person would misunderstand or be deceived.
  - No false, unjustified expectations of favorable results;
  - Don't imply ability to influence government agencies or courts;
  - Underbid the engagement
    - likely at the time of the representation that the fees would be substantially increased; and
    - Not disclosed to client.
- Acts are likely discreditable if committed. [2.400.090]

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**Firm Organization, Name and License** [TAC 501.81; CPC 1.800.]

- Texas
  - License required if there’s an office in the state.
  - All practice must be through that firm license for clients with principle offices in the state and the engagement involves
    - SAS Audits;
    - SSAE examination of prospective financial information;
    - PCAOB engagements.

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**Firm Organization, Name and License** [TAC 501.81; CPC 1.800.]

- Licensed firms and their names must adhere to the advertising requirements
  - Can include
    - former CPA owners;
    - Current or former *foreign practitioner* owners;
    - Legal organization – e.g., LLC, etc
    - Indicates specialization(s) such as tax, investment, etc.
  - Can’t
    - include non-owners or non-CPAs;
    - Misleading trade or assumed name(s);
    - Name other than the firm’s *license name*.

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**Firm Organization, Name and License** [TAC 501.81; CPC 1.800.]

- Unlicensed firms must conspicuously disclaim “this firm is not a CPA firm” unless
  - Practicing as an attorney;
  - Employee, director or officer of federally-insured depository institution;
  - Practice privilege.
    - Basically, authorization to practice in Texas given to out-of-state firms or practitioners.

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**Firm Organization, Name and License** [TAC 501.81, CPC 1.800, 1.810.]

- AICPA
  - Firm names can't be *misleading*
  - All controlled firms must all comply with CPC
    - Providing litigation support, tax, financial planning.
  - Ownership with non-CPAs must be disclosed.

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**Client Confidentiality** [TX 501.75, AICPA 1.700]

- Generally, no disclosure without client or authorized representative's approval.
  - Potential conflicts when accepting board or trust positions. [CPC 1.700.080]
- Withdrawal – can “suggest” new CPA to ask client to allow them to discuss matters. [1.700.020.02]

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**Client Confidentiality** [TX 501.75, AICPA 1.700]

- Exceptions for
  - Fulfilling GAAP or GAAS disclosure requirements;
  - Applicable federal law or regulations (PCAOB included);
  - Validly issued subpoena\* (Congress or other);
  - Summons\* issued by
    - I.R.S.;
    - SEC;
    - Court.
  - Valid and enforceable subpoena;
  - Peer or other practice review\*;
  - Board investigative or disciplinary proceeding\*;
  - Litigation\*;
  - Ethical investigations by private professional organization(s)\*;
  - Practice sale, merger of part/all of member's firm with written non-disclosure agreement.

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**Reportable Events** [TX 501.91]

- Reported in writing to TSBPA within 30 days:
  - Felony conviction;
    - Includes deferred adjudication.
  - Any crime related to functions or duties of the CPA;
    - Alcohol or controlled substance abuse.
  - Any crime involving
    - Embezzlement; or
    - Improper financial statements.
  - Cancellation of right to practice as a CPA in any jurisdiction, including by SEC or IRS.

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**Discreditable Acts - Texas** [TAC 501.91, CPC 2.400.001]

- Fraud/deceit in obtaining CPA certificate;
- Dishonesty, fraud in practicing public accountancy;
  - violation of any of the provisions of Subchapter J or §901.458 of the Act (relating to Loss of Independence) applicable to a person certified or registered by the board;
  - final conviction of
    - a felony or imposition of deferred adjudication or community supervision in connection with a criminal prosecution of a felony under the laws of any state or the United States;
    - any crime or imposition of deferred adjudication or community supervision in connection with a criminal prosecution, an element of which is dishonesty or fraud under the laws of any state or the United States, a criminal prosecution for a crime of moral turpitude, a criminal prosecution involving alcohol abuse or controlled substances, or a criminal prosecution for a crime involving physical harm or the threat of physical harm;
  - cancellation, revocation, suspension or refusal to renew authority to practice as a CPA or a public accountant by any other state for any cause other than failure to pay the appropriate registration fee in such other state;

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**Discreditable Acts - Texas** [TAC 501.91, CPC 2.400.001]

- suspension or revocation of or any consent decree concerning the right to practice before any state or federal regulatory or licensing body for a cause which in the opinion of the board warrants its action;
- knowingly participating in the preparation of a false or misleading financial statement or tax return;
- fiscal dishonesty or breach of fiduciary responsibility of any type.

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**Discreditable Acts - Texas** [TAC 501.91: CPC 2.400.001]

- a final finding of conduct by state or federal courts of competent jurisdiction, agencies, boards, local governments or commissions for violations of state or federal laws or rules or findings of unethical conduct by licensees that engage in activities regulated by entities including but not limited to:
  - the Public Company Accounting Oversight Board,
  - Internal Revenue Service,
  - SEC;
  - U.S.
    - Department of Labor,
    - General Accounting Office,
    - HUD,
    - Texas
      - State Auditor,
      - State Treasurer,
      - State Securities Board,
      - Department of Insurance, and
      - Secretary of State

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**Discreditable Acts - Texas** [TAC 501.91: CPC 2.400.001]

- failure to comply with a final order of any state or federal court;
- repeated failure to respond to a client's inquiry within a reasonable time without good cause;
- intentionally
  - misrepresenting facts or making a misleading or deceitful statement to a client, the board, board staff or any person acting on behalf of the board;
  - giving false sworn testimony or perjury in court or in connection with discovery in a court proceeding or in any communication to the board or any other federal or state regulatory or licensing body;
- threats of bodily harm or retribution to a client;
- public allegations of a lack of mental capacity of a client which cannot be supported in fact;

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**Discreditable Acts - Texas** [TAC 501.91: CPC 2.400.001]

- voluntarily disclosing information communicated by an employer, past or present, or through employment status in connection with accounting services rendered to the employer, except:
  - With the employer's permission;
  - pursuant to the Government Code, Chapter 554 (commonly referred to as the "Whistle Blowers Act");
  - in an investigation or proceeding by the board;
  - in an ethical investigation conducted by a professional organization of CPAs;
  - in the course of a peer review under §901.159 of the Act (relating to Peer Review); or
  - any information that is required to be disclosed by the professional standards for reporting on the examination of a financial statement.
- breaching the terms of an agreed consent order entered by the board or violating any Board Order.

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**Discreditable Acts - Texas** [TAC 501.91; CPC 2.400.001]

- voluntarily disclosing information communicated by an employer, past or present, or through employment status in connection with accounting services rendered to the employer, except:
  - pursuant to:
    - a court order signed by a judge;
    - a summons under the provisions of:
      - the Internal Revenue Code of 1986 and its subsequent amendments;
      - the Securities Act of 1933 (15 U.S.C. §77a et seq.) and its subsequent amendments; or
      - the Securities Exchange Act of 1934 (15 U.S.C. §78a et seq.) and its subsequent amendments;
      - a congressional or grand jury subpoena; or
      - applicable federal laws, federal government regulations, including requirements of the PCAOB.

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**Discreditable Acts - AICPA** [TAC 501.91; CPC 2.400.001]

- Keep in mind that these acts can always be mitigated by showing that safeguards were applied to reduce the threat to an acceptable level.
  - Final determination of antidiscrimination law violation;
  - Disclosing or asking for CPA exam questions;
  - Failing to file or pay tax;
  - Material departure from agency, governmental bodies, commissions guides/rules/standards in *financial statements* or related information.
    - Including indemnification clauses prohibited by the respective board/agency etc.

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**Discreditable Acts - AICPA** [TAC 501.91; CPC 2.400.001]

- Keep in mind that these acts can always be mitigated by showing that safeguards were applied to reduce the threat to an acceptable level.
  - Financial statement negligence
    - With regard to materially false/misleading financial statement entries (directly or through others)
      - Makes or fails to correct an entry
      - Signs a document containing the entries/information.

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**Discreditable Acts - AICPA** [TAC 501.91; CPC 2.400.001]

- AICPA. Keep in mind that these acts can always be mitigated by showing that safeguards were applied to reduce the threat to an acceptable level.
  - Disclosing confidential information obtained through
    - Employment;
      - Prior or current.
    - Volunteer activities.

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**Discreditable Acts - AICPA - Permitted Disclosures** [TAC 501.91; CPC 2.400.001]

- permitted by law and authorized by the employer.
- required by law, for example, to
  - comply with a validly issued and enforceable subpoena or summons or
  - inform the appropriate public authorities of violations of law that have been discovered.
- Permitted on behalf of the employer to
  - obtain financing with lenders;
  - communicate with vendors, *clients*, and customers; or
  - communicate with the employer’s external accountant, attorneys, regulators, and other business professionals.

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**Discreditable Acts - AICPA - Permitted Disclosures** [TAC 501.91; CPC 2.400.001]

- There is a professional responsibility or right to disclose information, when not prohibited by law, to
  - initiate a complaint with, or respond to any inquiry made by, the Professional Ethics Division or trial board of the AICPA or a duly constituted investigative or disciplinary body of a state CPA society, board of accountancy, or other regulatory body;
  - protect the *member’s* professional interests in legal proceedings;
  - comply with professional standards and other ethics requirements; or
  - report potential concerns regarding questionable accounting, auditing, or other matters to the employer’s confidential complaint hotline or *those charged with governance*.

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## Institute of Management Accountants (IMA) Standards

- Members are obligated to
  - Public
  - Their profession
  - The organizations they serve.
- Integrity and Objectivity
  - Conflicts should be avoided or disclosed;
  - Don't take gifts, favors, hospitality that may influence a decision;
  - Stay away from activities that may prejudice your ability to carry out your duties ethically;
  - Avoid discreditable activities;
  - Convey professional opinion objectively (both favorable and unfavorable);
  - Disclose any constraints or professional limitations that would impact your judgment or successful performance of an activity.

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## Institute of Management Accountants (IMA) Standards

- Conflicts
  - Resolve ethical issues using
    - Organizational standards. If unresolved
      - Discuss with next level management that is not involved in the issue;
      - Take to supervisory groups such as Board of Directors, executive committee, trustees, etc.
    - Don't take the issue outside the organization unless legally prescribed; and, if all else fails,
    - Seek discussion with an objective advisor.

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## Institute of Management Accountants (IMA) Standards

- Competence
  - **Competence** includes
    - ongoing knowledge development;
    - Follow relevant standards when performing professional duties
      - Laws
      - Regulations
      - Technical standards
- Confidentiality
  - Disclose confidential information only when
    - Part of your professional duties; or
    - legally required.
  - Monitor and instruct subordinates about confidentiality responsibilities.
  - Personally or through others, don't use confidential information for unethical or illegal advantage.

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**Institute of Internal Auditors (IIA)**

- Integrity
  - Perform work with honesty, diligence and responsibility.
  - Observe and don't knowingly violate applicable laws, regulations;
    - Includes disclosures required by law or the profession.
  - No discreditable acts [undefined];
  - Contribute to the legal/ethical organizational objectives.

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**Institute of Internal Auditors (IIA)**

- Objectivity
  - No activities or relationships that
    - do or give the appearance that they impair
      - your professional judgment; or
      - Unbiased assessment.
    - May be in conflict with organizational interests.
  - Disclose all material facts that, if not disclosed, would distort the associated activities.

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**Institute of Internal Auditors (IIA)**

- Competency
  - Limit yourself to activities for which you have the necessary knowledge, skill and experience.
  - Strive to continually improve your quality, effectiveness and proficiency.
  - Follow International Standards for Internal Auditing Practice.
- Confidentiality
  - Information acquired from your duties should be
    - Not used for personal

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# **Module 5**

## **Tab 2 – Cases and Discussion Material**

## **Integrity and Objectivity:**

**Case 1:** Your firm is doing the CFO's tax return as well as the company audit. You are a partner in the same office as the lead engagement partner for the audit. In the course of preparing the CFO's tax return, you discover that the CFO is reporting twice what his company salary would indicate on his tax return.

- What added questions would you like to ask the CFO?
- If you're not comfortable with the CFO's answers, what are your options?

**Case 2:** You've been asked to be the director of a bank that is not an audit client of the firm. The bank has a significant number of CPAs and your clients as customers of the bank.

- What added questions might you want to ask?
- Can/should you take the position?

## **Independence:**

**Case 1:** Ima Gready, CPA has worked for Energy Co. for 5 years. She has recently been offered a position with the accounting firm that does Energy's audit.

- What added questions and/or information would you need to assess her ability to take the job offer?
- What ethical issues would you expect Ima would have to address before she can take the job?

**Case 2:** Phil N Thropic Charitable Foundation is the sole beneficiary of the Brim Estate that has been in probate for a number of years. The Foundation has asked your wife to serve as Trustee. You are in discussions with both the Executor of the Brim Estate and the Foundation to perform annual audits.

- Both as to the Foundation and the Estate, could you take assume the trustee position?

**Case 3:** Bob is a senior audit partner in a national accounting firm. Both he and his spouse have used Integrity Financial Services as the trustee for their retirement plans for over 10 years. Integrity happens to provide similar services for a number of other partners in the accounting firm. Integrity has provided both trustee and investment advisory services to Bob, his spouse and the other members of the partnership during that time. Integrity has approached Bob about performing their annual audit.

- Can Bob and/or the firm accept the engagement? Can Bob participate in the audit?

**Case 4:** Tamesha is an audit partner in a regional accounting firm. She also is a general partner in the Wildcatter Partnership, a private oil and gas drilling venture. Slick, Wildcatter's managing general partner, is forming a second private partnership to act as refiner to the Wildcatter partnership. Slick intends to be the managing general partner for the new partnership.

Slick has asked Tamesha if she and her firm will provide attest services for the new partnership, including helping her put together the financial portions of the private placement memorandum.

- Can Tamesha and/or her firm accept the engagement?

## **Professional Standards:**

**Case 1:** A Member cannot certify statements under GAAP if those statements contain departures from GAAP

- Does it matter that the member didn't know of the discrepancy? (NO)
- Does the variation have to be material? (YES)
- What if the discrepancy
  - makes the statements more accurate?
  - Makes the statements more informative?

**Case 2:** Greg Garious was one of your first clients when you started your practice in 1990. Since then, you have been preparing his tax returns and otherwise advising him on tax matters. In 2009, because of some differences over how aggressive to be on the tax return, Greg informed you that he would not be retaining your services in the future. At the time, Gregg had not paid his bill for over a year and owes you over \$45,000.

Early in 2011, Greg writes you a letter requesting that you send all of his papers as well as your workpapers to his new accountant.

- How would you respond to this request?
- Would your response be different if the engagement had been terminated before it was completed?

**Confidentiality:**

**Case 1:** Hy Road, CPA specializes in accounting for gas processing companies. Hy is getting ready to do the annual audit for one of his oldest and best audit and tax clients, DeepDrill.

Hy is currently conducting a first-year audit engagement for PipeLine Ltd, a competitor of DeepDrill. During the PipeLine audit, Hy learns that a major gas supplier to the refineries for both companies is about to file for bankruptcy.

- Can Hy perform the audit for both clients?
- Can the information Hy becomes privy to while doing the PipeLine audit be used in the DeepDrill engagement?

**Case 2:** Junkie Financial Services (Junkie) is a public company involved in the financial services sector, primarily in the leasing of capital assets to manufacturers. The leases are generally financial leases. The VP of Finance at Junkie since 2007 is Sarah Gold, CPA. Sarah obtained the CPA license in 1997 and worked for a BTG, Ltd, a large regional accounting firm until she took the job with Junkie.

In 2009, Junkie requested proposals for the selection of auditors. Three firms submitted proposals, including BTG. The bids each included a quote for audit services. The BTG proposal team was led by audit partner, Jerome Snookie, who was a classmate and good friend of Sarah's at UTA. While meeting Sarah for dinner one evening before the proposals were submitted, Jerome was able to obtain information about the bid amounts from the other accounting firms. As a result, the bid submitted by BTG was priced at \$30,000 less than the lowest bid, and this helped ensure that BTG obtained the audit. Sarah has already told Jerome that once they start the audit, they could get all sorts of "other work."

## **Conflict of Interest:**

**Case 1:** Imp Petuous, CPA's best audit clients (Wimpy) owns a series of successful fast-food franchises in the DFW area. Wimpy has recently been approached by two outside investors to fund opening two more fast-food stores in a neighboring city. After considering the offer and being advised by both Imp and his attorney, Wimpy decides to accept the investor's offer.

As part of the process, Wimpy incorporates all of his fast-food stores and goes public, bringing in the outside investors. He has asked Imp to sit on the new corporation's board of directors and Imp has agreed. As a member of the Board, Imp was offered stock options in the new corporation which he accepted. Imp has used the options to buy stock in the corporation and—applying avoidance of conflict-of-interest guidelines—disclose his lack of independence to appropriate parties.

A large tax client (Xia Wang) who has recently sold her business and has significant cash reserves has asked you to recommend one or more good investments for her funds.

- Imp would like you to comment on his recent stock purchase.
- Would you recommend Wimpy's company to Xia? If so, under what conditions? If not, why not?

## **Advertising**

**Case 1:** Norman CPA sends a direct-mail communication about his/her tax practice services to all of his audit client whose tax work is done by other CPA firms. Does Norman need to follow the "36 month" provisions?

## **Cumulative Case Study 1:**

Mary Eaves, CA, runs her public accounting practice from home.

### **A. Ralph Gora Paving**

In the summer of 2010, Mary's residence driveway was repaved by Ralph Gora Paving; Ralph was paid cash for the service. In early 2011, Ralph asked Mary if she could get his books up to date and file his personal tax return. Mary agreed and compiled the statements from the records and documents available and filed the return. Mary noted that there was no invoice and no deposit recorded for the repaving of her driveway, and similarly for the repaving of the driveway of three of her friends. Before filing the tax return, Mary got a letter from Ralph wherein he declared that the records provided to her were complete and correct.

### **B. Honest Ivan Ltd.**

Mary started the audit of the financial statements of Honest Ivan Ltd. (HIL), a used car parts dealer. Mary completed the interim audit and by the time she was completing the year-end audit, she formed a supportable opinion that HIL was selling stolen car parts. She confronted the owner with the problem and was told to keep her nose out of it. Mary immediately resigned from the audit.

Two days later she got a letter from another CPA inquiring about the existence of any circumstances he should consider in deciding whether to accept the engagement. Feeling somewhat relieved, Mary sent a letter saying she had withdrawn because the client was limiting the scope of her audit. The CPA then notified Mary that he had accepted the engagement and would contact her about information he may need; at this point Mary immediately packed up all of HIL's records that she still had, made copies of her working paper files and sent them to the CPA.

## Cumulative Case Study 2:

A few months ago, Jeremy Johnson, CPA, opened his public practice as a sole practitioner under the name “Jeremy Johnson, Certified Public Accountant and Associates”. Robert White, a non-CPA, works for Jeremy and is paid an annual salary equal to 50% of his billings to clients. Robert, who is keen on bringing in new business, has convinced two clients of a national CPA firm to move their accounting and auditing business to Jeremy’s, telling them that he would personally serve them better and that if a CPA is needed to sign something, he works for one. He guarantees that the fee will be no more than half of that paid in the prior year to the former accountants.

Robert pays his cousin, a CPA in public practice, a \$200 referral fee for the clients discussed above. The cousin is very busy but very selective when accepting new clients. Robert also pays his girlfriend a \$500 referral fee; she teaches English to new immigrants, many of whom are starting businesses and require accounting and taxation services.

When Robert tells Jeremy about the new business, Jeremy agrees to reimburse Robert for these payments. Jeremy’s brother, John, is also a CPA with a sole practitioner practice in another city. Jeremy and John have no financial interest in each other’s practices but have agreed to act as each other’s representatives in their respective cities.

Nick, a friend of Jeremy and a CPA who is not in public practice, makes his living from a number of commercial real estate properties he owns and operates in another city. Nick has agreed to act as Jeremy’s representative in his town and is paid \$100 for referrals.

Jeremy’s letterhead and promotional material includes the following under his practice name.

Jeremy Johnson – City one – phone and fax numbers

Robert White – City one – phone and fax numbers

John Johnson – City two

Nick Drake – City three.

At the bottom of the letterhead page the phrase “Jeremy Johnson is one of Texas’ Best Certified Public Accountants, Recognized by the Texas State Board of Public Accountancy with National Honors.” Jeremy had placed in the top 10 in Texas on the CPA examination in the year he took the exam.

### **Cumulative Case Study 3:**

Wide & Diggs CPAs has been in public practice for a number of years. Two years ago, Wide compiled the financial statements of Perfect Plumbing Ltd. (PPL) and helped negotiate a loan from a private lender. PPL is owned and operated by the common-law spouse of three years of Wide's mother. Wide & Diggs billed PPL \$1,000 for these services. Wide & Diggs, now needing money to renovate its office space, borrowed \$15,000 from PPL under the terms of a contract specifying the loan, interest and repayment terms.

Wanting to increase his firm's revenues, Wide asked his spouse to convince her good friend Agnes Able, a CPA working for a public accountants firm, to leave her firm and to bring her clients to Wide & Diggs. Wide's spouse took to the task with considerable zeal and called Agnes Able daily. After about one month, Wide & Diggs received a letter from the Texas State Board of Public Accountancy asking to reply in writing about a complaint of harassment made by Agnes Able. Wide personally called her and apologized. She accepted his apology and said there were no hard feelings. Wide thought nothing more of the matter.

Jake Overland, a very successful immigration lawyer, approached Diggs about the affairs of his business and more specifically about two items.

First, Overland would like Diggs to perform the annual mandatory audit of a lawyer's trust accounts required by the Texas Bar. Second, Overland, who has always charged a flat fee for his services, has recently found out that his services are not subject to franchise tax although he has been withholding and paying tax on such amounts.

From his past experience with other lawyer clients, Diggs believed that the audit of the trust accounts would not take much time, and agreed to perform the work for \$500. Overland and Diggs agreed to the above on a handshake. Diggs also offered to have his firm determine Overland's franchise tax amount in exchange for 50% of the recovered amount.

The partners at Diggs & Wide agreed to split the work on the Overland engagement with Diggs doing the audit and Wide, the franchise tax claim.

**Module 5**  
**Tab 2A– Responses to Cases and Discussion**  
**Material**

## **Integrity and Objectivity:**

### ***Case 1:***

Response: The AICPA's Statement of Standards for Tax Service (SSTS) are incorporated into the Texas Rules per Rule 501.62. As a result, under SSTS 2, a CPA must make a reasonable effort to obtain information to answer all questions when preparing return but is NOT required to independently verify the information unless the information appears to be incomplete, inconsistent or incorrect. Supporting documentation is not required unless necessary to verify numbers on the tax return. The fact that the answer may not be in taxpayer's favor is irrelevant.

If the client is informed of what the CPA believes to be an error, you can withdraw from the engagement. There are NO disclosure requirements.

### ***Case 2:***

Response: Whether compensated or not, before agreeing to be a director for the bank the CPA should consider the possible potential conflicts of interest and confidentiality issues under Rules 501.73 (integrity and objectivity) and 501.71.

There are potential confidentiality issue if as a director, the CPA would be making decisions that would impact bank customers that would include the CPA's clients since the CPA may be privy to information about one or more of the bank customers (e.g., his clients) that would cause him to make decisions as a direct that would not have been made without that information. This is turn may result in the CPA breaching his or her fiduciary duties as director.

Separately, this arrangement may be considered to be a "relationship with another person, entity, product, or service that could, in the certificate or registration holder's professional judgment, be viewed by the client, employer, or other appropriate parties as impairing the certificate or registration holder's objectivity." If so, it is appropriate to disclose to all parties and, with appropriate positive responses, continue on as director.

## **Independence:**

***Case 1:*** Response: One would want to know what Ima's responsibilities at the accounting firm would be in relation to the Energy audit or whether she is assuming other non-audit responsibilities. It would be best to make full disclosure to both Energy and the accounting firm of all possible conflicts and she should confirm both with Energy and the accounting firm that information provided during prior audits would remain confidential.

Ima would have to consider her responsibilities under Rule 501.71 for independence. If this is a public company subject to the SEC jurisdiction, there would be a one year "cooling off" period. She would probably also want to make sure that any relationship to the audit is disclosed with Energy.

***Case 2:*** Response: Whether or not any fees are paid to the spouse as trustee, this situation would most likely be considered to treat the CPA as having impaired their independence. [AICPA Interpretation 101.1]

***Case 3:*** Response: Independence is not necessarily impaired so long as Integrity is providing the same services under it's normal terms to Bob and the other partners. Impairment may occur if the potential risk of loss to any of the covered members were to become material.

Risk of loss could include financial instability of Integrity or potential market declines to the retirement assets. Risk of loss can consider: (1) loss protection provided by state or federal agencies; (2) insurance, public or private, on the retirement assets; (3) whether the retirement funds are pooled with Integrity's general funds and subject to credit risk or segregated in separate account(s) that are protected from general creditors.

***Case 4:*** Response: Subject to materiality considerations on Tamesha's part, since Slick has control over both partnerships, Tamesha's interest in Wildcatter would potentially impair her independence on any attest engagement for the new partnership. Since Slick has significant influence over both partnerships, Tamesha would be considered to have a joint, closely-held financial interest with Slick.

## **Professional Standards:**

### ***Case 1:***

- Does it matter that the member didn't know of the discrepancy? (NO)
- Does the variation have to be material? (YES)
- Response: "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"

***Case 2:*** Response: Rule 501.76 would not allow the CPA to hold such records hostage whether fees were due or not and could subject the CPA to a citation, a fine—or worse. From a loss-prevention standpoint, it's usually unwise to add fuel to the fire by not cooperating with former clients' transition to another CPA. Interestingly, while the AICPA would allow transmission to the new CPA, Texas Rules only require that the materials be provided to the client.

Much of this issue's risk exposure stems from confusion over what constitutes client records. AICPA ET Sec. 501.01 defines "client records" as any accounting or other records belonging to the client and provided to the CPA by, or on behalf of, the client. Texas considers client records to include: (1) worksheets in lieu of books of original entry, e.g. cash receipt or disbursement listings; (2) worksheets in lieu of G/L or subsidiary ledgers, e.g. A/R trial balances; (3) adjusting and closing J.E.'s [and supporting details, if necessary]; (4) consolidating or combining journal entries and worksheets.

If an engagement isn't completed, the CPA must return or furnish the originals of only those records originally obtained by the certificate or registration holder from the client. While AICPA interpretation 501-1 allows retaining adjusting entries, closing entries, consolidating entries until client pays a past due fee Texas does not allow this.

CPA developed working papers remain the property of the CPA, and ordinarily need not be provided to the client. However, a CPA must provide his/her workpaper detail to the client if either the work papers result in changes to the client's records or they constitute part of the records ordinarily maintained by the client.

Note: TSBPA recommends that CPA obtain a receipt or other written documentation of records delivery to a client.

## **Confidentiality:**

**Case 1:** Response: A CPA is not prohibited from performing engagements for competing clients. In fact, specializing in specific industries for competing companies can increase professional competence and expertise. The problem that can develop is in disclosure of information learned in audits of competitors. Rule 501.75 —"Confidential Client Information"—states: "a certificate or registration holder or any partner, officer, shareholder, or employee of a certificate or registration holder shall not voluntarily disclose information communicated to him by the client relating to, and in connection with, professional services rendered to the client by the certificate or registration holder" This rule prohibits the CPA from disclosing this information without the specific consent of the client, unless the information is a matter of public record and is acquired independently of the Top Fish engagement. The CPA firm should disclose the competing client relationships to each client prior to undertaking the engagements. This will help protect the firm from impairments of independence in appearance (as might be perceived by an aggrieved client if things go bad). Different partners at the firm should handle each engagement.

**Case 2:** Response: The Texas Code prohibited this as recently as 1997! However, AICPA has no such restriction and as Texas now follows AICPA independence rules, it would appear that this is no longer a violation. However, this could be viewed as creating an indirect financial interest, which if material, could impair independence.

There are also potential violations by:

- Sarah of Rule 501.75 (client confidence) since she has disclosed what may potentially be considered to be client confidential information to an outside party (Jerome).
- Both Sarah and Jerome of Rule 501.73(a) and (b) (integrity and objectivity) as the disclosure and later arrangements may constitute a conflict of interest.
- Both Sarah and Jerome of Rule 502.90(17) since Sarah has voluntarily disclosed employer information in connection with her accounting services.
- Generally, the arrangement may be considered to be acts discreditable to the profession.
- This may be considered to be a contingent fee under Rule 501.72 from Jerome's perspective since other work is being offered in the future.

## **Conflict of Interest:**

**Case 1:** Response: Referring Xia to another client would be imprudent from the standpoint of integrity and objectivity per ET section 102-3, which provides among other things that "a member shall maintain objectivity and integrity in the performance of any professional service." Investing in business deals with clients is often a mistake, especially when you also provide professional services to the business. Everyone is usually happy as long as the deal performs well and the client perceives you as a competent adviser with the client's best interests at heart.

When such a deal goes down the tubes, the client's perception of you can change quickly. To the client you appear to no longer have his or her best interests at heart, and juries tend to sympathize with clients, especially with the benefit of hindsight and all the facts laid out by a skilled attorney. In court the CPA is portrayed as having sacrificed the best interests of the client to self-interest.

In addition, disclosing a conflict of interest to the client looking for a good investment, while helpful, doesn't solve the problem. It later can be argued the client's consent was not "informed" by a third party such as an attorney. Don't get too comfortable with disclosure as a form of protection. In the end, the question is whether there is a perception the CPA no longer has unfettered loyalty to his or her clients.

## **Advertising:**

**Case 1:** Response: Not likely that the audit and tax work would be split; however, it is a client, but not for that service. Technically probably do not have to retain for 36 months the communication and list that party, but would be prudent to do so.

## **Cumulative Case Study 2:**

Potential Responses:

1. Public Accounting Practice – Organization and Conduct – Rule 501.77 and 501.81

Jeremy is responsible for Robert, a non-member in Jeremy's public practice, and he failed to make Robert abide by the RPC in various ways:

- Fee Quotation: Robert failed to obtain adequate information about the engagement prior to quoting a fee.
  - Advertising and Solicitation: Rule 501.82.
2. Robert's client solicitation techniques are arguably making unfavorable reflection on the competence of another firm are prohibited.
- Payment or Receipt of Commissions. Rule 501.71 and 501.73(d). Robert paid a commission to his girlfriend, a person who is not a public accountant (PA). In addition, Jeremy himself potentially breached Rule 501.71 by reimbursing Robert for the payment of commissions to his girlfriend.
  - Advertising and Promotion: Rule 501.81. Although Jeremy's claim about placing in the top 10 in Texas can be substantiated, the claim that he is one of Texas' best CPAs, recognized by the TSBPA with regional honors is arguably misleading.
    - o Claiming skills or attributes superior to those possessed by colleagues with equal qualifications contravenes the fundamental principles governing the conduct of CPAs.
    - o The letterhead is misleading because the firm appears larger than it actually is.
3. Association with Non-CPAs in Public Practice. Rules 501.77, 501.80 and 501.82. Jeremy may have violated the Rules by allowing the following:
- John and Nick appear as associates of Jeremy while they actually are not.
  - The reference to City two and City three is misleading given that the firm has no office in either cities.
  - Nick appears to be engaged in public practice while he actually is not.
  - The firm name should only make reference to one associate (Robert).
  - John's name could be included as long as he is clearly identified as a representative.
4. The firm has failed to ensure compliance with the rules of professional conduct (maintain the good reputation of the profession, integrity, etc.). As a result of the above, Jeremy, John and Nick, and the firm Jeremy Johnson have failed to maintain the good reputation of the profession.

### **Cumulative Case Study 3:**

#### Proposed Response:

1. Requirement to Reply in Writing. Rule 501.93. Wide & Diggs (W&D) failed to reply in writing within 30 days to the letter from the Institute that specifically requested a written reply from the firm.
2. Borrowing from Clients. W&D may have contravened the Rules when borrowing \$15,000 from PPL, a client that is not a financial institution or in the business of private lending; however, the following must be determined to establish if the Rules have really been breached:
  - Would Wide's common-law spouse's mother be considered a related party for purposes of the independence rules?
  - Is W&D performing any accounting or auditing services for PPL presently.
3. Fee Quotation. Rule 501(b)(1)(E). Diggs failed to obtain adequate information about the engagement on the trust accounts. He may however argue that the experience gained with the other lawyers' trust accounts gave him a sound basis to quote a fee.
  - While not required, it would be prudent for Diggs to obtain a written engagement letter from Overland.
- Contingent Fee. Rule 501.52(11). Although the contingent fee for the franchise tax engagement is in itself acceptable, the engagement acceptance seems to be tied to the offering of an audit engagement. If so, the fee arrangement could be seen as an influence which impairs judgment or objectivity on the audit engagement; the fee on the franchise tax engagement could be substantial given the success of the law firm. However, allocating the audit and the state tax engagements to two different partners could help mitigate the problem.
- Solicitation. Rule 501(b)(7) and 501(c). Wide contravened the Code by soliciting professional engagements from Agnes in a manner that is persistent or harassing.

**[Back to Start](#)**

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Richard S. Mark is currently an Associate Professor of Accounting at the University of Texas at Arlington teaching in the areas of ethics and financial accounting. He has dual undergraduate degrees in Mechanical Engineering and Pre-Medicine from the University of Colorado, a Juris Doctorate from University of Colorado, and a Master of Taxation (LL.M.) from the University of Denver. He is a CPA in the United States and a Chartered Accountant in the British Commonwealth.

Prior to joining the UTA faculty, Professor Mark was a sole-practitioner and later an associate at various Dallas law firms. He subsequently became a Director of Tax for Atlantic Richfield Company and later a tax manager at Arthur Young & Co (now Ernst & Young). He has also previously served on the board of directors of a number of private energy firms.

Over more than 4 decades, Professor Mark has conducted numerous professional development seminars for most of the Western, Southwestern and Southern state societies of CPAs and public and private companies. He has also consulted and provided expert testimony for the IRS; various global energy concerns including Exxon-Mobile, Chevron, Shell, Gulf, Phillips 66, Conoco; hedge fund and tax software companies; law firms; international government agencies within the State of Victoria in Australia; and the State of Alaska.

Professor Mark has been approved to train accounting students in ethics in preparation for the CPA exam since 2005 as well as to train CPA's in ethical compliance.