



Ethics and Professional Conduct for California CPAs

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Course # 4160626, Version 2004, 4 CPE Credits

your self-study.
 **your way.**

Course CPE Information

Course Expiration Date

Per AICPA and NASBA Standards (S9-06), QAS Self-Study courses must include an expiration date that is *no longer than one year from the date of purchase or enrollment*.

Field of Study

Regulatory Ethics. Some state boards may count credits under different categories—check with your state board for more information.

Course Level

Overview.

Prerequisites

There are no prerequisites.

Advance Preparation

None.

Course Description

This course is designed to meet the four-hour ethics CPE requirement for California CPAs. It provides an overview of ethical thought, covering the core values of the CPA profession and the application of these values to ethical reasoning. Covered in detail are applicable rules and statutes promulgated by the California Board of Accountancy, the California Accountancy Act, and the AICPA Code of Professional Conduct. Case studies are utilized throughout the course to highlight important issues.

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Instructional Design

This Self-Study course is designed to lead you through a learning process using instructional methods that will help you achieve the stated learning objectives. You will be provided with course objectives and presented with comprehensive information and facts demonstrated in exhibits and/or case studies. Review questions will allow you to check your understanding of the material, and a qualified assessment will test your mastery of the course.

Please familiarize yourself with the following instructional features to ensure your success in achieving the learning objectives.

Course CPE Information

The preceding section, “Course CPE Information,” details important information regarding CPE. If you skipped over that section, please go back and review the information now to ensure you are prepared to complete this course successfully.

Table of Contents

The table of contents allows you to quickly navigate to specific sections of the course.

Learning Objectives and Content

Learning objectives clearly define the knowledge, skills, or abilities you will gain by completing the course. Throughout the course content, you will find various instructional methods to help you achieve the learning objectives, such as examples, case studies, charts, diagrams, and explanations. Please pay special attention to these instructional methods, as they will help you achieve the stated learning objectives.

Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Glossary

The glossary defines key terms. Please review the definition of any words you are not familiar with.

Index

The index allows you to quickly locate key terms or concepts as you progress through the instructional material.

Qualified Assessment

Qualified assessments measure (1) the extent to which the learning objectives have been met and (2) that you have gained the knowledge, skills, or abilities clearly defined by the learning objectives for each section of the course. Unless otherwise noted, you are required to earn a minimum score of 70% to pass a course. If you do not pass on your first attempt, please review the learning objectives, instructional materials, and review questions and answers before attempting to retake the qualified assessment to ensure all learning objectives have been successfully completed.

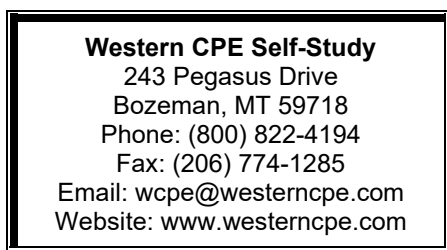
Answer Sheet

Feel free to fill the Answer Sheet out as you go over the course. To enter your answers online, follow these steps:

1. Go to www.westerncpe.com.
2. Log in with your username and password.
3. At the top right side of your screen, hover over “My Account” and click “My CPE.”
4. Click on the big orange button that says “View All Courses.”
5. Click on the appropriate course title.
6. Click on the blue wording that says “Qualified Assessment.”
7. Click on “Attempt assessment now.”

Evaluation

Upon successful completion of your online assessment, we ask that you complete an online course evaluation. Your feedback is a vital component in our future course development.



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Table of Contents

Course CPE Information	i
Instructional Design.....	ii
Table of Contents	iv
Chapter 1 – Ethics Background.....	1
Learning Objectives.....	1
Morals.....	1
What is Ethics?.....	1
The Relationship of Morals and Ethics	2
Summary	3
Illustrative Examples of Ethics.....	3
Professional Ethics	4
Legal vs. Ethical.....	5
Why Should We Study Professional Ethics?.....	5
Accounting Ethics	5
Ethical Core Foundations for CPAs	8
Independence	8
Integrity.....	9
Objectivity.....	9
Public Interest	9
Due Care	9
Chapter 1 – Review Questions	10
Ethical Reasoning.....	11
Case Studies – Threats and Safeguards.....	12
Ethical Dilemmas	14
Public Expectations of the CPA’s Responsibility	14
Motivations of Ethical Lapses	15
Chapter 1 – Review Questions	16
Chapter 2 – California Accountancy Statutes and Rules.....	17
Learning Objectives.....	17
Recent New Statutes and Rules	17
Trend in Recent California Board of Accountancy Enforcement Actions	18
The California Accountancy Act and the California Board of Accountancy Regulations	18
Article 3.5. Standards of Professional Conduct [5060 - 5063.10].....	19
5060. Name of Firm	19
5061. Commissions	19
5062. Report conforming to professional standards.....	20
5062.2. Restrictions on Accepting Employment with an Audit Client	21

5063. Reportable Events	21
5063.1. Reporting by Courts	23
5063.2. Reporting by Insurers	23
5063.3. Disclosure of Confidential Client Information Prohibited	23
5063.10. Restatements	24
Article 9- Rules of Professional Conduct	24
§ 50. Client Notification.....	24
§ 50.1. Attest Client Notification Regarding Composition of Firm Ownership.....	25
§ 51. Firms with Nonlicensee Owners.	25
§ 51.1. Notification of Non-Licensee Ownership.	25
§ 52. Response to Board Inquiry.....	25
§ 53. Discrimination Prohibited.	26
§ 54. Confidential Information Defined, Exception.	26
§ 54.1. Disclosure of Confidential Information Prohibited.....	27
§ 54.2. Recipients of Confidential Information.....	28
§ 56. Commissions -Basic Disclosure Requirement.	28
§ 56.1. Commissions -Professional Services Provided to the Client.....	29
56.2. Commissions -Disclosure Requirement and Other Rules of Professional Conduct.	29
§ 56.3. Commissions -Definitions.....	29
§ 56.4. "Officer" and "Director.".....	29
§ 57. Incompatible Occupations/Conflict of Interest.	30
§ 58. Compliance with Standards.....	30
§ 59. Reporting of Restatements.	30
§ 60. Reporting of Investigations by the Securities and Exchange Commission	31
§ 61. The Reporting of Settlements, Arbitration Awards, and Judgments.	31
§ 62. Contingent Fees.....	31
§ 63. Advertising.....	32
§ 65. Independence.	32
§ 67. Approval of Use of Fictitious Name	32
§ 68. Retention of Client's Records.....	33
§ 68.1. Working Papers Defined; Retention.....	33
§ 68.2. Identification of Audit Documentation.	34
§ 68.3. Retention Period for Audit Documentation.....	34
§ 68.4. The Document Assembly Period and Subsequent Changes in Audit Documentation.	34
§ 68.5. Audit Documentation Retention and Destruction Policy.	35
§ 69. Certification of Applicant's Experience.	35
Case Studies.....	36
A Little Extra Income – Contingent Fees.....	36
Return of client provided records.....	37
§ 68. Retention of Client's Records.....	37
Chapter 2 – Review Questions	38
Chapter 3 – The AICPA Code of Professional Conduct	39
Learning Objectives.....	39
About the Code.....	39
Preface.....	39
Part 1 – Members in Public Practice	40
Adverse interest threat.....	40
Advocacy threat	41
Familiarity threat.....	41
Management participation threat.....	41
Self-interest threat.....	41

Self-review threat.....	41
Undue influence threat.....	41
Rule 1.100 Integrity and Objectivity	42
Case Study – Married Tax Clients Divorcing	43
1.130 Preparing and Reporting Information.....	43
Case Study – Year End Adjustments and Loan Covenants.....	44
1.200 Independence.....	45
Chapter 3 – Review Questions	50
Rule 1.300 General Standards Rule.....	51
Competence.....	51
Case Study – Audit Engagement with No Prior Experience	51
1.310 Compliance with Standards Rule	52
Case Study – Peer Review Discoveries.....	52
1.320 Accounting Principles Rule.....	52
1.400.001 Acts Discreditable Rule.....	53
1.510.001 Contingent Fees Rule.....	54
1.520.001 Commissions and referral fees Rule.....	55
1.600.001 Advertising and other forms of solicitation.....	56
1.700.001 Confidential client information rule	56
1.800.001 Form of organization and name rule.....	58
Chapter 3 – Review Questions	59
Part 2 – Members in Business	60
Conceptual Framework Approach	60
Threats.....	61
Safeguards.....	62
2.100.001 Integrity and Objectivity Rule	64
2.130.030 Obligation of a Member to His or Her Employer’s External Accountant	65
2.170.010 – Pressure to Breach the Rules	65
Case Study – Fair Finance.....	65
2.300.001 General standards rule	66
2.310.001 Compliance with standards rule	67
2.320.001 Accounting principles rule.....	67
Case Study - The Company with Excess Reserves	67
Case Study - The Company with Undisclosed/Unrecorded Contingencies	68
2.400.001 Acts Discreditable Rule.....	69
2.400.070 Confidential Information from employment or volunteer activities.....	69
Part 3 – Other Members	70
3.400.001 Acts discreditable rule	70
3.400.070 Confidential Information from employment or volunteer activities.....	70

Chapter 3 – Review Questions	72
Review Question Answers and Rationales	73
Chapter 1	73
Chapter 2	74
Chapter 3	75
Glossary	78
Index.....	80
Qualified Assessment.....	82
Answer Sheet	87
Course Evaluation.....	88

Chapter 1 – Ethics Background

Learning Objectives

After completing this section of the course, you will be able to:

- Define ethics from an overall and professional perspective, noting the differences between morals and ethics
- Note the ethical requirements in California pertaining to new licensees and CPE
- Recognize the components and ethical thought process of the AICPA conceptual framework that assists the CPA in evaluating threats in ethical issues and identifying possible safeguards to these threats

Morals

Many use ethics and morals as synonyms. However, they are not the same thing. Morals are values that help an individual distinguish that which is right from that which is wrong. Individual moral values can be influenced by family, education, religion, friends and acquaintances and a host of other factors. In the United States, there are several moral values that are shared by most people. These include:

- Stealing is morally wrong
- Murder is morally wrong

Most people view these moral values as being absolute. However, when certain facts and circumstances are introduced, a person's moral view may change. Is stealing food to feed your starving child morally wrong? Is killing a person who was engaged in the act of killing your spouse morally wrong? Is the death penalty morally wrong?

Honesty is a moral principle that many would assert is good. However, does everyone live by this principle? How many people have justified telling a "little white lie" to save someone's feelings? How many people, in business dealings, have omitted certain facts regarding the transaction hoping that the other party wouldn't discover them? How many people have lied to get out of a traffic ticket?

What about theft? Is it stealing when you receive your restaurant bill and pay the total, but don't point out that there are items missing on the bill?

In selling a product or service, is it misleading to tout all the benefits but none of the drawbacks? Because the distinction of what is right and what is wrong is seldom an absolute distinction and differs among individuals based on their background and other factors, nations, societies and even professions have adopted specific rules of conduct to address certain situations.

What is Ethics?

Ethics are a framework of values established by society or a group. Generally speaking, it is a standard or a set of values created by a society, government or ruling body upon which one can compare against to determine if a person is acting properly or not. Ethical standards or values can change over time as society changes and they can also differ between nationalities. However, they represent a standard that is not necessarily dependent on the individual's viewpoint. Ethical standards are designed to promote a behavior that can generate a sense of trust and fairness.

The Relationship of Morals and Ethics

Honesty and integrity are accepted ethical standards of society and most professions. However, some people take the moral view that honesty and integrity are not always required. As an example, some people, when selling a used car, may take the view that not disclosing defects in the automobile is not wrong. If the buyer doesn't discover it in his/her due diligence, it's the buyer's problem. Is this considered ethical behavior? No, it is not.

Since there can be a difference between individual moral views and ethical rules, the table below illustrates some common situations that highlight the difference between ethical values and individual moral values.

Activity	Example Moral View	Society's Ethical View
You were given too much change from a purchase.	It's not my problem if the cashier can't count. I'm keeping the change.	I agreed to a price when I purchased the product. I should return the excess change given as it was the result of an error.
Someone drops a \$5 bill on the sidewalk and continues walking.	Finders keepers!	You should return the \$5 bill to its rightful owner, if possible.
I've got a ton of cash income that won't be reported to the IRS.	No way that's going on my tax return. The IRS gets more than enough of my hard earned money.	All income should be reported to the IRS.

In the above activities, the example individual's moral decision does not conform to society's ethical standard. Without ethics, there would be no reasonable standard of good behavior. There are also moral views that have a higher standard than the prevailing ethical views and can influence prevailing ethics. History provides several examples, two of which are addressed below.

Alcohol

Is the business of alcohol production moral? There are many who, based on religious or other values, would argue that it is not. Their arguments range from the damage to families to the damage inflicted by drunk drivers. Their individual moral views condemn the consumption and production of alcohol.

Is the business of alcohol production ethical? It depends on the time period. During prohibition in the United States, individual moral views influenced society and the production of alcohol was considered to be an unethical practice. The social framework of values stated that this was unacceptable.

However, after prohibition and to the current day, the production of alcohol is not considered by society as a whole to be unethical behavior. These businesses are considered vital employers in our communities and no longer condemned.

Nike

Milton Friedman said the duty of business is "to make as much money as possible while conforming to the basic rules of the society, both those embodied in the law and those embodied in ethical custom." During the 1980s and 1990s, Nike was an admired company whose products

and market share continued to grow. Its brand was well known due to extensive advertising and endorsements by professional athletes.

However, during the 1990s, it was also discovered that factories contracted by Nike in Cambodia and Pakistan used child labor in the production of its products. Included in the allegations were that the factories contracted by Nike in Cambodia had children working 7 days a week for up to 16 hours a day.

These were not Nike's factories; they were contract manufacturers. The ethical customs of these countries did not discourage child labor. In many cases, the labor of children was necessary to ensure that families did not starve. Nike did not violate any laws.

There was a great deal of criticism levied against Nike in the United States as the prevailing moral view is that child labor is wrong, even if it occurs in a different country with different ethical standards. The protests caused Nike to evaluate the working conditions in its contract manufacturers and take steps to curb these practices.

Nike conformed to Friedman's assertion that it should make as much money as possible within the law and accepted rules. Prevalent moral views caused Nike to adopt higher ethical standards than those required by law and the accepted rules.

Summary

Morality is based on personal beliefs and may or may not reflect the core values of a society. Morals govern an individual's perception of right and wrong. Ethics, on the other hand, is dependent on the core values of society and constitute a set of rules. These rules are generally consistent but may vary over time as societal values change and can be influenced by individual moral values. Moral views do not always represent ethical views. Some do not consider lying to be an immoral act, especially if it accomplishes a desired goal. However, most ethical views consider lying to be unethical.

Important point: Ethics are rules of conduct that apply to a particular group. It defines the right thing to do in the context of the group. Members of the group may have a different moral view, but are held to the ethical views of the group nonetheless. However, if enough members share the same moral view, the rules of conduct may change, resulting in a different ethical code.

Illustrative Examples of Ethics

You want to purchase a new car and trade in your old car. The old car has a bad transmission, but only slips occasionally. When the auto dealership from which you are buying the new car appraises your vehicle for its trade-in value, the transmission does not slip resulting in a higher trade-in value. Do you disclose the defect in the transmission?

Our society values integrity and honesty. One question to ask is "how will this be viewed when the transmission defect is discovered?" From the auto dealership's point of view, your actions would not be considered to be ethical as you were not forthcoming about the defect. As honesty and integrity represent ethical values and not disclosing the defect would violate these values, the ethical approach would be to disclose the defect in the transmission.

Your daughter backed your car into the side of your brick house. There is no damage to your house, however, one tail light is broken. Two weeks later, a car rear ends you as you are coming home from work. There is only damage to the bumper resulting from the accident. When the insurance claim is filed, what should you claim as damages from the accident?

Once again, society values integrity and honesty. It would be very easy to claim that the entire amount of the damage was due to the accident. However, this would not conform to the values of honesty and integrity. The ethical course of action is to only claim the damage to the bumper as damages resulting from the accident.

In these examples, there are a couple of easy tests that can be performed to determine what is ethical by social standards.

The Publicity Standard – The publicity standard asks whether the action would be considered ethical if it was published and everyone knew about it. Using the automobile with the bad transmission as an example, would you be comfortable not disclosing the defect if you thought that your lack of disclosure would be on the front page of tomorrow’s newspaper? You likely wouldn’t be. It would result in a negative public perception of your honesty and integrity and damage your reputation in the community. Using this test, nondisclosure of the defective transmission is not ethical.

The Person Looking Over Your Shoulder Standard – This standard asks whether the action would be considered ethical if someone else were with you and looking over your shoulder to evaluate your conduct. In the example of the car with a broken tail light, if your insurance agent was with you when your daughter backed the car into the house and damaged the tail light, would you still consider claiming that the broken tail light was a result of the car that rear ended you? This is also not likely. In this case, your insurance agent may question your honesty and integrity. Using this test, claiming the broken tail light is the result of the rear end collision is not ethical.

Basically, these standards ask whether the conduct would be considered ethical if someone or everyone knew of your actions?

Case Study: You receive a survey in the mail with a check to “Bearer” for \$50 as an honorarium for filling out the survey. You did not request the survey and have never been associated with the firm conducting the survey.

What is your moral view regarding the \$50 check? Do you cash it and not fill out the survey? Do you only cash it if you fill out the survey?

What is the ethical thing to do with the \$50 check? Does this view change use the “Publicity Standard”? Does it change using the “Person Looking Over Your Shoulder Standard”?

Professional Ethics

Professionals are regarded as being able to make decisions and judgments that the general public cannot because they do not possess the training and qualifications necessary to do so.

Professional ethics are rules and responsibilities in a professional setting. Many professions have ethical rules of conduct. The Hippocratic Oath is probably the most well-known professional

value. Quite simply the medical profession promises to uphold certain ethical values such as all acts should be in the best interest of the patient. Attorneys are governed by a code of professional conduct which dictates rules of ethics and is generally enforced by a state governing body. The American Bar Association Model Rules of Professional Conduct has been adopted by many state legislatures or judicial systems. Professional engineers also generally have a code of professional conduct. The specific rules will depend on the specific engineering profession. What the medical, legal, and engineering professions have in common is that each has created a framework of values and rules that guide the way that profession makes decisions and acts.

Important point: Not all professions have the same ethical requirements. For a medical doctor, an essential to the ethical canon is to do no harm. An attorney has an ethical obligation to be an advocate for his/her client. These do not necessarily relate to a CPA. However, these ethical requirements have been established as being important to the particular group to which they relate.

Legal vs. Ethical

If something is legal, must it also be ethical? In professional ethics, there is generally a standard of conduct that is higher than that required by the law. Using the example of Nike, it was required by society to conform to a higher standard in its contract manufacturers even though its practices were completely legal.

Important point: Remember that ethics is about what is right or wrong based on written or unwritten rules of conduct. Laws are about what is legal or illegal.

Why Should We Study Professional Ethics?

The study of ethics permits the professional to understand the values and rules of conduct established by the group of professionals to which he/she belongs. It also permits the professional to compare his/her moral views to the required ethical rules. When you understand the values of the group, you can use these values to resolve ethical conflicts.

Legal and moral views do not always conform to ethical requirements. If the CPA did not understand the ethical requirements of the profession, he/she would be unaware of these requirements and may unwittingly have an ethics violation. Even though this may not have violated the CPAs moral view of what is wrong and did not violate the legal view of what is wrong, it is still an ethical violation.

Having an understanding of the professional values embodied by the rules helps in ethical decision making. Rules cannot encompass every situation that may arise. In a dilemma, it is important to have a good understanding of the ethical values, principles, and rules to make the right decision.

Important point: Without a good grasp of ethical obligations, values, and principles, you run a high risk of an ethical violation.

Accounting Ethics

Accounting professionals have their own specific additional framework of values and rules as it relates to their profession. The California Board of Accountancy (CBA) has Rules of Professional Conduct that are applicable to all California CPAs. “The board may by regulation,

prescribe, amend, or repeal rules of professional conduct appropriate to the establishment and maintenance of a high standard of integrity and dignity in the profession” – Rule 5018-Rules and Standards of Professional Conduct.¹

Every licensee of the California Board of Accountancy in this state shall be governed and controlled by the rules and standards adopted by the board.

As a result of accounting scandals such as Enron, the CPA profession has responded with an emphasis on ethics education. Ethics training is now used at the college level for those studying to be a CPA. This emphasis on ethics education actually stems from the Greek philosopher Aristotle who said, “Excellence is an art won by training and habituation. We do not act rightly because we have virtue or excellence, but we rather have those because we have acted rightly. We are what we repeatedly do. Excellence, then, is not an act but a habit.”

Therefore, reinforcement of ethics through education develops ethical habits.

New licensees entering into the profession in California have specific ethics requirements that must be met.

§ 87.1. Continuing Education Requirements for New Licensees.

- a) All continuing education must be completed on or after the date the initial license was issued.
- b) Once a license is issued, the licensee must complete 20 hours of continuing education as described in Section 87(a)(2) and (a)(3) for each full six month period from the date the initial license was issued to the first license expiration date in order to fulfill the continuing education requirement for license renewal. If the time period between the date the initial license was issued and the first license expiration date is less than six full months, no continuing education is required for license renewal.
- c) A licensee who is required to complete a total of 80 hours of continuing education pursuant to subsection (b) shall also complete four hours of ethics education pursuant to Section 87(b).
- d) Once a license is issued, a licensee who engages in financial or compliance auditing of a governmental agency at any time between the date the initial license was issued and the first license expiration date shall complete six hours of governmental auditing continuing education as part of each 20 hours of continuing education required under subsection (b). Continuing education in the areas of governmental accounting and auditing shall meet the requirements of Section 87(c). A licensee who meets the requirements of this subsection shall be deemed to have met the requirements of subsection (e).
- e) Once a license is issued, a licensee who engages in audit, review, compilation, or attestation services at any time between the date the initial license was issued and the first license expiration date shall complete six hours of continuing education in accounting and auditing as part of each 20 hours of continuing education required under subsection (b). Continuing education in the areas of accounting and auditing shall meet the requirements of Section 87(d).
- f) A licensee who is required to complete a total of 80 hours of continuing education pursuant to this section and must complete continuing education pursuant to subsection (d) or (e) shall also complete an additional four hours of continuing education specifically related to the prevention, detection, and/or reporting of fraud affecting financial statements. This continuing education shall be part of the total hours of continuing education required by this section, but shall not be part of the continuing education required by subsection (d) or (e).
- g) If an initial license expires as defined in Section 81(b)(2), the licensee must complete an additional 20 hours of continuing education as described in Section 87(a)(2) and (a)(3) for each full six month period from the date of license expiration to the date on which the licensee applies for license renewal, up to a total of 80 hours of continuing education. If the time period between the date the license expired and the date on which the licensee applies for license renewal is less than six full months, no additional continuing

¹ http://www.dca.ca.gov/cba/laws_and_rules/acct_act.pdf

education is required for license renewal.

- h) All continuing education required by this section shall be completed in the two-year period immediately preceding the date on which the licensee applies for license renewal. If the date on which the licensee applies for license renewal is less than two years from the date the initial license was issued, all continuing education must be completed on or after the date the initial license was issued.
- i) Failure to Comply. A licensee's willful failure to comply with the requirements of this section shall constitute cause for disciplinary action pursuant to Section 5100 (g) of the Accountancy Act.

There are also ethic requirements in continuing education. Each California licensee is required to complete 4 hours of ethics (see 87 (b) below) in a two-year period and to also complete a 2 hour board-approved regulatory ethics review course every 6 years (see 87.8 below).

§ 87. Basic Requirements.

- a) 80 Hours. As a condition for renewing a license in an active status, a licensee shall complete at least 80 hours of continuing education in the two-year period immediately preceding license expiration, and meet the reporting requirements described in Section 89(a). A licensee engaged in the practice of public accountancy as defined in Section 5051 of the Business and Professions Code is required to hold a license in an active status. No carryover of continuing education is permitted from one license renewal period to another.
 - (1) A licensee renewing a license in an active status, shall complete a minimum of 20 hours in each year of the two-year license renewal period, with a minimum of 12 hours of the required 20 hours in technical subject areas as described in subsection (a)(2).
 - (2) Licensees shall complete a minimum of 50 percent of the required continuing education hours in the following technical subject areas: accounting, auditing, fraud, taxation, consulting, financial planning, ethics as defined in subsection (b), regulatory review as defined in Section 87.8, computer and information technology (except for word processing), and specialized industry or government practices that focus primarily upon the maintenance and/or enhancement of the public accounting skills and knowledge needed to competently practice public accounting.
 - (3) Licensees may claim no more than 50 percent of the required number of continuing education hours in the following non-technical subject areas: communication skills, word processing, sales, marketing, motivational techniques, negotiation skills, office management, practice management, and personnel management.
 - (4) Programs in the following subject areas are not acceptable continuing education: personal growth, self-realization, spirituality, personal health and/or fitness, sports and recreation, foreign languages and cultures and other subjects which will not contribute directly to the professional competence of the licensee.
- b) Ethics Continuing Education Requirement

A licensee renewing a license in an active status shall complete four hours of the 80 hours of continuing education required pursuant to subsection (a) in an ethics course. The course subject matter shall consist of one or more of the following areas: a review of nationally recognized codes of conduct emphasizing how the codes relate to professional responsibilities; case-based instruction focusing on real-life situational learning; ethical dilemmas facing the accounting profession; or business ethics, ethical sensitivity, and consumer expectations. Programs in the following subject areas are not acceptable toward meeting this requirement: sexual harassment, workplace harassment, or workplace violence. Courses must be a minimum of one hour as described in Section 88.2.
- c) Government Auditing Continuing Education Requirement.

A licensee who engages in planning, directing, conducting substantial portions of field work, or reporting on financial or compliance audits of a governmental agency shall complete 24 hours of the 80 hours required pursuant to subsection (a) in the areas of governmental accounting, auditing or related subjects. This continuing education shall be completed in the same two-year license renewal period as the report is issued. A governmental agency is defined as any department, office, commission, authority, board, government-owned corporation, or other independent establishment of any branch of federal, state or local government. Related subjects are those which maintain or enhance the licensee's knowledge of governmental operations, laws, regulations or reports; any special requirements of governmental agencies; subjects related to the specific or unique environment in which the audited entity operates; and other auditing subjects which may be appropriate to government auditing engagements. A licensee who meets the

- requirements of this subsection shall be deemed to have met the requirements of subsection (d).
- d) **Accounting and Auditing Continuing Education Requirement.**
A licensee who engages in planning, directing, performing substantial portions of the work, or reporting on an audit, review, compilation, or attestation service, shall complete 24 hours of the 80 hours of continuing education required pursuant to subsection (a) in the course subject matter pertaining to financial statement preparation and/or reporting (whether such statements are prepared on the basis of generally accepted accounting principles or other comprehensive bases of accounting), auditing, reviews, compilations, industry accounting, attestation services, or assurance services. This continuing education shall be completed in the same two-year license renewal period as the report is issued. If no report is issued because the financial statements are not intended for use by third parties, the continuing education shall be completed in the same two-year license renewal period as the financial statements are submitted to the client.
 - e) **Accounting and Auditing Continuing Education Requirement When Providing Preparation Engagements as Highest Level of Service.**
A licensee who provided preparation engagements as his/her highest level of service shall complete eight hours of the 80 hours of continuing education required pursuant to subsection (a) in preparation engagements or accounting and auditing as described in Section 87(d).
 - f) A licensee who must complete continuing education pursuant to subsections (c), (d), or (e) of this section shall also complete an additional four hours of continuing education specifically related to the prevention, detection, and/or reporting of fraud affecting financial statements. This continuing education shall be part of the 80 hours of continuing education required by subsection (a), but shall not be part of the continuing education required by subsections (c), (d), or (e).
 - g) **Failure to Comply.**
A licensee's willful failure to comply with the requirements of this section shall constitute cause for disciplinary action pursuant to Section 5100(g) of the Accountancy Act. § 87.8. Regulatory Review Course.

§ 87.8. Regulatory Review Course.

- a) In order to renew a license in an active status, a licensee shall, within the six years preceding the license expiration date, complete a continuing education course on the provisions of the California Accountancy Act and the California Board of Accountancy Regulations specific to the practice of public accountancy in California emphasizing the provisions applicable to current practice situations. The course also will include an overview of historic and recent disciplinary actions taken by the Board, highlighting the misconduct which led to licensees being disciplined. The course shall be a minimum of two hours, and a licensee shall select from a list of Board-approved courses. The two hours can be counted towards the 80 hours required pursuant to Section 87.
- b) A licensee shall report completion of the Regulatory Review course at the time of renewal.

Ethical Core Foundations for CPAs

Independence

A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.²

The AICPA independence rules broadly state that a CPA must be independent of a client in both fact and appearance during the course of a professional attest engagement. Both actual and apparent conflicts of interest must be avoided so that there is no question that an objective examination of the financial statements has been performed and that they may be relied upon. Independence is required for Audit engagements and Review engagements. A lack of independence must be disclosed on the Compilation report related to a Compilation engagement.

² AICPA Code of Professional Conduct

Integrity

Integrity refers to the CPA's adherence to an ethical code which requires the CPA to be honest and not subordinate his judgment to personal gain. It can be thought of as the little angel on your shoulder that tells you what is right.

Objectivity

Objectivity refers to being unbiased and not influenced by personal prejudices. A CPA must maintain an impartial attitude in the performance of professional responsibilities. To be objective, you must be free of conflicts of interest.

Both integrity and objectivity require that the CPA not subordinate his or her judgment to others.

Public Interest

CPAs in the practice of public accountancy and in industry have a responsibility to serve the public interest. CPAs must act in a manner that best serves the public, clients and employers.

Due Care

A CPA must exercise due care in fulfilling his or her professional responsibilities. Due care means that the CPA has the requisite knowledge to fulfill the requirements of the service to be provided. It also means that the CPA will fulfill the engagement or employment duties ensuring that technical standards and other requirements of the accounting profession are upheld.

Chapter 1 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

1. What is the difference between morals and ethics?
 - a. They are the same thing.
 - b. While different concepts, they will always result in the same answer as to whether a particular act is good or bad.
 - c. Morals represent individual values that help people decide what is right and wrong. Ethics are a framework of values established by society or a group.
 - d. Morals are a set of rules established by society.
2. How many CE hours in the past two years must be in accounting and auditing if the CPA audits financial statements and wants to renew her license?
 - a. 4.
 - b. 24.
 - c. 40.
 - d. 2.

Ethical Reasoning

Professional codes of conduct cannot address every specific circumstance that may compromise compliance with the rules. Accordingly, it is necessary to apply ethical judgment in these cases. Within the AICPA Code of Professional Conduct, there is now a conceptual framework that assists the CPA in evaluating threats in ethical issues and identifying possible safeguards to these threats. The standard for compliance is “...a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that compliance with the rules is not compromised.”

The conceptual framework provides CPA members with a methodology to identify and mitigate ethical issues not covered by specific rules and interpretations. This is characterized as the threats and safeguards approach. This approach is intended to identify and evaluate threats to compliance with ethical standards and then provide safeguards to ensure that the threat(s) are reduced to an acceptable level. An acceptable level is that which an informed and reasonable third party would conclude that compliance with the rules is not compromised.

Threats for a member in public practice fall into the following categories:

- **Adverse interest threat.** The threat that a member will not be objective because the member’s interests are in opposition to the interests of a client.
- **Advocacy threat.** The threat that a member will promote a client or employer’s position or opinion to the point that his or her objectivity is compromised.
- **Familiarity threat.** The threat that because of a long or close relationship with a client or employer, a member will become too sympathetic to their interests or too accepting of their work.
- **Management participation threat.** The threat that a member will perform the role of client management or assume client management responsibilities.
- **Self-interest threat.** The threat that a member could benefit from an interest in or a relationship with a client or persons associated with the client.
- **Self-review threat.** The threat that a member will not appropriately evaluate the results of a service performed by the member, or by an individual in the member’s firm or employing organization, that the member will rely upon in forming a judgment as part of providing another service.
- **Undue influence threat.** The threat that a member will subordinate his or her judgment to that of an individual associated with a client or other relevant third party because of the individual’s (1) reputation or expertise, (2) aggressive or dominant personality, or (3) attempts to coerce or exercise excessive influence over the member.³

Safeguards are presented in three categories: Those created by the profession or related legislation or regulation, those implemented by a client and those implemented by a firm. To be effective, safeguards should either eliminate the threat or reduce it to an acceptable level. Safeguards must be evaluated to ensure that they are effective. This evaluation is dependent on each specific situation. A particular safeguard is not always effective in every circumstance.

³ AICPA Code of Professional Conduct

This methodology is only used in instances not specifically covered by rules and interpretations. It provides a conceptual framework to evaluate compliance in those situations where there is no applicable rule or interpretation.

Case Studies – Threats and Safeguards

You are the Controller of a manufacturer. The President is close to budgeted sales for the year and is intent on meeting his goal. At 12/31, he is very close but it does not appear as if sales will meet the budgeted goal. The President decides to fill purchase orders that call for shipment in the first week of January. Product is placed on a tractor trailer and moved away from the loading dock to an empty area of the parking lot. The tractor trailer filled with product sits in the parking lot until a truck picks it up on Jan. 4. These are counted as sales for the year and the President meets his budgeted goal. These sales are not material to revenue. What should you do?

Example Thought Process

This is an ethical issue faced by many CPAs in business. Operational executives want to meet their commitments from a standpoint of pride or one of meeting compensation goals. The CPA is faced with the determination of what is the ethical thing to do.

Periodicity is a concept that all CPAs must live with. Basically, all transactions must be recorded in the proper accounting period. In this case, sales were recorded in one accounting period, but the actual shipment occurred in a subsequent accounting period.

Objectivity indicates that you must be free from conflicts of interest. This would include the influence of the President. The CPA must make this decision without any prejudice.

Integrity requires adherence to the standards of the profession. In this case, the profession requires that sales be booked in the proper period. The question is whether the mechanical act of loading a truck and parking it in a parking lot constitutes a sale.

Due care requires that appropriate technical standards are upheld. The goods are not on their way to a customer and it would be difficult to argue that the revenue recognition process is complete. Once again, does the mechanical act of loading a truck and parking it in a parking lot constitute a sale?

The threats in this instance may be advocacy, self-interest, and undue influence. A safeguard would be to have an independent board of directors that the Controller could consult. Unfortunately, this safeguard does not exist, so these threats to compliance are not at an acceptable level.

If you consulted another CPA, their question may be whether it's material. You answer no. However, if the CPA asks the question that presents the ethical quandary, "Is it right?" Your likely answer is also no. Ethics deals with right or wrong rather than material or immaterial.

Based on the analysis, above, the ethical path is to refuse to book these sales in the wrong period. The ethical foundations of integrity, objectivity and due care call for this action. This may cause some issues with the President and may even jeopardize your job. It is, however, the proper ethical path.

Your friend has approached you to prepare his personal and business tax return. Throughout this year, he has told you of the success that he has had in his business, a restaurant that caters to the lunch crowd in the business district of town. Based on your discussions with him, you know that it's a predominantly cash business. When you review the business records, you note that the business has recorded a loss. Further review shows credit card sales being reported, but very few cash sales. You also note that your friend's reported personal income seems quite low relative to his lifestyle. You're just preparing the tax returns, yet you inquire of your friend as to whether the amounts are correct. He says that "they are the numbers that I want to report." Should you accept your friend as a client?

Example Thought Process

This presents a difficult issue. When you accept a tax client, your responsibility does not extend to auditing the information provided to you. However, do you have an ethical responsibility when you know, or have reason to suspect, the information is incorrect?

Objectivity requires that you be free of any conflicts of interest and personal prejudices. It is important to evaluate this situation from the standpoint of a potential client, rather than helping a friend.

Integrity requires that you use your best judgment in evaluating this situation. A new client would be nice, but is it the right thing to do?

Is the public interest served by being associated with someone who may be understating taxable income?

The threat in this instance is familiarity. If you have no partners to objectively evaluate new clients, this threat is not at an acceptable level.

Consultation with other CPAs also indicates that something smells fishy to them as well. They may quote the AICPA Statement on Standards for Tax Services 3-2 which states "In preparing or signing a return, a member may in good faith rely, without verification, on information furnished by the taxpayer or by third parties. **However, a member should not ignore the implications of information furnished and should make reasonable inquiries if the information furnished appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to the member.** Further, a member should refer to the taxpayer's returns for one or more prior years whenever feasible." Additionally, they may quote Section 10.34 (d) of Treasury Department Circular 230 which states "The practitioner may not, however, ignore the implications of information furnished to, or actually known by, the practitioner, and must make reasonable inquiries if the information as furnished appears to be incorrect, inconsistent with an important fact or another factual assumption, or incomplete."

Sometimes being ethical entails avoiding that which is potentially unethical. This case has a possibility, but not a certainty, of association with someone shirking his responsibility to pay tax. To preserve your professional integrity and not have it challenged (even if the challenge is unfounded), you should ask your friend to find another tax professional.

Important point: Not all ethical conduct can be covered by rules. It is important to be able to discern right from wrong using societal, professional, and other values and principles.

Ethical Dilemmas

Many of the instances above represent ethical dilemmas. An ethical dilemma occurs when the appropriate course of action is not followed due to internal or external pressures. In the examples, above, the pressures may have been possible loss of job, a desire to please a superior or a feeling of obligation to someone else.

Ethical dilemmas must be evaluated using the core values of the profession as a guide. An evaluation of threats and safeguards to compliance is also needed. As part of this evaluation process, a CPA may also wish to consult his or her peers for their perspective.

After evaluating the ethical dilemma using the core values of the profession, understanding the threats and safeguards, and consulting with peers, what happens if the dilemma is still not resolved? One possible course of action is to obtain advice from the AICPA Professional Ethics Division. A telephone and email hotline has been established to educate and promote understanding of ethical standards and to respond to specific inquiries regarding the AICPA Code of Professional Conduct. The email address is ethics@aicpa.org and the telephone number is 888-777-7077.

Another possible alternative is to consult with legal counsel. It would be important to consult with legal counsel that has a good understanding of the ethical obligations of the CPA profession.

Public Expectations of the CPA's Responsibility

A synopsis of the CPA's responsibilities to the public and the related public expectations is found in the preface to the AICPA Code of Professional Conduct. This section states that CPAs have a responsibility to maintain the public's confidence and, in carrying out their duties as professionals, should exercise professional and moral judgments in all activities.

The accounting profession's public "consists of *clients*, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of *members* to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on *members*. The public interest is defined as the collective well-being of the community of people and institutions that the profession serves."⁴

At the heart of the public's expectations of a CPAs responsibility is the public interest principle. This principle is to maintain the public's confidence, serve the public interest and honor the public trust. The CPA should act in a way that the public, clients' and employers' interests are best served.

The public expects the CPA to honor the core foundations of the profession which are: Independence (where applicable), integrity, objectivity, due care and, of course, to serve the public interest.

⁴ AICPA Code of Professional Conduct

Motivations of Ethical Lapses

To promote ethical conduct, it is important to understand the motivations behind unethical conduct. There are many motives that spur unethical conduct. A few are presented below to help the CPA to understand and ethically react to these motivations.

Greed – personal financial gain is a strong motive. This could be in the form of a client retention bonus, a new client bonus, another type of bonus or other compensation arrangement that is meant to be ethically achieved. It could also be in the form of financial gain that is fraudulently achieved by fraud or deception. Greed can overshadow ethics if the CPA is not careful.

Self-interest – this can include a promotion, maintaining your position in a firm or company, meeting budget commitments, keeping a client or even personal pride. It, too, is a strong motive.

Undue influence – The core foundation of objectivity requires a CPA to be unbiased and free of conflicts of interest. However, undue influence can occur when a superior in an organization wants you to engage in an unethical practice or face loss of your employment. It can also occur when a client or employer has a well-known reputation that influences your desire to please them and this becomes superior to your integrity and objectivity.

Familiarity – Once again, this deals with objectivity. You may become so familiar with a client that you advocate their position. You are not free of bias.

By understanding these motivations/threats, you can prepare yourself to respond ethically.

Chapter 1 – Review Questions

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3. Which of the following best describes the undue influence threat?
 - a. Perform an unethical act or lose your job.
 - b. Promoting a client or employers position to the point that objectivity is compromised.
 - c. A long or close relationship causes a CPA to become too sympathetic to the client or employer's interests.
 - d. The CPAs interests are in opposition to the client or employer.

Chapter 2 – California Accountancy Statutes and Rules

Learning Objectives

After completing this section of the course, you will be able to:

- Recognize the standards of professional conduct contained in Article 3.5 of the California Accountancy Act
- Recognize the rules of professional conduct as contained in Article 9 of the California Board of Accountancy Regulations

Recent New Statutes and Rules

The California Board of Accountancy has requested that we emphasize the minimum yearly CE requirement referred to as the 20/12 CE requirement. Since 2012, licensees renewing a license in an active status are required to complete a minimum of 20 hours of CE in each year of their 2 year license renewal period include a minimum of 12 hours in technical subject matter. The CBA is seeing a high rate of noncompliance and licenses are being referred to the CBA Enforcement Division.

2020 Changes

Electronic Distribution of the UPDATE Newsletter

Starting in 2020, the UPDATE newsletter will be posted to the CBA website and an email notification will be distributed to all CBA licensees and applicants regarding its availability.

License Renewal and Initial License Fee Increases

Effective January 1, 2020, the renewal and initial licensure fees are \$250. Previously, the renewal and initial licensure fees were \$120.

Collection of email addresses from all licensees and applicants

Beginning in 2020, CBA will increase the use of email to improve and streamline communication with you. The CBA will send to licensees a letter with instructions (and a unique PIN) to visit the CBA website and provide their email address, if they have one. The CBA requests that licensees register their email address by January 31, 2020. Save your PIN so you may visit the CBA webpage and update your email within 30 days of any change.

2018 Change

In January 2018, the California Accountancy Act, 5063.3, was amended to clarify that during the sale or merger of a practice, a licensee may only disclose client information to the purchaser if the parties enter into a written nondisclosure agreement.

Question: I submitted a Peer Review Reporting Form to the CBA during the 3-year-phase-in period. Do I need to report again?

Explanation: Beginning January 1, 2014, CBA required ALL licensees to report their specific peer review information at the time of license renewal.

Question: If I have to submit a Peer Review Reporting Form to the CBA every 2 years with my license renewal, does that mean I have to have a peer review every 2 years?

Explanation: No, reporting is done at the time of license renewal but peer reviews are only required every 3 years. This means that some years you will report the same peer review results two renewal cycles in a row.

Trend in Recent California Board of Accountancy Enforcement Actions

For fiscal 2018-2019, the CBA issued 517 citations. The top three most prevalent causes of citations by the board were:

1. related to continuing education rules
 2. responses to a Board inquiry
 3. reporting to the Board.
1. The majority of citations issued for violations of continuing education rules related to licensees renewing in an active status who failed to complete at least 20 hours of continuing education, with at least 12 hours in a technical subject area, each year. The rules related to continuing education are found in the California Board of Accountancy Regulations, section 87.
 2. Section 52 of the California Board of Accountancy Board Regulations requires that a licensee (a) respond to a Board inquiry within 30 days, (b) respond to a subpoena within 30 days, (c) appear in person upon written notice or subpoena and (d) provide true and accurate information to the Board.
 3. Section 45 of the California Board Regulations requires that a licensee report specific peer review information to the Board.

PRACTICE PRIVILEGE REPORTING

The following table depicts the enforcement aspects of the CBA's mobility program in these identified areas:

PRACTICE PRIVILEGE REPORTING FISCAL YEAR 2018-19	TOTAL
Pre-Notification Forms Received	0
Securities and Exchange Commission Discipline Identified	6
Public Company Accounting Oversight Board Discipline Identified	6
Out-of-State Accounting Firms that Reported Other Discipline	10
External Complaints Against Practice Privilege Holders	4

The California Accountancy Act and the California Board of Accountancy Regulations

This section covers the California Accountancy Act Article 3.5 Standards of Professional Conduct and California Board of Accountancy Regulations Article 9-Rules of Professional Conduct.

Read the rules in detail.

The California Accountancy Act may be found at <http://www.dca.ca.gov/cba/about-cba/accountancy-act.shtml>

The California Board of Public Accountancy Regulations may be found at <http://www.dca.ca.gov/cba/about-cba/regulations.shtml>

Article 3.5. Standards of Professional Conduct [5060 - 5063.10]

5060. Name of Firm

- a) No person or firm may practice public accountancy under any name which is false or misleading.
- b) No person or firm may practice public accountancy under any name other than the name under which the person or firm holds a valid permit to practice issued by the board.
- c) Notwithstanding subdivision (b), a sole proprietor may practice under a name other than the name set forth on his or her permit to practice, provided the name is registered by the board, is in good standing, and complies with the requirements of subdivision (a).
- d) The board may adopt regulations to implement, interpret, and make specific the provisions of this section including, but not limited to, regulations designating particular forms of names as being false or misleading.

Example situation: Sara Teasdale has opened a practice which is comprised of herself and Margaret Hatcher, a part-time receptionist. Naming her firm Teasdale and Associates would be misleading since it implies that Sara has an associate working with her rather than a part-time receptionist.

5061. Commissions

- a) Except as expressly permitted by this section, a person engaged in the practice of public accountancy shall not:
 - 1) pay a fee or commission to obtain a client or
 - 2) accept a fee or commission for referring a client to the products or services of a third party.
- b) A person engaged in the practice of public accountancy who is not performing any of the services set forth in subdivision (c) and who complies with the disclosure requirements of subdivision (d) may accept a fee or commission for providing a client with the products or services of a third party where the products or services of a third party are provided in conjunction with professional services provided to the client by the person engaged in the practice of public accountancy. Nothing in this subdivision shall be construed to permit the solicitation or acceptance of any fee or commission solely for the referral of a client to a third party.
- c) A person engaged in the practice of public accountancy is prohibited from performing services for a client, or an officer or director of a client, or a client-sponsored retirement plan, for a commission or from receiving a commission from a third party for providing the products or services of that third party to a client, or an officer or director of a client, or a client-sponsored retirement plan, during the period in which the person also performs for that client, or officer or director of that client, or client-sponsored retirement plan, any of the services listed below and during the period covered by any historical financial statements involved in those listed services:

- 1) An audit or review of a financial statement.
 - 2) A compilation of a financial statement when that person expects, or reasonably might expect, that a third party will use the financial statement and the compilation report does not disclose a lack of independence.
 - 3) An examination of prospective financial information.
 - 4) For purposes of this subdivision, “director” means any person as defined under Section 164 of the Corporations Code and “officer” means any individual reported to a regulatory agency as an officer of a corporation. However, “director” and “officer” does not include a director or officer of a nonprofit corporation, or a corporation that meets the board’s definition of small business, as specified by regulation.
- d) A person engaged in the practice of public accountancy who is not prohibited from performing services for a commission, or from receiving a commission, and who is paid or expects to be paid a commission, shall disclose that fact to any client or entity to whom the person engaged in the practice of public accountancy recommends or refers a product or service to which the commission relates.
- e) The board shall adopt regulations to implement, interpret, and make specific the provisions of this section including, but not limited to, regulations specifying the terms of any disclosure required by subdivision (d), the manner in which the disclosure shall be made, and other matters regarding the disclosure that the board deems appropriate. These regulations shall require, at a minimum, that a disclosure shall comply with all of the following:
- 1) Be in writing and be clear and conspicuous.
 - 2) Be signed by the recipient of the product or service.
 - 3) State the amount of the commission or the basis on which it will be computed.
 - 4) Identify the source of the payment and the relationship between the source of the payment and the person receiving the payment.
 - 5) Be presented to the client at or prior to the time the recommendation of the product or service is made.
- f) For purposes of this section, “fee” includes, but is not limited to, a commission, rebate, preference, discount, or other consideration, whether in the form of money or otherwise.
- g) This section shall not prohibit payments for the purchase of any accounting practice or retirement payments to individuals presently or formerly engaged in the practice of public accountancy or payments to their heirs or estates.

<p>Important point: A CPA may accept commissions in limited situations. If a client requires independence, a CPA may NOT receive a commission or referral fees for a product or service to be supplied to the client. If a client does not require independence under section 5061 commissions, referral fees or other compensation must be disclosed to the client in writing at the time of the recommendation, referral or sale.</p>
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5062. Report conforming to professional standards

A licensee shall issue a report which conforms to professional standards upon completion of a compilation, review or audit of financial statements.

5062.2. Restrictions on Accepting Employment with an Audit Client

A licensee shall not accept employment with a publicly traded corporation or its affiliate within 12 months of the date of issuance of a financial statement report if both of the following criteria are met:

- a) The licensee has participated in an audit engagement for the corporation and held responsibility, with respect to the audit engagement, requiring the licensee to exercise significant judgment in the audit process. Responsibilities meeting the requirements of this subdivision include, but are not limited to, positions, however titled, where the licensee was the person in charge of the fieldwork, up through positions where the licensee was a partner on the engagement.
- b) The employment would permit the licensee to exercise significant authority over accounting or financial reporting, including authority over the controls related to those functions.

Important point: A CPA must appear to be objective and not give the appearance of having a conflict of interest; consequently, if a CPA has participated in an audit engagement of a publicly traded company or affiliate where he/she was in a decision-making position then the CPA should not accept employment within 12 months of the issued financial statement if the new position would allow him/her to exercise authority over the accounting or financial controls.

5063. Reportable Events

- a) A licensee shall report to the board in writing of the occurrence of any of the following events occurring on or after January 1, 1997, within 30 days of the date the licensee has knowledge of these events:
 - 1) The conviction of the licensee of any of the following:
 - A. A felony.
 - B. Any crime related to the qualifications, functions, or duties of a public accountant or certified public accountant, or to acts or activities in the course and scope of the practice of public accountancy.
 - C. Any crime involving theft, embezzlement, misappropriation of funds or property, breach of a fiduciary responsibility, or the preparation, publication, or dissemination of false, fraudulent, or materially misleading financial statements, reports, or information.

As used in this section, a conviction includes the initial plea, verdict, or finding of guilt, pleas of no contest, or pronouncement of sentence by a trial court even though that conviction may not be final or sentence actually imposed until appeals are exhausted.
- 2) The cancellation, revocation, or suspension of a certificate, other authority to practice or refusal to renew a certificate or other authority to practice as a certified public accountant or a public accountant, by any other state or foreign country.
- 3) The cancellation, revocation, or suspension of the right to practice as a certified public accountant or a public accountant before any governmental body or agency.

- b) A licensee shall report to the board in writing the occurrence of any of the following events occurring on or after January 1, 2003, within 30 days of the date the licensee has knowledge of the events:
 - 1) Any restatement of a financial statement and related disclosures by a client audited by the licensee.
 - 2) Any civil action settlement or arbitration award against the licensee relating to the practice of public accountancy where the amount or value of the settlement or arbitration award is thirty thousand dollars (\$30,000) or greater and where the licensee is not insured for the full amount of the award.
 - 3) Any notice of the opening or initiation of a formal investigation of the licensee by the Securities and Exchange Commission or its designee.
 - 4) Any notice from the Securities and Exchange Commission to a licensee requesting a Wells Submission.
 - 5) Any notice of the opening or initiation of an investigation by the Public Company Accounting Oversight Board or its designee, as defined pursuant to subdivision (g).
- c) A licensee shall report to the board in writing, within 30 days of the entry of the judgment, any judgment entered on or after January 1, 2003, against the licensee in any civil action alleging any of the following:
 - 1) Dishonesty, fraud, gross negligence, or negligence.
 - 2) Breach of fiduciary responsibility.
 - 3) Preparation, publication, or dissemination of false, fraudulent, or materially misleading financial statements, reports, or information.
 - 4) Embezzlement, theft, misappropriation of funds or property, or obtaining money, property, or other valuable consideration by fraudulent means or false pretenses, or other errors or omissions.
 - 5) Any actionable conduct by the licensee in the practice of public accountancy, the performance of bookkeeping operations, or other professional practice.
- d) The report required by subdivisions (a), (b), and (c) shall be signed by the licensee and set forth the facts which constitute the reportable event. If the reportable event involves the action of an administrative agency or court, then the report shall set forth the title of the matter, court or agency name, docket number, and dates of occurrence of the reportable event.
- e) A licensee shall promptly respond to oral or written inquiries from the board concerning the reportable events, including inquiries made by the board in conjunction with license renewal.
- f) Nothing in this section shall impose a duty upon any licensee to report to the board the occurrence of any of the events set forth in subdivision (a), (b), or (c) either by or against any other licensee.
- g) The board may adopt regulations to further define the reporting requirements of this section.

<p>Important point: Basically, if you do anything improper, be it criminal or civil, then you probably need to report it to the State Board of Accountancy within 30 days. The third most common reason California CPAs were disciplined in the past 3 years was for violating BPC section 5100(a) – Conviction of a Crime, and right behind violating</p>

5100(a) was BPC section 5063 – Reportable Events. The Accountancy Act requires licensees to self-report a multitude of events, including conviction of a felony, or of ANY crime related to the qualifications, functions, or duties of a CPA, and any crime involving theft and embezzlement.

Disciplinary case: Mr. Gray failed to report his criminal conviction, violating a protective order, in writing to the CBA within 30 days of his knowledge of his conviction. He was charged, in addition to other violations, with violating 5063. Reportable Events. Mr. Gray’s license was suspended for 6 months and he was required to notify his clients of his suspension.

5063.1. Reporting by Courts

Within 10 days of entry of a conviction described in paragraph (1) of subdivision (a) of Section 5063 or a judgment described in subdivision (c) of Section 5063 by a court of this state, the court that rendered the conviction or judgment shall report that fact to the board and provide the board with a copy of the conviction or judgment and any orders or opinions of the court accompanying or ordering the conviction or judgment.

5063.2. Reporting by Insurers

Within 30 days of payment of all or any portion of any civil action settlement or arbitration award against a licensee of the board in which the amount or value of the settlement or arbitration award is thirty thousand dollars (\$30,000) or greater, any insurer or licensed surplus broker providing professional liability insurance to that licensee shall report to the board the name of the licensee, the amount or value of the settlement or arbitration award, the amount paid by the insurer or licensed surplus broker, and the identity of the payee.

Important point: Anyone providing a CPA with professional liability insurance must report to the board any settlements or awards exceeding \$30,000 so again the Board will be made aware of the situation.

5063.3. Disclosure of Confidential Client Information Prohibited

- a) No confidential information obtained by a licensee, in his or her professional capacity, concerning a client or a prospective client shall be disclosed by the licensee without the written permission of the client or prospective client, except the following:
 - 1) Disclosures made by a licensee in compliance with a subpoena or a summons enforceable by order of a court.
 - 2) Disclosures made by a licensee regarding a client or prospective client to the extent the licensee reasonably believes it is necessary to maintain or defend himself or herself in a legal proceeding initiated by the client or prospective client.
 - 3) Disclosures made by a licensee in response to an official inquiry from a federal or state government regulatory agency.
 - 4) Disclosures made by a licensee or a licensee’s duly authorized representative to another licensee in connection with a proposed sale or merger of the licensee’s professional practice, provided the parties enter into a written nondisclosure agreement with regard to all client information shared between the parties.
 - 5) Disclosures made by a licensee to either of the following:
 - A. Another licensee to the extent necessary for purposes of professional consultation.

- B. Organizations that provide professional standards review and ethics or quality control peer review.
 - 6) Disclosures made when specifically required by law.
 - 7) Disclosures specified by the board in regulation.
- b) In the event that confidential client information may be disclosed to persons or entities outside the United States of America in connection with the services provided, the licensee shall inform the client in writing and obtain the client's written permission for the disclosure.

Important point: In the practice of public accountancy, client information is to be kept confidential unless the client has given permission for its release. However, information may be released under the requirements of federal law or regulation, standards of the public accounting profession, or pursuant to a court order, court investigation, professional organization investigation or in the course of peer reviews.

5063.10. Restatements

- a) Any restatement of a financial statement that is included in any report filed with the United States Securities and Exchange Commission shall be exempt from the requirement described in paragraph (1) of subdivision (b) of Section 5063.
- b) Nothing in this section shall be construed to require the reporting of any restatement of a financial statement that is not required to be submitted to the board pursuant to the regulations adopted by the board in effect on the date this section becomes operative.

Article 9- Rules of Professional Conduct

§ 50. Client Notification

Every licensee engaged in the practice of public accountancy shall provide notice reasonably calculated to be received by the licensee's clients of the fact that the licensee is licensed by the California Board of Accountancy. For purposes of this section, "licensee" means a Certified Public Account, Public Accountant, accountancy partnership, or accountancy corporation licensed by the California Board of Accountancy. Notice shall be provided by any of the following methods:

- a) Displaying the certificate of licensure issued by the Board in the office or the public area of the premises where the licensee provides the licensed service.
- b) Providing a statement to each client to be signed and dated by the client and retained in that person's records that states the client understands the person is licensed by the California Board of Accountancy.
- c) Including a statement that the licensee is licensed by the California Board of Accountancy either on letterhead or on a contract for services where the notice is placed immediately above the signature line for the client in at least 12 point type.
- d) Posting a notice in a public area of the premises where the licensee provides the licensed services, in at least 48-point type, that states the named licensee is licensed by the California Board of Accountancy.
- e) Any other method of written notice, including a written notice that is electronically transmitted or a written notice posted at an Internet Website.

§ 50.1. Attest Client Notification Regarding Composition of Firm Ownership.

Any licensee employed by a firm in which no licensee owners are authorized to sign reports on attest engagements pursuant to Business and Professions Code Section 5095 must, prior to engaging in attest services, provide written notification to any attest client or prospective attest client of the ownership composition of the firm. Notice shall be provided by any of the following methods:

- a) Providing a statement to the attest client or prospective attest client to be signed and dated by the client and retained in the client's records, which states the client or prospective client understands that no firm owners are authorized to sign reports on attest engagements.
- b) Posting a written notice on the firm's Internet Web site, disclosing all owner's names and whether each is authorized to sign reports on attest engagements pursuant to Business and Professions Code Section 5095.

Important point: If no owner is licensed to sign reports on attest engagements and the firm is conducting attest services, the firm must provide written notification of its ownership composition.

§ 51. Firms with Nonlicensee Owners.

At initial registration and at renewal, all firms shall certify that any nonlicensee owner with his or her principal place of business in this state has been informed regarding the rules of professional conduct applicable to accountancy firms. This certification shall be signed by a licensed partner or licensed shareholder of the firm.

§ 51.1. Notification of Non-Licensee Ownership.

- a) Any firm with a nonlicensee owner or owners that has one or more offices located in California shall notify each client served by an office located in California of the actual or potential involvement of a nonlicensee owner or owners in any service to be provided to the client by the firm. Notice shall be provided by any of the following methods:
 - 1) Providing a statement to each client served by a California office to be signed and dated by the client and retained in the firm's records that states that the client understands that services will or may be provided by a nonlicensee owner of the firm.
 - 2) Including a statement that the firm has a nonlicensee owner or owners who may provide client services in any contract for services, proposal letter, or engagement letter with the client served by a California office.
- b) A copy of the statement, contract, engagement letter, or proposal letter containing this notice shall be maintained by the public accounting firm in the client's files for a minimum of five years from the date of the notice.

§ 52. Response to Board Inquiry

- a) A licensee shall respond to any inquiry by the Board or its appointed representatives within 30 days. The response shall include making available all files, working papers and other documents requested.
- b) A licensee shall respond to any subpoena issued by the Board or its executive officer or the assistant executive officer in the absence of the executive officer within 30 days and in accordance with the provisions of the Accountancy Act and other applicable laws or regulations.

- c) A licensee shall appear in person upon written notice or subpoena issued by the Board or its executive officer or the assistant executive officer in the absence of the executive officer.
- d) A licensee shall provide true and accurate information and responses to questions, subpoenas, interrogatories or other requests for information or documents and not take any action to obstruct any Board inquiry, investigation, hearing or proceeding.

Important point: You must respond within 30 days to the Board. A licensee must provide accurate information and responses to questions, subpoenas, and other requests for information or documents.

§ 53. Discrimination Prohibited.

No licensee or registrant shall engage in any conduct or practice which shall deny any person an opportunity or benefit of employment within the accounting profession based on race, color, religious creed, national origin, ancestry, physical handicap, sex, marital status, sexual orientation or age.

§ 54. Confidential Information Defined, Exception.

"Confidential information" includes all information obtained by a licensee, in his or her professional capacity, concerning a client or a prospective client, except that it does not include information obtained from a prospective client who does not subsequently become a client, where all of the following conditions are met:

- a) The licensee provides reasonable notice to the prospective client or the prospective client's representative that the information will not be treated as confidential information in the event the provider does not become a client and that providing such information will not preclude the licensee from being employed by a party adverse to the potential client in any current or future legal action or proceeding. For purposes of this section "reasonable notice" shall mean the following:
 - 1) With respect to oral communications, including telephonic communications, reasonable notice consists of oral notice to the speaker given immediately by the licensee upon hearing that client information is being presented or will be presented.
 - 2) With respect to written communications, including electronic and facsimile communications, reasonable notice consists of an oral or written notice to the sender within one business day.
- b) The licensee, on request, returns the original and all copies of documents provided by the prospective client or his or her representative within 30 days.
- c) The licensee does not utilize in any manner the information obtained, except that nothing shall prohibit the licensee from utilizing the same information obtained from an independent source such as through litigation discovery.

Confidentiality has become a big issue in today's world. CPAs and firms need to take precautions to ensure that data is safeguarded.

The IRS warned tax preparation professionals in a March 18 [2013] email that the security of taxpayer accounts and personal information should be a top priority, as referenced in [Revenue Procedure 2007-40](#), which outlines the

obligations of IRS e-file providers.⁵ Publication 4557 discusses Safeguarding Taxpayer Data and Publication 4600 discusses safeguarding Taxpayer Information as it relates to filing of tax returns.

§ 54.1. Disclosure of Confidential Information Prohibited.

- a) No confidential information obtained by a licensee, in his or her professional capacity, concerning a client or a prospective client shall be disclosed by the licensee without the written permission of the client or prospective client, except for the following:
 - 1) disclosures made by a licensee in compliance with a subpoena or a summons enforceable by order of a court;
 - 2) disclosures made by a licensee regarding a client or prospective client to the extent that the licensee reasonably believes that it is necessary to maintain or defend himself/herself in a legal proceeding initiated by that client or prospective client;
 - 3) disclosures made by a licensee in response to an official inquiry from a federal or state government regulatory agency;
 - 4) disclosures made by a licensee or a licensee's duly authorized representative to another licensee in connection with a proposed sale or merger of the licensee's professional practice;
 - 5) disclosures made by a licensee to (A) another licensee to the extent necessary for purposes of professional consultation and to (B) professional standards review, ethics or quality control peer review organizations;
 - 6) disclosures made when specifically required by law;
 - 7) disclosures made at the direct request of the client to a person or entity that is designated by the client at the time of the request.
- b) In the event that confidential client information may be disclosed to persons or entities outside the United States in connection with the services provided, the licensee shall so inform the client in writing and obtain the client's written permission for the disclosure.

Question: If a CPA uses an external service provider (a separate legal entity) to process confidential information such as tax returns, will written permission from the client be required?

Explanation: If confidential information is disclosed to an outside third party then written permission from the client is required.

Question: Would written permission from the client be required if a CPA “stored” confidential client documents or information on an Internet file server?

Explanation: No. Written permission would not be required since the documents or information are stored within an outside service provider, rather than being disclosed.

Question: I just received a subpoena that states I need to bring all records and associated work papers to court. What should I do?

Explanation: You should notify your client of the subpoena; however, confidentiality of records does not extend to criminal or bankruptcy laws nor does it limit the authority of California or any agency in this state from subpoenaing

⁵ <http://www.accountingweb.com/article/irs-warns-tax-preparers-review-their-safeguards-client-data/221375>

and using the information in connection with an investigation, public hearing or other proceeding so you need to go to court and bring the materials specifically listed in the subpoena.

Question: My client, Dr. Brown has a medical practice with 2 other doctors. The medical practice is undergoing some financial difficulties and Dr. Brown's wife has asked me to provide her with some financial information relating to Dr. Brown's income. What should I do?

Explanation: Since Dr. Brown is your client you cannot divulge confidential information concerning his finances without his approval – even to a spouse.

§ 54.2. Recipients of Confidential Information.

Members of the Board, its appointed representatives professional practice reviewers and other persons designated in section 54.1(a)(4)-(a)(6) shall not disclose information concerning licensees or their clients which comes to their attention in carrying out their professional responsibilities; provided, however, such information may be disclosed:

- a) as part of disciplinary proceedings with the Board,
- b) as part of legal actions in which the Board is a party,
- c) in response to an official inquiry from a federal or state governmental regulatory agency,
- d) in compliance with a subpoena or summons enforceable by order of a court, or
- e) when otherwise specifically required by law.

Question: If a complaint is filed against me does that become public information?

Explanation: No complaints are not public information. However, if the complaint results in a citation or enforcement action, the citation or enforcement action is public information.

§ 56. Commissions -Basic Disclosure Requirement.

- a) A licensee shall not accept any fee or commission permitted by Business and Professions Code Section 5061 unless he or she complies with the provisions of this section and Section 56.1
- b) A licensee who may receive a fee or commission pursuant to Business and Professions Code Section 5061 shall furnish to the client, at or prior to the time the recommendation of the product or service is made, a written disclosure statement in 12 point type or larger that contains the following information:
 - 1) The fact that the fee or commission is to be paid for professional services and that a fee or commission cannot be accepted solely for the referral of the client to the products or services of a third party.
 - 2) A description of the product(s) or service(s) which the licensee is recommending to the client, the identity of the third party that is expected to provide the product or service, the business relationship of the licensee to the third party, a description of any fee or commission which may be received by the licensee, including, but not limited to, any supplemental fee or commission or other compensation allocable to the client being provided with the product or service of the third party. Where the product(s) or service(s) cannot be specifically identified at the time of the initial disclosure, this information shall be included in a supplemental disclosure within 30 days of receipt of the fee or commission.
 - 3) The dollar amount or value of the fee or commission payment(s) or the basis on which the payment(s) shall be computed.

- c) The written disclosure shall be on letterhead of the licensed firm or shall be signed by the licensee. The disclosure statement shall be signed and dated by the client and contain an acknowledgment by the client that the client has read and understands the information contained in the disclosure. Supplemental disclosures as described in subsection (b)(2) of Section 56 need not be signed by the client or by the licensee. The licensee shall retain the disclosure statements for a period of five years and shall provide copies to the client.

§ 56.1. Commissions -Professional Services Provided to the Client.

The professional services which must be provided to the client in conjunction with the products or services of a third party under Business and Professions Code Section 5061(b) shall include consultation with the client regarding the third party's product or service in relation to the client's circumstances.

56.2. Commissions -Disclosure Requirement and Other Rules of Professional Conduct.

Nothing in Section 56 permits a licensee either (1) to accept any fee or commission which would violate the requirement that a licensee be independent in the performance of services in accordance with professional standards (Section 65) or (2) to concurrently engage in the practice of public accountancy and in any other business or occupation which impairs the licensee's independence, objectivity, or creates a conflict of interest in rendering professional services (Section 57). However, the act of a licensee taking a fee or commission as permitted by Business and Professions Code Section 5061 and in conformity with Section 56 does not, by itself, constitute an impairment of a licensee's objectivity or create a conflict of interest in rendering professional services.

Example situation: A CPA firm with a tax client, who is not an attest client, receives a commission from a software company for recommending new tax software to the client. Assuming appropriate disclosure of the commission to the client under Section 65 and 57, this is permitted.

§ 56.3. Commissions -Definitions.

For purposes of Sections 56, 56.1, and 56.2 of the Board's regulations the following definitions apply:

- a) "Licensee" means a Certified Public Accountant, Public Accountant, or firm licensed by the Board of Accountancy, including a firm with nonlicensee owners, that is engaged in the practice of public accountancy as defined by Business and Professions Code Section 5051.
- b) The term "a third party" means all persons other than the licensee, the licensee's client, and any licensee firm of which the licensee is an employee, partner, or owner.
- c) "The basis on which the payment(s) shall be computed" shall be a formula which can be used to calculate the dollar amount or value of the fee or commission once the dollar amount or value of the transaction is known.

§ 56.4. "Officer" and "Director."

The terms "director" and "officer" as defined under Section 5061(c) does not include a director or officer of a nonprofit corporation, or a corporation that together with any affiliates, has 100 or less employees or average annual gross receipts of ten million dollars (\$10,000,000) or less over the previous three tax years. The term "average annual gross receipts" means all pecuniary gross

receipts (less returns, allowances and interaffiliate transactions), the assignment of such receipts notwithstanding, of a business concern from whatever source derived, as entered or to have been entered on its regular books of account for its most recently completed fiscal year (whether on a cash, accrual, completed contracts, percentage of completion or other commonly recognized and accepted accounting method).

§ 57. Incompatible Occupations/Conflict of Interest.

A licensee shall not concurrently engage in the practice of public accountancy and in any other business or occupation which impairs the licensee's independence, objectivity, or creates a conflict of interest in rendering professional services.

§ 58. Compliance with Standards.

Licensees engaged in the practice of public accountancy shall comply with all applicable professional standards, including but not limited to generally accepted accounting principles and generally accepted auditing standards.

§ 59. Reporting of Restatements.

- a) To comply with the requirements of paragraph (1) of subdivision (b) of Business and Professions Code Section 5063, a licensee who issues a report on a client's restated financial statement shall report to the Board:
 - 1) Any restatement of a financial statement reporting the correction of any error in a previously issued financial statement of a client that is a government agency located in California, when the financial restatement(s) exceeds the planning materiality used by the licensee in conjunction with the current year audit. For purposes of this paragraph, planning materiality means the planned level of misstatements, individually or in aggregate, that would cause the financial statements to not be presented fairly, in all material respects, in conformity with generally accepted accounting principles.
 - 2) Any restatement of a financial statement of a charitable organization registered by the Office of the Attorney General's Registry of Charitable Trusts which is issued for purposes of correcting any error in a previously issued financial statement and which has resulted in the filing of an amended or superseding Internal Revenue Service Form 990 or 990PF.
- b) The report required by subsection (a) shall be made by the licensee issuing the report on the restatement even if the licensee did not perform the original audit. The report required by subsection (a) shall be provided to the Board within 30 days of issuance of the restatement, shall be signed by the licensee, and shall set forth the facts which constitute the reportable event including an explanation of the reason for the restatement. The report made under paragraph (a)(1) of this section shall include copies of the original and the restated financial statements. The report made under paragraph (a)(2) of this section shall include only those portions of the original and the amended Forms 990 or 990PF related to the reissued financial statement.

§ 60. Reporting of Investigations by the Securities and Exchange Commission

Pursuant to Section 5063(b)(3); Reporting of Notices of Requests for Wells Submissions Pursuant to Section 5063 (b)(4); and Reporting of Investigations by the Public Company Accounting Oversight Board Pursuant to Section 5063(b)(5).

- a) For purposes of reporting pursuant to Section 5063 (b)(5), notice of the opening or initiation of an investigation by the Public Company Accounting Oversight Board shall include any notice by the Public Company Accounting Oversight Board that it is initiating an investigation of the licensee.
- b) Reports received by the Board pursuant to the requirements of subsection (a) of this section or of paragraphs (3), (4) or (5) of subdivision (b) of Business and Professions Code 5063 shall not be publicly disclosed other than (1) in the course of any disciplinary proceeding by the Board after the filing of a formal accusation; (2) in the course of any legal action to which the Board is a party; (3) in response to an official inquiry from a state or federal agency; (4) in response to a subpoena or summons enforceable by order of a court; or (5) when otherwise specifically required by law.

§ 61. The Reporting of Settlements, Arbitration Awards, and Judgments.

- a) To meet the reporting requirements of paragraph (b)(2) of Section 5063, licensees 58 shall report settlements and arbitration awards consistent with that provision that are the result of actions brought by persons located, residing, or doing business in California.
- b) Reports of judgments in civil actions alleging negligent conduct (but not dishonesty, fraud, or gross negligence) by a licensee pursuant to paragraph (c)(1) of Section 5063 shall be limited to those judgments in which a person located, residing in or doing business in California is a named party to the action or where the alleged conduct relates to the practice of public accountancy in California. Nothing in this subsection limits a licensee's responsibility to report under any other paragraph of subdivision (c) of Section 5063.
- c) Reports received by the Board pursuant to the requirements of subsection (a) of this section shall not be publicly disclosed other than (1) in the course of any disciplinary proceeding by the Board after the filing of a formal accusation; (2) in the course of any legal action to which the Board is a party; (3) in response to an official inquiry from a state or federal agency; (4) in response to a subpoena or summons enforceable by order of a court; or (5) when otherwise specifically required by law.

§ 62. Contingent Fees.

- a) A licensee shall not:
 - 1) Perform for a contingent fee any professional services for, or receive such a fee from, a client for whom the licensee or the licensee's firm performs:
 - A. an audit or review of a financial statement; or
 - B. a compilation of a financial statement when the licensee expects or reasonably should expect that a third party will use the financial statement and the licensee's compilation report does not disclose a lack of independence; or
 - C. an examination of prospective financial information; or
 - D. any other attest engagement when the licensee expects or reasonably should expect that a third party will use the related attestation report; or

E. any other services requiring independence.

- 2) Prepare an original tax return for a contingent fee for any client.
- 3) Prepare an amended tax return, claim for tax refund, or perform other similar tax services for a contingent fee for any client.
- 4) Perform an engagement as a testifying expert for a contingent fee.

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

- b) Except as stated in the next paragraph, a contingent fee is a fee established for the performance of any service pursuant to an arrangement in which no fee will be charged unless a specific finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of such service.

Solely for purposes of this section, fees are not regarded as being contingent if fixed by courts or governmental entities acting in a judicial or regulatory capacity, or in tax matters if determined based upon the results of judicial proceedings or the findings of governmental agencies in a judicial or regulatory capacity or there is a reasonable expectation of substantive review by a taxing authority.

Example situation: A CPA firm with a tax client, who is also an attest client, enters into a contingent fee arrangement to protest a property valuation for local property taxes. This is an acceptable contingent fee arrangement.

Example situation: A CPA firm with an audit client charges a contingent fee to the client for providing investment advisory services. This is a prohibited contingent fee arrangement as it relates to an attest client.

§ 63. Advertising.

A licensee shall not advertise or use other forms of solicitation in any manner which is false, fraudulent, misleading, or in violation of Section 17500 of the Business and Professions Code.

Example situation: A CPA firm advertises that “We will lower your taxes.” This is unacceptable as it implies a guarantee of favorable results.

§ 65. Independence.

A licensee shall be independent in the performance of services in accordance with professional standards.

§ 67. Approval of Use of Fictitious Name

No sole proprietor may practice under a name other than the name set forth on his or her permit to practice unless such name has been registered with the Board. Any registration issued under this section shall expire five years after the date of issuance unless renewed prior to its expiration.

Question: I am a sole proprietor of a small accounting firm that provides primarily compilation and tax preparation services. I recently registered a fictitious name for my firm with the city and county where I practice. Do I need to register the fictitious name with the CBA? If so, is there a fee?

Explanation: Under Business and Professions Code Section 5060, a fictitious name application must be approved by the CBA before the name can be used. There is no fee to register the fictitious name.

§ 68. Retention of Client's Records.

A licensee, after demand by or on behalf of a client, for books, records or other data, whether in written or machine sensible form, that are the client's records shall not retain such records. Unpaid fees do not constitute justification for retention of client records. Although, in general the accountant's working papers are the property of the licensee, if such working papers include records which would ordinarily constitute part of the client's books and records and are not otherwise available to the client, then the information on those working papers must be treated the same as if it were part of the client's books and records.

Important point: Client records cannot be retained because of nonpayment.

Question: I prepared income tax returns for a former client and provide him the original returns for filing with the taxing agencies and a copy for his records. He is now requesting an additional copy. Am I required to provide this former client with an additional copy of the income tax returns?

Explanation: No. If you were hired and prepared income tax returns for the client and provided the client with a copy of the returns, as defined under the Internal Revenue Code Section 6107(a), then you are not required to provide additional copies under applicable BPC and CBA regulations. You are, however, required to return tax records provided by the client and provide a copy of the licensee's working papers that support information on the tax returns.

§ 68.1. Working Papers Defined; Retention.

- a) Working papers are the licensee's records of the procedures applied, the tests performed, the information obtained and the pertinent conclusions reached in an audit, review, compilation, tax, special report or other engagement. They include, but are not limited to, audit of other programs, analyses, memoranda, letters of confirmation and representations, abstracts of company documents and schedules or commentaries prepared or obtained by the licensee. The form of working papers may be handwriting, typewriting, printing, photocopying, photographing, computer, data, or any other letters, words, pictures, sounds, or symbols or combinations thereof.
- b) Licensees shall adopt reasonable procedures for the safe custody of working papers and shall retain working papers for a period sufficient to meet the needs of the licensee's practice and to satisfy applicable professional standards and pertinent legal requirements for record retention.
- c) Licensees shall retain working papers during the pendency of any Board investigation, disciplinary action, or other legal action involving the licensee. Licensees shall not dispose of such working papers until notified in writing by the Board of the closure of the investigation or until final disposition of the legal action or proceeding if no Board investigation is pending.

§ 68.2. Identification of Audit Documentation.

- a) To provide for the identification of audit documentation, audit documentation shall include an index or guide to the audit documentation which identifies the components of the audit documentation.
- b) In addition to the requirements of Business and Professions Code Section 5097(b), audit documentation shall provide the date the document or working paper was completed by the preparer(s) and any reviewer(s), and shall include the identity of the preparer(s) and any reviewer(s).
- c) Audit documentation shall include both the report date and the date of issuance of the report.

§ 68.3. Retention Period for Audit Documentation.

- a) The retention period mandated by Business and Professions Code Section 5097 shall be measured from the date of issuance of the report (report release date).
- b) If audit documentation is required to be kept for longer than seven years because of a pending Board investigation or disciplinary action, audit documentation shall not be destroyed until the licensee has been notified in writing by the Board of the closure of a Board investigation or disciplinary proceeding.
- c) Any documents required to be maintained by Business and Professions Code Section 5097 or these regulations shall be maintained in accessible form.
- d) Audit documentation shall be retained whether or not the documentation supports the auditor's final conclusions. All audit documentation regarding any significant matter related to the audit shall be retained whether or not the documentation contains information or data inconsistent with the auditor's final conclusions. Significance of a matter shall be determined based on an objective analysis of the facts and circumstances. Audit documentation to be retained shall also include all documentation of consultations on, or resolutions of, any differences of opinion regarding the exercise of professional judgment.

§ 68.4. The Document Assembly Period and Subsequent Changes in Audit Documentation.

- a) Audit documentation that is not completed prior to the date of issuance of the report shall be completed during the document assembly period specified in this subsection.
 - 1) The document assembly period is the 60-day period following the date of issuance of the report. If the report is not issued in connection with such an engagement, the document assembly period ends 60 days after the date that the fieldwork was completed. If the auditor was unable to complete such an engagement, then the document assembly period ends 60 days from the date the engagement ceased.
 - 2) Notwithstanding the document assembly period specified in paragraph (1) of this subsection, licensees shall comply with applicable professional standards specifying a shorter document assembly period.
- b) After the end of the document assembly period, any, removal, deletion, substitution, or editing of audit documentation, is prohibited. Additions to audit documentation shall comply with the requirements in subsection (c).

- c) In addition to any other documentation required by professional standards, any addition to audit documentation after the end of the document assembly period shall include the following:
 - 1) the reason for the addition,
 - 2) the identity of the persons preparing and approving the addition, and
 - 3) the date of the addition. The documentation which is added shall contain sufficient detail to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, reason for, and extent of the addition.
- d) Nothing in this section authorizes the deferral of audit procedures required to be performed prior to the date of issuance of the report.

Important point: Once the document assembly period has ended, nothing can be removed, deleted, substituted or edited. Additions can be made if documented properly.

§ 68.5. Audit Documentation Retention and Destruction Policy.

- a) Licensees shall maintain, and document compliance with, a written Audit Documentation Retention and Destruction Policy which provides for the preservation of audit documentation for the full time period required by Business and Professions Code Section 5097. The policy and documentation of compliance shall be available to the Board upon request.
- b) This policy shall provide for the authorized custody, security, access, retention, and destruction of the documentation. This policy shall, at a minimum, include the following:
 - 1) procedures for the maintenance of back-up copies of electronic audit documentation at secure locations,
 - 2) procedures for maintaining audit documentation,
 - 3) procedures for approving any changes to audit documentation,
 - 4) procedures for approving the destruction of documentation when no longer required to be maintained by Business and Professions Code Section 5097.
- c) The procedure required by subsection (b)(4) shall provide for identifying the persons, by name or position, authorized to approve the destruction of audit documentation. In the alternative, the procedure required by subsection (b)(4) may be self-executing once the retention period has expired.

Important point: Licensees doing audit work must have a written Audit Documentation Retention and Destruction Policy that meets at a minimum the specifications listed in §68.5.

§ 69. Certification of Applicant's Experience.

- a) Any licensee who shall have been requested by an applicant to prepare and submit to the board certification of the applicant's experience and shall have refused to prepare and submit said certification shall, when requested by the board, explain in writing, or, when so requested by the board, explain in person, the basis for refusal to complete and submit said certification.
- b) Any licensee who shall have signed a certification of experience shall, when requested by the board, explain in writing, or, when so requested by the board, explain in person, the

information provided on any said certification of experience, in any situation including, but not limited to, the following:

- 1) Where there is an alleged disagreement between an applicant and any licensee as to dates and/or type of work performed;
 - 2) Where there is satisfactorily answered certification of experience submitted to the board, but the period of experience appears to be unduly short;
 - 3) Where the board seeks to verify on a sample basis information submitted by an applicant or attested thereto on a certification of experience; or
 - 4) Where the board reasonably believes that the information in the certification of experience may be false or incorrect.
- c) Any false or misleading statement, made by a licensee as to material matters in the certification of an applicant's experience, shall constitute a violation of Section 5100(g) of the Accountancy Act.
- d) Inspection by the board or its representatives of documentation relating to an applicant's fulfillment of the experience requirements set forth in Sections 5092, 5093, and 5095 of the Accountancy Act and Sections 12 and 12.5 herein above may be made at any of the board's offices or at such other places as the board may designate.
- e) The failure or refusal, by any licensee to complete and submit a certification of experience or to comply with a request for explanation of said certification or inspection of documentation as set forth in this rule constitutes a violation of Section 5100(g) of the Accountancy Act.
- f) Any unreasonable act or failure to act which jeopardizes an applicant's chances for obtaining a certificate, shall constitute a violation of Section 5100(g) of the Accountancy Act.

Case Studies

A Little Extra Income – Contingent Fees

A young California CPA was employed as an assistant controller for a private enterprise. To earn some extra income, this CPA decided to offer to prepare tax returns to the public. He proposes what he considers to be a unique arrangement where his fee will be the greater of \$200 or 10% of the income tax refund. What are the ethical issues that this young CPA should consider?

Discussion

California Board of Accountancy Regulations, section 62 (a) (2) and (3) related to Contingent Fees, states that a licensee shall not prepare an original or amended tax return or claim for a tax refund for a contingent fee for any client. A contingent fee is defined as a fee that is dependent upon the finding or result of such service. Predicating the fee on the refund amount makes the proposed fee arrangement a contingent fee.

So, the young CPA would be violating the California Board of Accountancy Regulations, section 62, because he is charging a contingent fee for the preparation of an original tax return.

Return of client provided records

You performed the audit of a privately held company last year and have not yet been paid for the work. You have retained all documents provided by your client, including financial records prepared by them. They have requested return of their records for a partial payment of the fee. What are the related ethical issues involved in the state of California?

Discussion

California Board of Accountancy Regulations, section 68, addresses the return of working papers. It states:

§ 68. Retention of Client's Records.

A licensee, after demand by or on behalf of a client, for books, records or other data, whether in written or machine sensible form, that are the client's records shall not retain such records. Unpaid fees do not constitute justification for retention of client records. Although, in general the accountant's working papers are the property of the licensee, if such working papers include records which would ordinarily constitute part of the client's books and records and are not otherwise available to the client, then the information on those working papers must be treated the same as if it were part of the client's books and records.

So, client provided records must always be returned to the client upon demand. This CPA has violated this rule. A copy of the CPAs work papers, to the extent that such working papers explain or detail the material in the work product and are not otherwise available to the client, must also be returned to the client. The return of records may not be predicated on payment.

Chapter 2 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

4. A CPA receives a commission for the sale of software to a client. Is the commission permissible?
 - a. A commission is never permissible.
 - b. Commissions are only permissible if related to the purchase of an accounting practice.
 - c. It is permissible if the CPA does not provide any audit, review, compilation (expected that a third party will use the financial statements and lack of independence is not disclosed) or examination of prospective financial information services for the client and the commission is disclosed in writing to any person or entity to whom the commission relates.
 - d. A commission is always permissible.
5. You were convicted of driving under the influence of alcohol. You should:
 - a. Report it to the CBA within 30 days.
 - b. Report it to the CBA prior to license renewal.
 - c. Not report it to the CBA as only felony convictions should be reported.
 - d. Wait until you are contacted by the CBA.
6. When should client provided records be returned?
 - a. Upon demand by the client.
 - b. Client provided records are not required to be returned to the client.
 - c. Client provided records are only required to be returned if related fees are paid.
 - d. After a 7-year retention period.

Chapter 3 – The AICPA Code of Professional Conduct

Learning Objectives

After completing this section of the course, you will be able to:

- Recognize the ethical standards contained in the AICPA Code of Professional Conduct
- Specify the action a CPA must take when there is a possible conflict of interest
- Identify situations where a CPA's independence may or may not be impaired and what is considered an act discreditable
- Identify threats and safeguards that are applicable to CPAs in public practice and in business

About the Code

The AICPA Code of Professional Conduct is separated into four sections. The preface is applicable to all members. This contains an overview of the code as well as the principles of professional conduct. Part one is for members in public practice. Part two relates to members in business and part three is for other members. Each of the three parts is comprised of rules and, within each rule, interpretations.

In addition to categorizing the rules and interpretations by the line of business, the Code also uses a conceptual framework of identifying threats to compliance with the rules and evaluating safeguards to those threats. It should be noted that the conceptual framework does not permit a CPA the latitude of applying judgment where none has existed before. This framework is meant to be used in situations where there is no specific rule or interpretation. As an example, if a CPA is a director of an attest client, there are no safeguards to reduce the threats to independence to an acceptable level. The interpretations of the rules specify that independence is impaired in this situation.

Preface

The AICPA Code of Professional Conduct (the code) begins with this preface, which applies to all members. The term member, when used in part 1 of the code, applies to and means a member in public practice; when used in part 2 of the code, applies to and means a member in business; and when used in part 3 of the code, applies to and means all other members, such as those members who are retired or unemployed.⁶

The preface also indicates that members should consult other sources for ethical guidance and interpretations, if applicable. These other sources include:

- The applicable state board of accountancy
- The applicable state CPA society
- The SEC
- The PCAOB

The preface also discusses the principles of professional conduct. These principles are:

- Responsibilities
- The Public Interest

⁶ AICPA Code of Professional Conduct

- Integrity
- Objectivity and independence
- Due Care
- Scope and Nature of Services

Review the Preface of the Code of Professional Conduct at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Part 1 – Members in Public Practice

The conceptual framework for members in public practice provides members with a methodology to identify and mitigate ethical issues not covered by specific rules and interpretations. This is characterized as the threats and safeguards approach. This approach is intended to identify and evaluate threats to compliance with ethical standards and then provide safeguards to ensure that the threat(s) are reduced to an acceptable level. An acceptable level is that which an informed and reasonable third party would conclude that compliance with the rules is not compromised.

Threats for a member in public practice fall into the following categories:

- **Adverse interest threat.** The threat that a member will not be objective because the member's interests are in opposition to the interests of a client.
- **Advocacy threat.** The threat that a member will promote a client or employer's position or opinion to the point that his or her objectivity is compromised.
- **Familiarity threat.** The threat that because of a long or close relationship with a client or employer, a member will become too sympathetic to their interests or too accepting of their work.
- **Management participation threat.** The threat that a member will perform the role of client management or assume client management responsibilities.
- **Self-interest threat.** The threat that a member could benefit from an interest in or a relationship with a client or persons associated with the client.
- **Self-review threat.** The threat that a member will not appropriately evaluate the results of a service performed by the member, or by an individual in the member's firm or employing organization, that the member will rely upon in forming a judgment as part of providing another service.
- **Undue influence threat.** The threat that a member will subordinate his or her judgment to that of an individual associated with a client or other relevant third party because of the individual's (1) reputation or expertise, (2) aggressive or dominant personality, or (3) attempts to coerce or exercise excessive influence over the member.⁷

These threats are illustrated as follows:

Adverse interest threat

- a. The client has expressed an intention to commence litigation against the member.

⁷ AICPA Code of Professional Conduct

- b. A client or officer, director, or significant shareholder of the client participates in litigation against the firm.
- c. A subrogee asserts a claim against the firm for recovery of insurance payments made to the client.
- d. A class action lawsuit is filed against the client and its officers and directors and the firm and its professional accountants.

Advocacy threat

- a. A member provides forensic accounting services to a client in litigation or a dispute with third parties.
- b. A firm acts as an investment adviser for an officer, a director, or a 10 percent shareholder of a client.
- c. A firm underwrites or promotes a client's shares.
- d. A firm acts as a registered agent for a client.
- e. A member endorses a client's services or products.

Familiarity threat

- a. A member's immediate family or close relative is employed by the client.
- b. A member's close friend is employed by the client.
- c. A former partner or professional employee joins the client in a key position and has knowledge of the firm's policies and practices for the professional services engagement.
- d. Senior personnel have a long association with a client.
- e. A member has a significant close business relationship with an officer, a director, or a 10 percent shareholder of a client.

Management participation threat

While no specific threats are cited, it is noted that a member may take on such management tasks during an engagement to perform non-attest services.

Self-interest threat

- a. The member has a financial interest in a client, and the outcome of a professional services engagement may affect the fair value of that financial interest.
- b. The member's spouse enters into employment negotiations with the client.
- c. A firm enters into a contingent fee arrangement for a tax refund claim that is not a predetermined fee.
- d. Excessive reliance exists on revenue from a single client.

Self-review threat

- a. The member relies on the work product of the member's firm.
- b. The member performs bookkeeping services for a client.
- c. A partner in the member's office was associated with the client as an employee, an officer, a director, or a contractor.

Undue influence threat

- a. The firm is threatened with dismissal from a client engagement.
- b. The client indicates that it will not award additional engagements to the firm if the firm continues to disagree with the client on an accounting or tax matter.

- c. An individual associated with a client or any relevant third party threatens to withdraw or terminate a professional service unless the member reaches certain judgments or conclusions.⁸

Safeguards are presented in three categories: (1) Those created by the profession or related legislation or regulation, (2) those implemented by a client, and (3) those implemented by a firm. To be effective, safeguards should either eliminate the threat or reduce it to an acceptable level. Safeguards must be evaluated to ensure that they are effective. This evaluation is dependent on each specific situation. A particular safeguard is not always effective in every circumstance. This methodology is only used in instances not specifically covered by rules and interpretations. It provides a conceptual framework to evaluate compliance in those situations where there is no applicable rule or interpretation.

Section 1.000.020 addresses those situations in which member's ethical obligations may conflict. The specific example used is when a member suspects that fraud may have occurred at a client company, but reporting the fraud would violate the obligation of client confidentiality. In these situations, the member should consider consulting with other CPAs in the firm or obtain counsel from an attorney familiar with the ethical obligations of CPAs. If the conflict remains unresolved, the member should consider whether to continue his or her relationship with the particular employer, client or engagement.

Review 1.000.010.01 – 1.000.020.07 including the suggested safeguards at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Rule 1.100 Integrity and Objectivity

In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.⁹

Objectivity refers to being unbiased and not influenced by personal prejudices. A CPA must maintain an impartial attitude in the performance of professional responsibilities. Integrity refers to the CPA's adherence to an ethical code which requires the CPA to be honest and not subordinate his judgment to personal gain.

In applying the Integrity and Objectivity rule, in the absence of a related interpretation of the rule, the conceptual framework is utilized for assessing the relationship or circumstance and the appropriate safeguard that is used to reduce compliance threats to a minimum of an acceptable level.

Conflicts of interest are created when the CPA has an interest or relationship that may threaten the CPA's integrity and objectivity. Both actual and apparent conflicts of interest must be avoided so that there is no question that an objective examination of the financial statements has

⁸ AICPA Code of Professional Conduct

⁹ AICPA Code of Professional Conduct

been performed and that they may be relied upon. Adequate safeguards should be put in place to ensure that all threats to a CPA's integrity and objectivity are reduced to an acceptable level. When a conflict of interest exists, even if there are appropriate safeguards in place to reduce the threat to an acceptable level, the CPA should disclose the existence of the conflict to all clients and other appropriate parties to the conflict and obtain their consent to perform the contemplated professional services. This disclosure and consent may be general and apply to clients in a particular market or sector. In this case, the disclosure may be part of the CPA's standard terms and conditions for an engagement. Disclosure and consent may also be specific to a client. In this case, disclosure should describe the particular conflict and safeguards in place in a manner sufficient to allow the client to make an informed decision regarding consent.

In the performance of attest services that require independence, independence issues cannot be mitigated by disclosure and consent.

Review 1.110 – 1.120 including examples of possible conflicts of interest at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Case Study – Married Tax Clients Divorcing

A married couple who are clients of the firm are going through a divorce. Both want the firm to continue to provide tax planning and other tax services to them throughout the divorce proceeding. What should the firm do?

Discussion – A conflict exists as the two parties involved in the divorce are likely going to be in an adversarial position to each other, from a tax standpoint as well as many other standpoints. This is a specific conflict provided in 1.110.010.03(e). In this case, there is a direct connection between the professional service being provided (tax planning) and the parties' interests. While safeguards could be implemented such as using separate tax planning teams and establishing barriers within the firm to prevent passing along confidential client information and client files, these may be impractical in this situation. In this case, any risk can be eliminated by declining the engagement for one or both parties. However, both may be represented if there is appropriate disclosure and consent and there is no bias toward one client over the other. Disclosure and consent is required even if safeguards reduce the threats to compliance to an acceptable level. This also relates to situations where partnerships or business associations are being dissolved. Treasury Department Circular 230 also addresses conflicts of interest. Section 10.29 of Circular 230 defines a conflict of interest when the representation of one client will be directly adverse to another client. When a conflict of interest exists, you may not represent a client in an IRS matter unless (i) you reasonably believe that you can provide competent and diligent representation to all affected clients, (ii) your representation is not prohibited by law, and (iii) all affected clients give informed, written consent to your representation.¹⁰

1.130 Preparing and Reporting Information

The following are examples of threats to compliance with the Integrity and Objectivity rule as it relates to knowing misrepresentations in the preparation of financial statements and records:

¹⁰ IRS Guidance to Practitioners Regarding Professional Obligations Under Treasury Circular No. 230

- a. makes, or permits or directs another to make, materially false and misleading entries in an entity's *financial statements* or records;
- b. fails to correct an entity's *financial statements* or records that are materially false and misleading when the *member* has the authority to record the entries; or
- c. signs, or permits or directs another to sign, a document containing materially false and misleading information.¹¹

These example threats to compliance are the result of self-interest, familiarity, undue influence as well as client advocacy. There should be adequate safeguards in place to ensure that a CPA's judgment is not subordinated in the preparation or reporting of financial information as well as knowingly misrepresenting facts related to a professional engagement. Appropriate research and consultation with others should be conducted to ensure compliance. If a firm has a mechanism for resolving differences of opinion, this should also be pursued.

In evaluating the significance of any identified *threats*, the *member* should determine, after appropriate research or consultation, whether the result of the position taken by the supervisor or other person

- a. fails to comply with professional standards, when applicable;
- b. creates a material misrepresentation of fact; or
- c. may violate applicable laws or regulations.¹²

If the CPA concludes that the threats cannot be reduced to an acceptable level, then he or she should consider withdrawing from the organization or engagement.

Review 1.130 – 1.150 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Case Study – Year End Adjustments and Loan Covenants

You are a CPA in the practice of public accountancy. Your largest audit client has not had a good year. Prior to any year-end adjustments, the client is profitable, but very close to violating a profit based bank loan covenant. The historic formula that has been used to calculate Allowance for Bad Debts indicates an additional amount of Bad Debt Expense is required and this adjustment would cause your client to violate the bank loan covenant. The client has asked you if it can book less than the amount required by the calculation in order to pass the bank loan covenant but still receive an unqualified audit opinion. The difference between the calculated amount and the amount requested by the client is material to the financial statements and other tests confirm the amount of the adjustment. What would you do?

Discussion – There are threats to the CPAs integrity and objectivity in this case. The client is the firm's largest, creating a self-interest threat as well as an undue influence threat. Additionally, the client is requesting that a material adjustment to the financial statements not be recorded. While there are safeguards for these threats, failure to make an adjustment to correct an entities' financial statements that are materially false is a breach of the standards of professional conduct.

¹¹ AICPA Code of Professional Conduct

¹² AICPA Code of Professional Conduct

1.200 Independence

A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council.¹³

The AICPA independence rules broadly state that a CPA must be independent of a client in both fact and appearance during the course of a professional attest engagement. Both actual and apparent conflicts of interest must be avoided so that there is no question that an objective examination of the financial statements has been performed and that they may be relied upon. Independence is required for Audit engagements and Review engagements. A lack of independence must be disclosed on the Compilation report related to a Compilation engagement. When there is no specific interpretation of the Independence rule, the conceptual framework is utilized for assessing the relationship or circumstance and the appropriate safeguard that is used to reduce compliance threats to a minimum of an acceptable level. In applying this framework to independence, if the code specifies that independence is deemed to be impaired in certain situations or circumstances, there are no safeguards to reduce the threat to an acceptable level and the CPA is not independent.

Network Firms – Firms may join membership associations to utilize association services and resources. These associations are typically separate legal entities, unrelated to their members. A typical association is not considered to be a network firm.

An association deemed to be a network firm has some or all of these characteristics:

.06 When an association is formed for the purpose of cooperating to enhance the *firms'* capabilities to provide *professional services*, and one of the characteristics described in paragraphs .07–.18 of this section also applies, the association is considered to be a *network*.

.07 Sharing a common brand name. This characteristic exists when the association's members or entities *controlled* by the association's members share the use of a common brand name or share common initials as part of the *firm* name.

.08 A *firm* that does not use a common brand name as part of its *firm* name but makes reference in its stationery or promotional materials to being a member of an association of *firms* should carefully consider how it describes that membership and take steps to avoid the perception that it belongs to a *network*. The *firm* may wish to avoid such perception by clearly describing the nature of its membership in the association (for example, by stating on its stationery or promotional material that it is “an independently owned and operated member firm of XYZ Association”).

.09 Sharing common control. This characteristic exists when entities within the association are under common *control* with other firms in the association through ownership, management, or other means (for example, by contract). However, compliance with association requirements as a condition of membership does not indicate that members are under common *control*; rather, it reflects the type of cooperation that is expected when an entity joins the association.

.10 Sharing profits or costs. This characteristic exists when entities within the association share profits or costs. Following are examples of profit and cost sharing that would not create a *network*:

- a. Sharing immaterial costs

¹³ AICPA Code of Professional Conduct

- b. Sharing costs related to operating the association
- c. Sharing costs related to the development of audit methodologies, manuals, and training courses
- d. Arrangements between a *firm* and an otherwise unrelated entity to jointly provide a service or develop a product

.11 *Sharing a common business strategy.* This characteristic exists when entities within the association share a common business strategy. Sharing a common business strategy involves ongoing collaboration among the *firms* whereby the *firms* are responsible for implementing the association's strategy and held accountable for performance pursuant to that strategy. An entity's ability to pursue an alternative strategy may be limited by the common business strategy because, as a member, it must act in accordance with the common business strategy and, therefore, in the best interest of the association.

.12 An entity is not considered to be a *network firm* merely because it cooperates with another entity solely to market *professional services* or responds jointly to a request for a proposal for the provision of a *professional service*.¹⁴

If an association is deemed to be a network firm, it is required to comply with the Independence rule with respect to audit or review clients of other network firms.

Alternative Practice Structures – In cases where a CPA firm is part of a larger entity, independence threats extend beyond the CPA firm alone. Non-CPAs who exert significant influence over the larger entity as well as possible client associations with the larger entity must be evaluated for independence as well.

Indemnification of a Covered Member - Threats to compliance with the "Independence Rule" [1.200.001] would be at an *acceptable level* and a *covered member's independence* would not be *impaired* if the *covered member* includes in engagement letters a clause that provides that its *attest client* would release, indemnify, defend, and hold the *covered member* (and the *covered member's partners*, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management.¹⁵

Indemnification of an Attest Client - Threats to compliance with the "Independence Rule" [1.200.001] would not be at an *acceptable level* and could not be reduced to an *acceptable level* by the application of *safeguards* if the *covered member* enters into an agreement providing, among other things, that the *covered member* indemnifies the *attest client* for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to the *attest client's* acts. The *covered member's independence* would be *impaired* under these circumstances.¹⁶

Unpaid Fees - Unpaid fees would impact independence if they remain unpaid for any professional services provided more than one year from the report date. However, unpaid fees from a client in bankruptcy do not violate this rule.

¹⁴ AICPA Code of Professional Conduct

¹⁵ AICPA Code of Professional Conduct

¹⁶ AICPA Code of Professional Conduct

Financial Interests - Independence is impaired if the CPA has (a) a direct financial interest in the client, (b) a material indirect financial interest in the client (c) is a trustee, executor or administrator of a trust or estate that has a direct financial interest in the client or a material indirect financial interest in the client. A direct financial interest is the ownership of stock or other equity shares by a CPA or his immediate family. An indirect financial interest is one which is not directly controlled by the CPA but the CPA is the beneficiary and an independent intermediary controls the investment. A mutual fund would be an example in this case. In determining whether an indirect financial interest is material, it should be measured against the CPA's net worth, including that of his immediate family.

Example situation: A mutual fund with assets of \$5,000,000 has 5% of its assets invested in an attest client. The CPA who audits the attest client owns 2% of the outstanding shares of the mutual fund with a value of \$100,000. The indirect financial interest of the CPA in the mutual fund is \$5,000 ($2\% \times 5\% \times \$5,000,000$). This amount should be measured against the net worth of the CPA and his immediate family to determine if it is material.

The CPA's immediate family and close relatives must be considered when making a determination of independence. Immediate family consists of a spouse, spousal equivalent and/or dependent. Close relatives include the CPA's nondependent children, siblings and parents. If a member of the immediate family or close relative has a key position with the client, independence is impaired. A key position is defined in the "Definitions" section of the AICPA Code of Conduct (0.400.27). If a close relative had a financial interest in the client, it must be evaluated to determine if it is material to the close relative and whether it enabled the close relative to exercise influence over the client.

Note: The rules provide that independence must be in fact. There must be no bias on the part of the professional in rendering an attest opinion. If a CPA had a material financial interest in an entity, the ability to render an objective opinion would be impaired. Having a close relative with a material financial interest in an entity may not impair the CPA's independence in fact. However, there would be an appearance of impairment to the outside public. A reasonable person, with knowledge of the situation, could conclude that the professional in an attest engagement would not be capable of rendering an objective judgment.

Ownership in a joint investment may also impair independence. If the CPA and the client, or a key member of client's management, both have a direct ownership interest in a non-client and the ownership interest to the client or client's management is material, independence is impaired. If the CPA has an indirect ownership investment in a joint investment, then it must be material to the CPA to impair independence.

Example situation: If a CPA owned a vacation home jointly with the officer of a client. Assuming that this investment was material to the officer of the client, it would impair independence as the CPA has a direct financial interest in an entity that is material to the client.

Deposit Accounts – When a CPA audits a financial institution where a deposit account is maintained, a self-interest threat exists. If it is not anticipated that the financial institution will experience any financial difficulties, this threat may be reduced to an acceptable level if the deposit account is fully insured by the FDIC or other similar government agency and the level of uninsured amounts, if any, is immaterial to the net worth of the CPA.

Loans and Leases - A CPA that has an unsecured loan that is not material to his/her net worth, a mortgage loan or other secured loans from a client financial institution client is “grandfathered” if three conditions are met. (1) The loan must have been made under normal lending procedures, terms and requirements. (2) The loan is kept current at all times and the terms have not been altered. (3) The loan was obtained PRIOR to the financial institution becoming a client.

There are also other specifically permitted loans. The most common of these are automobile loans and leases collateralized by the automobile where the loan or lease was obtained under the institution’s normal lending procedures, terms and requirements and is kept current at all times.

Example situation: An accounting firm was engaged to audit the financial statements of a financial institution. A partner in the firm spent approximately 11 hours in connection with the audit and approximately 329 hours in connection with non-audit services. During the audit engagement period, the particular partner purchased a home and sought a mortgage loan through a broker. The broker selected the financial institution that was audited by the partner’s firm to provide the mortgage loan. This was done during a period that was audited by the firm. The partner was charged with violating the AICPA code of professional conduct as he obtained a loan from the financial institution during the period the firm was engaged to audit the financial institution.

For leases, section 1.260.040 was added in 2018 (Effective after December, 2019) and states that a CPA on the attest engagement or one who is in a position to influence the attest engagement or a CPA firm that enters into or renegotiates a lease with an attest client will have independence impaired unless a) The lease is established at arm’s length and on market terms, b) The lease is not material to any parties and c) lease amounts are paid on time and in accordance with the terms of the lease.

For existing leases, 1.260.040 states that a CPA on the attest engagement or one who is in a position to influence the attest engagement or a CPA firm will have independence impaired unless a) the lease was entered into prior to the period of engagement or the party becoming an attest client, b) the lease is not material to the CPA, c) the lease is established at arm’s length and on market terms, and d) lease amounts are paid on time and in accordance with the terms of the lease. The role of the CPA on the attest engagement or with the firm must also be evaluated for threats to compliance.

Current Employment with an Attest Client - An employment association with an attest client or the appearance of an employment association will impair independence. However, if a CPA acts as an adjunct faculty member at a client educational institution, independence may not be impaired if certain conditions are met. Included in these conditions are that the CPA is not a member of the attest team and does not have a key position and is non-tenured. These conditions are fully explained in section 1.275.

Actual or Threatened Litigation - Situations involving threatened or actual litigation are complex and diverse, making it difficult to identify precise points at which *threats* to the *covered member’s* compliance with the “Independence Rule” [1.200.001] would be at an *acceptable level*. There are situations regarding litigation between *covered members* and *attest clients* in which *threats* to the *covered member’s* compliance with the “Independence Rule” would not be at an *acceptable level* and could not be reduced to an *acceptable level* by *safeguards* and *independence* would be *impaired*. Examples of these situations are:

- a. An *attest client's* present management commences litigation alleging deficiencies in audit work performed for the *attest client* or expresses its intention to commence such litigation, and the *covered member* concludes that it is probable that such a claim will be filed.
- b. A *covered member* commences litigation against an *attest client's* present management alleging management fraud or deceit.¹⁷

Nonattest Services - The performance of non-attest services by a CPA is one of the more complex issues surrounding the question of independence. The basic rule is that the CPA should not perform management functions or make management decisions for the attest client. A list of general activities that would impair independence is provided that includes authorizing executing or consummating a transaction, preparing source documents, having custody of client assets, supervising client employees and establishing or maintaining internal controls for a client. Tax compliance services do not impair independence as long as the CPA does not step into the management role. The CPA should not have custody or control over the client's funds and the client must be responsible for reviewing and approving the tax return and related payment and must also sign the return prior to filing.

Note: If the covered member performs services that are construed to be management functions, independence in an attest engagement is impaired. These functions include supervision, check signing, approval, decision making, etc. However, if a covered member's involvement is advisory in nature, independence is not impaired. Advisory functions would include helping to interpret financial statements, attending board meetings, assisting in obtaining bank relationships, etc.

Example situation: A CPA performed an audit of a corporation. During the same year, the CPA created journal entries and coded deposits and disbursements for reporting in the general ledger without the approval of his client. The CPA was charged with violating the Independence rule with respect to independence as he was performing management functions and, in effect, auditing his own work.

Review 1.200 – 1.297.030 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

¹⁷ AICPA Code of Professional Conduct

Chapter 3 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

7. In performing non-attest services, a member may maintain independence by:
 - a. Making management decisions and perform management functions.
 - b. Authorizing transactions on behalf of the client.
 - c. Maintaining and monitoring internal controls.
 - d. Performing tax compliance services in which the client reviews and approves the tax return, signs the return prior to filing and is responsible for any payment.
8. Preparing and transmitting a tax return:
 - a. Will impair a member's independence.
 - b. Will not impair independence as long as the CPA does not have control over the client's funds and a representative of the client reviews and approves the tax return and related payment and signs the tax return prior to its filing.
 - c. Never impairs a member's independence.
 - d. Will not impair independence if only the CPA reviews and approves the return and signs the return.

Rule 1.300 General Standards Rule

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

- A. *Professional Competence*. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- B. *Due Professional Care*. Exercise due professional care in the performance of professional services.
- C. *Planning and Supervision*. Adequately plan and supervise the performance of professional services.
- D. *Sufficient Relevant Data*. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.¹⁸

Competence

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

.02 A member's agreement to perform professional services implies that the member has the necessary competence to complete those services according to professional standards and to apply the member's knowledge and skill with reasonable care and diligence. However, the member does not assume a responsibility for infallibility of knowledge or judgment.

.03 The member may have the knowledge required to complete the services in accordance with professional standards prior to performance. A normal part of providing professional services involves performing additional research or consulting with others to gain sufficient competence.

.04 If a member is unable to gain sufficient competence, the member should suggest, in fairness to the client and public, the engagement of a competent person to perform the needed professional service, either independently or as an associate.¹⁹

Important point: A CPA shall not undertake any engagement for professional services which cannot be expected to be completed with competence and compliance with auditing standards (if applicable), accounting principles and other professional standards.

Case Study – Audit Engagement with No Prior Experience

A CPA undertook an engagement to audit an employee benefit plan. The CPA was unfamiliar with this type of work. As a result, financial reports were misstated and required audit procedures were not performed.

Discussion – The CPA did not possess the requisite competence to undertake the engagement, nor did the CPA obtain the necessary competence as certain procedures were not performed and the financial reports were misstated. In this case, the CPA should have declined the engagement. By taking the engagement, the CPA violated the General Standards rule.

¹⁸ AICPA Code of Professional Conduct

¹⁹ AICPA Code of Professional Conduct

1.310 Compliance with Standards Rule

A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.²⁰

The following are designated to promulgate standards:

- Federal Accounting Standards Advisory Board (FASAB)
- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- Public Company Accounting Oversight Board (PCAOB)
- International Accounting Standards Board (IASB)
- Accounting and Review Services Committee (ARSC)
- Auditing Standards Board (ASB)
- Management Consulting Services Executive Committee
- Tax Executive Committee (TEC)
- Forensic and Valuation Services Executive Committee

Case Study – Peer Review Discoveries

A CPA audits the financial statements of an entity and issues an unqualified audit report. Peer review notes that the CPA failed to (a) Document all procedures performed and conclusions reached, (b) Obtain a representation letter, (c) Obtain adequate evidence, (d) Perform alternative procedures with respect to accounts receivable confirmations mailed with no reply, (e) Gain an understanding of internal controls in planning the audit, and (f) Document the reasons for not recording certain valuation allowances.

Did the CPA comply with Professional Standards?

Did the CPA comply with Professional Standards if he/she only failed to obtain a representation letter?

Discussion –The CPA did not comply with GAAS and violated professional standards. All of these steps are required to comply with the Compliance with Standards Rule.

1.320 Accounting Principles Rule

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

²⁰ AICPA Code of Professional Conduct

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.²¹

This rule requires that in forming an opinion, GAAP must be followed and any departure from GAAP must be justified. GAAP is considered to be any statement by an authoritative body designated by the AICPA. It is incumbent on the auditor to ensure that the financial statements on which an opinion is being rendered comply with GAAP. The following bodies are designated by the Council to promulgate accounting principles:

- Federal Accounting Standards Advisory Board (FASAB)
- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- International Accounting Standards Board (IASB)

Review 1.300-1.320.040 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

1.400.001 Acts Discreditable Rule

A member shall not commit an act discreditable to the profession.²²

Acts discreditable include:

- Discrimination or harassment in the workplace
- Solicitation or disclosure of CPA Examination questions and answers
- Failure to file a tax return or pay a tax liability
- Negligence in the preparation of financial statement or records
- Failure to follow government auditing standards in addition to generally accepted auditing standards
- Disclosure of confidential information acquired as a result of employment or volunteer relationships without proper authority or consent unless there is a legal or professional responsibility to disclose
- False, misleading or deceptive acts in promoting or marketing professional services
- Use of the CPA credential in a manner that is false, misleading, or deceptive
- Improper retention of client records when requested by the client

Most of these rules are self-explanatory. There are some more complex issues surrounding client records, though. If a client requests his records, a CPA should respond as follows:

Records provided by the client should be returned. It does not matter if there are outstanding engagement fees due to the CPA.

Records prepared by the CPA and supporting records should be provided if they are complete or the work product has been completed. These records would include information not in the client's records without which, the client's financial information is incomplete. Examples of

²¹ AICPA Code of Professional Conduct

²² AICPA Code of Professional Conduct

these records are adjusting, closing, or consolidating journal entries along with supporting computations. These records may be withheld if there are fees due related to the preparation of the records.

A CPA's work papers, which include audit programs, analytical review, results of statistical sampling and analysis, are the property of the CPA and do not need to be provided to the client.

Example situation: An audit client of a CPA firm changed auditing firms. They demand the CPA firm work papers which include audit programs and planning documents to help prospective audit firms prepare a bid for the engagement. The CPA firm refuses and prevails because it is the owner of the work papers and these do not need to be provided to the client.

Review 1.400-1.400.240 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

1.510.001 Contingent Fees Rule

1.510.001 - A member in public practice shall not

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

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

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

A member's fees may vary depending, for example, on the complexity of services rendered.²³

²³ AICPA Code of Professional Conduct

Contingent fees are those that are dependent upon and determined by a certain result. CPAs may not accept contingent fees related to attest engagements nor may a CPA accept any contingent fees for any service from an attest client except for specific tax services noted below. In general, a CPA may not charge a contingent fee for tax return preparation or amendment of a tax return for inadvertent omissions of data. There are specific examples in tax matters where a contingent fee is appropriate, even for an attest client. These examples generally revolve around the expectation that the issue at hand is subject to interpretation by a governmental agency or court. Specific examples include filing an amended return that is the subject of a test case (for another taxpayer) or is in respect to an issue for which the taxing authority is developing a position, protesting an assessed value of property and obtaining a private letter ruling.

Example situation: A CPA firm with a tax client, who is also an attest client, enters into a contingent fee arrangement to protest a property valuation for local property taxes. This is an acceptable contingent fee arrangement.

Example situation: A CPA firm with an audit client charges a contingent fee to the client for providing investment advisory services. This is a prohibited contingent fee arrangement.

1.520.001 Commissions and referral fees Rule

A. *Prohibited commissions*

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

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

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

B. *Disclosure of permitted commissions*

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

C. *Referral fees*

Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.²⁴

CPAs are prohibited from receiving commissions from a client when they perform attest functions for the client, compile financial information without disclosure of a lack of

²⁴ AICPA Code of Professional Conduct

independence or examine prospective financial information. If a CPA receives a permitted commission or referral fee, he must disclose the fee to the client or the person/entity to whom the compensation relates. Effective January 31, 2017, this disclosure must be in writing under 1.520.080.

Example situation: A CPA firm with a tax client, who is not an attest client, receives a commission from a software company for recommending new tax software to the client. Assuming appropriate disclosure of the commission to the client, this is permitted.

Review 1.500-1.520.080 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

1.600.001 Advertising and other forms of solicitation

A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching, or harassing conduct is prohibited.²⁵

The Interpretation of this rule offers four specific examples of unacceptable advertising or other forms of solicitation. They are advertising which:

- Creates false or unjustified expectations of favorable results
- Implies the ability to influence a court, regulatory agency or some similar body
- Represents that a service or future service will be performed for a stated fee when it is likely that the fee will be increased
- Contains representations that would cause a reasonable person to misunderstand or be deceived

Example situation: A CPA firm advertises that “We will lower your taxes.” This is unacceptable as it implies a guarantee of favorable results.

Use of the CPA Credential - A member should refer to applicable state accountancy laws and board of accountancy rules and regulations for guidance regarding the use of the CPA credential. A member who fails to follow the accountancy laws, rules, and regulations on use of the CPA credential in any of the jurisdictions in which the CPA practices would be considered to have used the CPA credential in a manner that is false, misleading, or deceptive and in violation of the “Advertising and Other Forms of Solicitation Rule.”²⁶

Review 1.600-1.600.100 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

1.700.001 Confidential client information rule

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

²⁵ AICPA Code of Professional Conduct

²⁶ AICPA Code of Professional Conduct

This rule shall not be construed (1) to relieve a member of his or her professional obligations under the Compliance with Standards Rule 1.310.001 and the Accounting Principles Rule 1.320.001 to affect in any way the member's obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member's compliance with applicable laws and government regulations, (3) to prohibit review of a member's professional practice under AICPA or state CPA society or Board of Accountancy authorization, or (4) to preclude a member from initiating a complaint with, or responding to any inquiry made by, the professional ethics division or trial board of the Institute or a duly constituted investigative or disciplinary body of a state CPA society or Board of Accountancy.

Members of any of the bodies identified in (4) above and members involved with professional practice reviews identified in (3) above shall not use to their own advantage or disclose any member's confidential client information that comes to their attention in carrying out those activities. This prohibition shall not restrict members' exchange of information in connection with the investigative or disciplinary proceedings described in (4) above or the professional practice reviews described in (3) above.²⁷

A CPA should obtain the consent of the client before disclosing any confidential client information. There are 3 general exceptions within the rule: (1) compliance and ethics inquiries made by a recognized investigative or disciplinary body, (2) subpoenas or summons enforceable by court order, and (3) peer review.

Note that the prohibition specifically relates to confidential information. It is permissible to name clients for whom a CPA provided services as long as the disclosure does not release any confidential information. As an example, if a CPA whose practice is limited to bankruptcy matters reveals the client's name, it would suggest that the client is experiencing financial difficulties, a piece of confidential information.

Questions have arisen regarding the use of third party service providers and revealing client information to prospective purchasers of a CPA's firm. In both instances, a confidentiality agreement or other appropriate precautions should be used prior to revealing confidential client information. When a third party service provider is used, the CPA must also be reasonably assured that there are appropriate procedures in place to prevent the unauthorized release of confidential client information. In the case of a third party service provider, if a confidentiality agreement is not obtained, specific client consent should be obtained prior to releasing confidential client information.

The CPA may defend himself against actual or threatened litigation by a client. The rules are not designed to prevent a CPA from releasing information to a liability insurance carrier, an attorney representing the CPA or a court of law.

1.700.110 was added in December 2018 to address concerns over third party quality reviews of a member's tax practice. Treasury Regulation 301.7216-2(p) must be satisfied in these cases.

²⁷ AICPA Code of Professional Conduct

Loss of confidential client data through theft of a laptop computer or computer “hackers” is an area not specifically addressed in the Interpretations. The CPA should note that a majority of states have passed laws requiring companies to notify consumers whose personal information has been compromised. Most of these data breach disclosure laws are strict and include civil or criminal penalties as well as private right of action in a court of law. Many of the states that have enacted these laws provide exemptions from the notification requirements if the data is encrypted.

Review 1.700-1.700.500 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

1.800.001 Form of organization and name rule

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

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

A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its CPA owners are members of the Institute.²⁸

CPA firms must be owned by a majority of licensed CPAs if they are to provide traditional attest functions. Any entity that holds itself out to be a CPA firm must also be owned by a majority of CPAs. The CPA firm name may not include the name of any non-CPA. This ensures that the public is not misled.

Example situation: A CPA firm is comprised of Smith, Jones, Adams and Wallace. Smith, Jones and Adams are all CPAs. Wallace is not a CPA. A firm name of Smith, Jones, Adams, Wallace, CPAs would not be permitted as it includes the name of a non-CPA.

Review 1.800-1.820.030 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

²⁸ AICPA Code of Professional Conduct

Chapter 3 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

9. If a CPA uses a third party service provider, before releasing confidential client information to the service provider, the CPA should:
 - a. Enter into a confidentiality agreement with the service provider and obtain reasonable assurance that the service provider has procedures in place to prevent the release of confidential client information to others.
 - b. Inform the client of the intent to use a third party service provider.
 - c. Never use a third party service provider.
 - d. Perform an audit of the third party service provider's controls and render an opinion as to their adequacy.
10. A CPA may use a contingent fee arrangement for:
 - a. An audit of financial statements.
 - b. Preparation of a tax return.
 - c. Obtaining a private letter ruling from the IRS.
 - d. An examination of prospective financial information.
11. When a client requests that his records be returned and the engagement is complete and all related fees have been paid, the CPA is not obligated to return:
 - a. Records provided by the client.
 - b. Records prepared by the CPA without which, the client's financial information is incomplete.
 - c. Supporting records related to the work product.
 - d. The CPA's working papers.

Part 2 – Members in Business

The conceptual framework for members in business also provides a methodology to identify and mitigate ethical issues not covered by specific rules and interpretations. Like the framework for members in public practice, this approach is intended to identify and evaluate threats to compliance with ethical standards for those members in business and then provide safeguards to ensure that the threat(s) are reduced to an acceptable level. An acceptable level is that which an informed and reasonable third party would conclude that compliance with the rules is not compromised. As with members in public practice, this methodology is only used in instances not specifically covered by rules and interpretations.

Conceptual Framework Approach

.06 Under the conceptual framework approach, *members* should identify *threats* to compliance with the rules and evaluate the significance of those *threats*. *Members* should evaluate identified *threats* both individually and in the aggregate because *threats* can have a cumulative effect on a *member's* compliance with the rules. *Members* should perform three main steps in applying the conceptual framework approach:

- a. *Identify threats.* The relationships or circumstances that a *member* encounters in various engagements and work assignments or positions will often create different *threats* to complying with the rules. When a *member* encounters a relationship or circumstance that is not specifically addressed by a rule or an *interpretation*, under this approach, the *member* should determine whether the relationship or circumstance creates one or more *threats*, such as those identified in paragraphs .09–.14 that follow. The existence of a *threat* does not mean that the *member* is in violation of the rules; however, the *member* should evaluate the significance of the *threat*.
- b. *Evaluate the significance of a threat.* In evaluating the significance of an identified *threat*, the *member* should determine whether a *threat* is at an *acceptable level*. A *threat* is at an *acceptable level* when a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat* would not compromise the *member's* compliance with the rules. *Members* should consider both qualitative and quantitative factors when evaluating the significance of a *threat*, including the extent to which existing *safeguards* already reduce the *threat* to an *acceptable level*. If the *member* evaluates the *threat* and concludes that a reasonable and informed third party who is aware of the relevant information would be expected to conclude that the *threat*
c. does not compromise a *member's* compliance with the rules, the *threat* is at an *acceptable level* and the *member* is not required to evaluate the *threat* any further under this conceptual framework approach.
- d. *Identify and apply safeguards.* If, in evaluating the significance of an identified *threat*, the *member* concludes that the *threat* is not at an *acceptable level*, the *member* should apply *safeguards* to eliminate the *threat* or reduce it to an *acceptable level*. The *member* should apply judgment in determining the nature of the *safeguards* to be applied because the effectiveness of *safeguards* will vary depending on the circumstances. When identifying appropriate *safeguards* to apply, one *safeguard* may eliminate or reduce multiple *threats*. In some cases, the *member* should apply multiple *safeguards* to eliminate or reduce one *threat* to an *acceptable level*. In other cases, an identified *threat* may be so significant that no *safeguards* will eliminate the *threat* or reduce it to an

acceptable level, or the *member* will be unable to implement effective *safeguards*. Under such circumstances, providing the specific *professional services* would compromise the *member's* compliance with the rules, and the *member* should determine whether to decline or discontinue the *professional services* or resign from the *employing organization*.

Threats

.07 Many *threats* fall into one or more of the following six broad categories: adverse interest, advocacy, familiarity, self-interest, self-review, and undue influence.

.08 Examples of *threats* associated with a specific relationship or circumstance are identified in the *interpretations* of the code. Paragraphs .09–.14 of this section define and provide examples, which are not all inclusive, of each of these *threat* categories.

.09 *Adverse interest threat*. The *threat* that a *member* will not act with objectivity because the *member's* interests are opposed to the interests of the *employing organization*. Examples of adverse interest *threats* include the following:

- a. A *member* has charged, or expressed an intention to charge, the *employing organization* with violations of law.
- b. A *member* or the *member's immediate family* or *close relative* has a financial or another relationship with a vendor, customer, competitor, or potential acquisition of the *employing organization*.
- c. A *member* has sued or expressed an intention to sue the *employing organization* or its officers, directors, or employees.

.10 *Advocacy threat*. The *threat* that a *member* will promote an *employing organization's* interests or position to the point that his or her objectivity is compromised. Examples of advocacy *threats* include the following:

- a. Obtaining favorable financing or additional capital is dependent upon the information that the *member* includes in, or excludes from, a prospectus, an offering, a business plan, a financing application, or a regulatory filing.
- b. The *member* gives or fails to give information that the *member* knows will unduly influence the conclusions reached by an external service provider or other third party.

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

- a. A *member* uses an *immediate family's* or a *close relative's* company as a supplier to the *employing organization*.
- b. A *member* may accept an individual's work product with little or no review because the individual has been producing an acceptable work product for an extended period of time.
- c. A *member's immediate family* or *close relative* is employed as a *member's* subordinate.
- d. A *member* regularly accepts gifts or entertainment from a vendor or customer of the *employing organization*.

.12 Self-interest threat. The *threat* that a *member* could benefit, financially or otherwise, from an interest in, or relationship with, the *employing organization* or persons associated with the *employing organization*.

Examples of self-interest *threats* include the following:

- a. A *member's* immediate family or close relative has a *financial interest* in the *employing organization*.
- b. A *member* holds a *financial interest* (for example, shares or share options) in the *employing organization*, and the value of that *financial interest* is directly affected by the *member's* decisions.
- c. A *member* is eligible for a profit or other performance-related bonus, and the value of that bonus is directly affected by the *member's* decisions.

.13 Self-review threat. The *threat* that a *member* will not appropriately evaluate the results of a previous judgment made or service performed or supervised by the *member*, or an individual in the *employing organization* and that the *member* will rely on that service in forming a judgment as part of another service.

Examples of self-review *threats* include the following:

- a. When performing an internal audit procedure, an internal auditor accepts work that he or she previously performed in a different position.
- b. The *member* accepts the work previously performed by the *member*, alone or with others, that will be the basis for providing another *professional service*.

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

- a. A *member* is pressured to become associated with misleading information.
- b. A *member* is pressured to deviate from a company policy.
- c. A *member* is pressured to change a conclusion regarding an accounting or a tax position.
- d. A *member* is pressured to hire an unqualified individual.

Safeguards

.15 Safeguards may partially or completely eliminate a *threat* or diminish the potential influence of a *threat*.

The nature and extent of the *safeguards* applied will depend on many factors. To be effective, *safeguards* should eliminate the *threat* or reduce it to an *acceptable level*.

.16 Safeguards that may eliminate a *threat* or reduce it to an *acceptable level* fall into two broad categories:

- a. *Safeguards* created by the profession, legislation, or regulation
- b. *Safeguards* implemented by the *employing organization*

.17 The effectiveness of a *safeguard* depends on many factors, including those listed here:

- a. The facts and circumstances specific to a particular situation
- b. The proper identification of *threats*
- c. Whether the *safeguard* is suitably designed to meet its objectives
- d. The party(ies) who will be subject to the *safeguard*
- e. How the *safeguard* is applied
- f. The consistency with which the *safeguard* is applied
- g. Who applies the *safeguard*
- h. How the *safeguard* interacts with a *safeguard* from another category
- i. Whether the *employing organization* is a *public interest entity*

.18 Examples of *safeguards* within each category are presented in the following paragraphs. Because these are only examples and are not intended to be all inclusive, it is possible that *threats* may be sufficiently mitigated through the application of other *safeguards* not specifically identified herein.

.19 The following are examples of *safeguards* created by the profession, legislation, or regulation:

- a. Education and training requirements on ethics and professional responsibilities
- b. Continuing education requirements on ethics
- c. Professional standards and the threat of discipline
- d. Legislation establishing prohibitions and requirements for entities and employees
- e. Competency and experience requirements for professional licensure
- f. Professional resources, such as hotlines, for consultation on ethical issues

.20 Examples of *safeguards* implemented by the *employing organization* are as follows:

- a. A tone at the top emphasizing a commitment to fair financial reporting and compliance with applicable laws, rules, regulations, and corporate governance policies
- b. Policies and procedures addressing ethical conduct and compliance with laws, rules, and regulations
- c. Audit committee charter, including independent audit committee members
- d. Internal policies and procedures requiring disclosure of identified interests or relationships among the *employing organization*, its directors or officers, and vendors, suppliers, or customers
- e. Internal policies and procedures related to purchasing controls
- f. Internal policies and procedures related to customer acceptance or credit limits
- g. Dissemination of corporate ethical compliance policies and procedures, including whistle-blower hotlines, the reporting structure, dispute resolution, or other similar policies, to promote compliance with laws, rules, regulations, and other professional requirements
- h. Human resource policies and procedures *safeguarding* against discrimination or harassment, such as those concerning a worker's religion, sexual orientation, gender, or disability
- i. Human resource policies and procedures stressing the hiring and retention of technically competent employees
- j. Policies and procedures for implementing and monitoring ethical policies
- k. Assigning sufficient staff with the necessary competencies to projects and other tasks
- l. Policies segregating personal assets from company assets

- m. Staff training on applicable laws, rules, and regulations
- n. Regular monitoring of internal policies and procedures
- o. A reporting structure whereby the internal auditor does not report to the financial reporting group
- p. Policies and procedures that do not allow an internal auditor to monitor areas where the internal auditor has operational or functional responsibilities
- q. Policies for promotion, rewards, and enforcement of a culture of high ethics and integrity
- r. Use of third-party resources for consultation as needed on significant matters of professional judgment.²⁹

Safeguards must be evaluated to ensure that they are effective. This evaluation is dependent on each specific situation. A particular safeguard is not always effective in every circumstance. This methodology is only used in instances not specifically covered by rules and interpretations. It provides a conceptual framework to evaluate compliance in those situations where there is no applicable rule or interpretation.

Section 2.000.020 addresses those situations in which member's ethical obligations may conflict. If the conflict remains unresolved, the member should consider whether to continue his or her relationship with the particular assignment or employer.

2.100.001 Integrity and Objectivity Rule

In the performance of any professional service, a member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.³⁰

Objectivity refers to being unbiased and not influenced by personal prejudices. A CPA must maintain an impartial attitude in the performance of professional responsibilities. Integrity refers to the CPA's adherence to an ethical code which requires the CPA to be honest and not subordinate his judgment to personal gain.

In applying the Integrity and Objectivity rule, in the absence of a related interpretation of the rule, the conceptual framework is utilized for assessing the relationship or circumstance and the appropriate safeguard that is used to reduce compliance threats to a minimum of an acceptable level.

Conflicts of interest are created when the CPA has an interest or relationship that may threaten the CPA's integrity and objectivity. Both actual and apparent conflicts of interest must be avoided so that there is no question that an objective examination of the financial statements has been performed and that they may be relied upon. Adequate safeguards should be put in place to ensure that all threats to a CPA's integrity and objectivity are reduced to an acceptable level. When a conflict of interest exists, even if there are appropriate safeguards in place to reduce the threat to an acceptable level, the CPA should disclose the existence of the conflict to the employing organization and other appropriate parties to the conflict and obtain their consent to perform the contemplated professional services. This disclosure should be made even if the

²⁹ AICPA Code of Professional Conduct

³⁰ AICPA Code of Professional Conduct

threats are reduced to an acceptable level. A member is encouraged to document the conflict of interest, the safeguards employed to reduce any threats to an acceptable level and also document the disclosure and consent obtained.

One of the most common ethics violations by a CPA in business relates to subordination of judgment.

Example situation: A CPA who was the controller and chief financial officer of a public company backdated shipping documents and then signed the management representation letter stating that the financial statements were prepared in conformity with GAAP. This individual was charged with violating the Integrity and Objectivity Rule 2.100.001, specifically a departure from 2.130.010, Knowing misrepresentations in the preparation of financial statements or records as well as 2.130.020, Subordination of judgment by a member.

Example situation: A CPA who was chief financial officer of a financial institution did not correct customer loans that were altered to appear current by deferring payment due dates. This CPA signed the form 10-K knowing that the financial statements were materially misstated. This individual was charged with violating the Integrity and Objectivity Rule, specifically a departure from 2.130.010, Knowing misrepresentations in the preparation of financial statements or records and 2.130.030, Obligations of a member to his or her employer's external accountant.

2.130.030 Obligation of a Member to His or Her Employer's External Accountant

.01 The "Integrity and Objectivity Rule" [2.100.001] requires a member to maintain objectivity and integrity in the performance of a professional service. When dealing with an employer's external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which the employer's external accountant requests written representation.³¹

2.170.010 – Pressure to Breach the Rules

This interpretation discusses pressures that could cause a member to breach the rules. Threats to breach the rules, particularly the integrity and objectivity rule, may come from employers and other interests. In addressing these issues, the member should evaluate the pressure and identify any safeguards. If the pressure to breach the integrity and objectivity rule has not been eliminated, the member should decline the professional activity or consider whether to continue the employment relationship.

Review 2.100-2.170.010 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Case Study – Fair Finance

Fair Finance, an Ohio finance company, was purchased by Tim Durham and James Cochran in 2002. Fair financed its receivable portfolio with interest bearing investment certificates issued to residents of Ohio under an Ohio program that permitted these securities as long as the issuer reported financial information and qualified with the Ohio Division of Securities. Rick D. Snow, CPA was hired as Chief Financial Officer. According to a federal indictment, Durham and Cochran were using the proceeds of the investment certificates, approximately \$200 million, to fund their lavish lifestyle as well as other failing business ventures. The \$200 million was lent to

³¹ AICPA Code of Professional Conduct

Durham and Cochran by Fair Finance. The indictment also states that “Durham, Cochran and Snow falsely represented, in registration documents and offering circulars submitted to the Ohio Division of Securities and in offering circulars distributed to investors, that the loans on Fair’s books and assets that could support Fair’s sale of investment certificates when they knew in reality that the loans were worthless or grossly overvalued, producing little or no cash proceeds, supported by insufficient or nonexistent collateral to assure repayment and in part advances, salaries and lines of credit for Durham and Cochran’s personal expenses.” In 2005, a CPA firm warned Durham, Cochran and Snow about loans for personal use and to failing businesses. It informed them that the loans had insufficient collateral and were impaired. The resolution of the matter was to fire the CPA firm and provide unaudited information to the Ohio Division of Securities. While Snow never took part in the scheme to fund his lifestyle with investor money nor was it asserted that he took any investor money, other than his salary, Snow was indicted along with Durham and Cochran. Durham was sentenced to 50 years in prison, Cochran was sentenced to 25 years in prison and Snow was sentenced to 10 years in prison.

What were the threats that Rick Snow should have considered?

Which rules did he violate?

Discussion – Snow did not consider the threats of advocacy, familiarity, undue influence, and self-interest. Rather than confront these issues or evaluate them, he continued his participation by attesting to materially false financial information. The appropriate course of action would have been to evaluate the threats and, if the inappropriate activities continued, to withdraw his association with the company.

Snow violated the Integrity and Objectivity Rule as well as the General Standards Rule requiring Due Professional Care. He also violated the Accounting Principles Rule as he attested to misleading financial information.

2.300.001 General standards rule

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

- A. *Professional Competence.* Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- B. *Due Professional Care.* Exercise due professional care in the performance of professional services.
- C. *Planning and Supervision.* Adequately plan and supervise the performance of professional services.
- D. *Sufficient Relevant Data.* Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.³²

Note that 2.300.001 requires Professional Competence. While this can be obtained through education or other means, a CPA may not perform work for which he does not have the requisite skills.

³² AICPA Code of Professional Conduct

2.310.001 Compliance with standards rule

A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.³³

2.320.001 Accounting principles rule

A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that has a material effect on the statements or data taken as a whole. If, however, the statements or data contain such a departure and the member can demonstrate that due to unusual circumstances the financial statements or data would otherwise have been misleading, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons why compliance with the principle would result in a misleading statement.³⁴

GAAP is considered to be any statement by an authoritative body designated by the AICPA. The following bodies are designated by the Council to promulgate technical standards under Rule 203:

- Federal Accounting Standards Advisory Board (FASAB)
- Financial Accounting Standards Board (FASB)
- Governmental Accounting Standards Board (GASB)
- International Accounting Standards Board (IASB)

The accounting principles rule does not mandate the use of GAAP. Financial statements may be prepared by members in business using frameworks other than GAAP as long as the financial statements or reports do not purport to be in accordance with GAAP.

Review 2.300-2.320.040 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Case Study - The Company with Excess Reserves

A private company was having a great year. It was so good, that management was worried that next year may be perceived as bad by comparison. A large bank line would be up for renewal at the end of the following year and the perception that the company was not performing as well could jeopardize the renewal of the bank line.

When the CFO brought up this concern, the President and company founder asked if anything could be done to “shift” some profits from one year to the next. After some thought, the CFO indicated that the company had a number of reserve accounts that had some element of judgment

³³ AICPA Code of Professional Conduct

³⁴ AICPA Code of Professional Conduct

to them. One of these was the Allowance for Bad Debts, another was a reserve for product liability while another was a product warranty reserve.

The CFO explained that the CPAs who audited the books generally audited for understatement of these reserves. Overstatement, as long as it was not too great, would likely not be a large concern. By added some extra to these reserve accounts, then reversing it in the subsequent year, the goal of shifting profits from one year to the next would be accomplished. The amount of profit “shifted” was material to the financial statements.

What are the threats in this case?

Which rules were violated?

What is your responsibility to your auditors?

Discussion – The principle threat in this case is advocacy. The threats of self-interest, familiarity, and undue influence may also play a part, but this is not definite from the facts presented in the case. The CFO is promoting the President’s position to the extent that his objectivity has been compromised.

Many aspects of financial statement preparation involve the use of judgment. CPAs must use their best professional judgment in establishing reserves and valuation allowances. In this case, there is no evidence that the CFO is establishing higher reserves from an objective evaluation of facts and circumstances and employing conservatism. Rather, the CFO is consciously plotting to reduce income in the current year so that the subsequent year will look better. The rules violated are the Integrity and Objectivity Rule (knowing misrepresentations in the preparation of financial statements), General Standards Rule and Accounting Principles Rule.

Part of Integrity and Objectivity is 2.130.030 – Obligation of a member to his or her employer’s external accountant. This states that when dealing with an employer’s external accountant, a CPA must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts.

Case Study - The Company with Undisclosed/Unrecorded Contingencies

A company was wrapping up the year-end financial statements and was barely passing certain bank loan covenants. The operations executive announces to the president and the CFO that they just discovered a flaw in an assembly process that impacted the last month of shipments from the prior year. He anticipates that at least 20% of this product will be returned as defective. The 20% is material to the financial statements as well as the company’s ability to meet its loan covenants.

The president asks the operations executive whether anyone else has been informed. The president is told that no one else knows except for a few people on the engineering staff and one line supervisor.

The president tells the operations executive to make sure that the engineers and supervisor keep their mouth shut and to not tell anyone else. He then asks the CFO, “You didn’t hear that, right?”

The CFO says that as far as he is concerned, the prior year is finished and any defective product will have to be handled in the current year as a charge to the warranty reserve.

What is the CFO's ethical obligation in this case?

Discussion – The Integrity and Objectivity Rule (knowing misrepresentations in the preparation of financial statements), General Standards Rule, and Accounting Principles Rule all require that the facts regarding defective product must be recognized in the financial statements related to the prior year. The CFO has succumbed to the threats of undue influence and advocacy and, in doing so, has violated the ethical standards of the profession.

2.400.001 Acts Discreditable Rule

A member shall not commit an act discreditable to the profession.³⁵

Acts discreditable include:

- Discrimination or harassment in the workplace
- Solicitation or disclosure of CPA Examination questions and answers
- Failure to file a tax return or pay a tax liability
- Negligence in the preparation of financial statements or records
- Use of the CPA credential in a manner that is false, misleading or deceptive

Negligence in the preparation of financial statements or records includes any of the following:

- a. Makes, or permits or directs another to make, materially false and misleading entries in the *financial statements* or records of an entity.
- b. Fails to correct an entity's *financial statements* that are materially false and misleading when the *member* has the authority to record an entry.
- c. Signs, or permits or directs another to sign, a document containing materially false and misleading information.³⁶

Example situation: A CPA is so busy that she forgets to file her taxes. This is a violation of 2.400.001 for failure to file a tax return or pay a tax liability.

2.400.070 Confidential Information from employment or volunteer activities

.05 A *member* would be considered in violation of the “Acts Discreditable Rule” [2.400.001] if the *member* discloses or uses any confidential employer information acquired as a result of employment or volunteer relationships without the proper authority or specific consent of the employer or organization for whom the *member* may work in a volunteer capacity, unless there is a legal or professional responsibility to use or disclose such information.

.06 The following are examples of situations in which *members* are permitted or may be required to disclose confidential employer information or when such disclosure may be appropriate:

- a. Disclosure is permitted by law and authorized by the employer.
- b. Disclosure is required by law, for example, to
 - i. comply with a validly issued and enforceable subpoena or summons or

³⁵ AICPA Code of Professional Conduct

³⁶ AICPA Code of Professional Conduct

- ii. inform the appropriate public authorities of violations of law that have been discovered.
- c. There is a professional responsibility or right to disclose information, when not prohibited by law, to
 - i. 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;
 - ii. protect the *member's* professional interests in legal proceedings;
 - iii. comply with professional standards and other ethics requirements; or
 - iv. report potential concerns regarding questionable accounting, auditing, or other matters to the employer's confidential complaint hotline or *those charged with governance*.
- d. Disclosure is permitted on behalf of the employer to
 - i. obtain financing with lenders;
 - ii. communicate with vendors, *clients*, and customers; or
 - iii. communicate with the employer's external accountant, attorneys, regulators, and other business professionals.³⁷

Review 2.400 – 2.400.100 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

Part 3 – Other Members

Other members are those not in public practice and those not in business. This may be CPAs who are retired or currently unemployed.

3.400.001 Acts discreditable rule

A member shall not commit an act discreditable to the profession.³⁸

Acts discreditable include:

- Discrimination or harassment in the workplace
- Solicitation or disclosure of CPA Examination questions and answers
- Failure to file a tax return or pay a tax liability
- Use of the CPA credential in a manner that is false, misleading, or deceptive

3.400.070 Confidential Information from employment or volunteer activities

.05 A *member* would be considered in violation of the “Acts Discreditable Rule” [3.400.001] if the *member* discloses or uses any confidential employer information acquired as a result of employment or volunteer relationships without the proper authority or specific consent of the employer or organization for whom the *member* may work in a volunteer capacity, unless there is a legal or professional responsibility to use or disclose such information.

³⁷ AICPA Code of Professional Conduct

³⁸ AICPA Code of Professional Conduct

.06 The following are examples of situations in which *members* are permitted or may be required to disclose confidential employer information or when such disclosure may be appropriate:

- a. Disclosure is permitted by law and authorized by the employer.
- b. Disclosure is required by law, for example, to
 - i. comply with a validly issued and enforceable subpoena or summons or
 - ii. inform the appropriate public authorities of violations of law that have been discovered.
- c. There is a professional responsibility or right to disclose information, when not prohibited by law, to
 - i. 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;
 - ii. protect the *member's* professional interests in legal proceedings;
 - iii. comply with professional standards and other ethics requirements; or
 - iv. report potential concerns regarding questionable accounting, auditing, or other matters to the employer's confidential complaint hotline or *those charged with governance*.
- d. Disclosure is permitted on behalf of the employer to
 - i. obtain financing with lenders;
 - ii. communicate with vendors, *clients*, and customers; or
 - iii. communicate with the employer's external accountant, attorneys, regulators, and other business professionals.³⁹

Review 3.000 – 3.400.100 at <http://pub.aicpa.org/codeofconduct/Ethics.aspx> or download a pdf file version at <http://www.aicpa.org/RESEARCH/STANDARDS/CODEOFCONDUCT/Pages/default.aspx> and scroll down to pdf versions available for download.

³⁹ AICPA Code of Professional Conduct

Chapter 3 – Review Questions

The review questions accompanying this course are designed to assist you in achieving the course learning objectives. The review section is not graded; do not submit it in place of your qualified assessment. While completing the review questions, it may be helpful to study any unfamiliar terms in the glossary in addition to course content. After completing the review questions, proceed to the review question answers and rationales.

12. Which of the following are appropriate ethical safeguards for a CPA in industry?
- a. Weak internal controls.
 - b. Open door policy that encourages the reporting of ethical issues.
 - c. Leadership that states that goals must be achieved at any cost.
 - d. Peer review.

Review Question Answers and Rationales

Review question answer choices are accompanied by unique, logical reasoning (rationales) as to why an answer is correct or incorrect. Evaluative feedback to incorrect responses and reinforcement feedback to correct responses are both provided.

Chapter 1

1. What is the difference between morals and ethics?
 - a. Incorrect. Morals are individual values of what is right and wrong. Ethics are established by a society or group to tell members what is right and wrong.
 - b. Incorrect. Individual moral views may differ significantly from ethical views. Use the examples of lying to get out of a traffic ticket or not pointing out that a restaurant bill is understated.
 - c. **Correct. Morals represent individual values that help people decide what is right and wrong. Ethics are a framework of values established by society or a group.**
 - d. Incorrect. Ethics are a set of rules established by society.
2. How many CE hours in the past two years must be in accounting and auditing if the CPA audits financial statements and wants to renew her license?
 - a. Incorrect. If a California CPA audits financial statements, there is a 24 hour accounting and auditing CE requirement. There is also a 4 hour fraud CE requirement.
 - b. **Correct. 24 CE hours must be in accounting and auditing if the CPA audits financial statements.**
 - c. Incorrect. 40 hours is the total technical subject area CE requirement applicable to all California CPAs. While accounting and auditing is considered one of many technical subject areas, the specific requirement for a California CPA who audits financial statements is 24 hours of CE in accounting and auditing.
 - d. Incorrect. 2 hours represents the CE hours of the required regulatory review course. This course is required every 6 years and applies to all CPAs, not just those who audit financial statements.
3. Which of the following best describes the undue influence threat?
 - a. **Correct. Perform an unethical act or lose your job represents an undue influence of another over a CPA.**
 - b. Incorrect. Promoting a client or employers position to the point that objectivity is compromised is more descriptive of the advocacy threat.
 - c. Incorrect. A long or close relationship that causes a CPA to become too sympathetic to the client or employer's interest is more descriptive of the familiarity threat.
 - d. Incorrect. The CPAs interests are in opposition to the client or employer is more descriptive of the adverse interest threat.

Chapter 2

4. A CPA receives a commission for the sale of software to a client. Is the commission permissible?
- a. Incorrect. A commission is never permissible. California Accountancy Act, section 5061, does permit the acceptance of a commission under certain circumstances. These circumstances are generally that no audit, review, compilation (expected that a third party will use the financial statements and lack of independence is not disclosed) or examination of prospective financial information services are being performed for the client in question, the commission is properly disclosed and the commission relates to professional services.
 - b. Incorrect. Commissions are only permissible if related to the purchase of an accounting practice. California Accountancy Act, section 5061, does not prohibit payments for the purchase of any accounting practice. However, there are other situations in which the acceptance of a commission is permissible. These include clients for whom no audit, review, compilation (expected that a third party will use the financial statements and lack of independence is not disclosed) or examination of prospective financial information services are being performed, the commission is properly disclosed and the commission relates to professional services.
 - c. **Correct. Under California Accountancy Act, section 5061, it is permissible if the CPA does not provide any audit, review, compilation (expected that a third party will use the financial statements and lack of independence is not disclosed) or examination of prospective financial information services for the client, the commission is disclosed in writing to any person or entity to whom the commission relates and the commission relates to professional services. A commission solely for the referral of a client to a third party is not permitted.**
 - d. Incorrect. A commission is always permissible. California Accountancy Act, section 5061, only permits a commission under certain circumstances. These circumstances include clients for whom no audit, review, compilation (expected that a third party will use the financial statements and lack of independence is not disclosed) or examination of prospective financial information services are being performed, the commission is properly disclosed and the commission relates to professional services being performed for the client.

5. You were convicted of driving under the influence of alcohol. You should:
- a. **Correct. Report it to the CBA within 30 days. Section 5063(a)(1)(B) requires that a conviction of any crime related to the qualifications, functions, or duties of a CPA must be reported within 30 days.**
 - b. Incorrect. Report it to the CBA prior to license renewal. This would violate section 5063 which requires reporting of the conviction of any crime related to the qualifications, functions or duties of a CPA to the CBA within 30 days. Failure to do so subjects the CPA to disciplinary action.
 - c. Incorrect. Not report it to the CBA as only felony convictions should be reported. Any conviction of a crime related to the qualifications, functions or duties of a CPA must be reported within 30 days. This would include a misdemeanor DUI conviction.
 - d. Incorrect. Wait until you are contacted by the CBA. Section 5063 of the California Accountancy Act requires reporting of the conviction of any crime related to the qualifications, functions or duties of a CPA to the CBA within 30 days. Failure to do so subjects the CPA to disciplinary action.
6. When should client provided records be returned?
- a. **Correct. Upon demand by the client. CBA Regulation 68 prohibits the licensee from retaining client records. Further, California Accountancy Act, section 5037 requires client records to be returned upon request and reasonable notice.**
 - b. Incorrect. Client provided records are not required to be returned to the client. Client records must be returned to the client upon demand. A copy of these records may be made and retained by the CPA.
 - c. Incorrect. Client provided records are only required to be returned if related fees are paid. CBA Regulation 68 specifically states that unpaid fees do not constitute justification for retention of client records. Client records must be returned upon demand by client.
 - d. Incorrect. After a 7-year retention period. There is a required 7-year retention period for audit documentation. However, CBA Regulation 68 and California Accountancy Act, section 5037 require that client records be returned to the client. A copy of these records may be made and retained by the CPA.

Chapter 3

7. In performing non-attest services, a member may maintain independence by:
- a. Incorrect. Making management decisions and perform management functions will impair independence.
 - b. Incorrect. Authorizing transactions on behalf of the client will impair independence.
 - c. Incorrect. Maintaining and monitoring internal controls will impair independence.
 - d. **Correct. Performing tax compliance services in which the client reviews and approves the tax return, signs the return prior to filing and is responsible for any payment is specifically permitted.**

8. Preparing and transmitting a tax return:
- a. Incorrect. This will not impair a member's independence as long as the CPA does not have control over the client's funds and a representative of the client reviews and approves the tax return and related payment and signs the return prior to its filing.
 - b. Correct. This will not impair independence as long as the CPA complies with the conditions set forth in the code.**
 - c. Incorrect. This may impair a member's independence if the CPA has control over the client's funds or a representative of the client does not review and approve the tax return and related payment or if the client does not sign the tax return prior to its filing
 - d. Incorrect. If only the CPA reviews and approves the return and is the only one to sign the return, independence would be impaired.
9. If a CPA uses a third party service provider, before releasing confidential client information to the service provider, the CPA should:
- a. Correct. The CPA should enter into a confidentiality agreement with the service provider and obtain reasonable assurance that the service provider has procedures in place to prevent the release of confidential client information to others. The CPA may also obtain the client's express consent to release confidential information.**
 - b. Incorrect. Informing the client of the intent to use a third party service provider does not constitute client consent. Without the added step of a confidentiality agreement and taking steps to obtain reasonable assurance that the service provider has procedures in place to prevent the release of confidential client information to others, simply informing the client does not fulfill the requirements.
 - c. Incorrect. A CPA may use a third party service provider if the CPA enters into a confidentiality agreement with the service provider and obtains reasonable assurance that the service provider has procedures in place to prevent the release of confidential client information to others or if the CPA obtains the client's express consent to release confidential information to the third party service provider.
 - d. Incorrect. A CPA is not obligated to perform an audit and render an opinion on the controls of the third party service provider. A CPA should, however, obtain a confidentiality agreement and obtain reasonable assurance that service provider has procedures in place to prevent the release of confidential client information to others.

10. A CPA may use a contingent fee arrangement for:
- a. Incorrect. An audit of financial statements is specifically excluded from permitted contingent fees.
 - b. Incorrect. The preparation of a tax return is specifically excluded from permitted contingent fees.
 - c. **Correct. Obtaining a private letter ruling from the IRS is permitted on a contingent fee basis as substantive consideration by a government agency will be given to the client's request.**
 - d. Incorrect. An examination of prospective financial information is specifically excluded from permitted contingent fees.
11. When a client requests that his records be returned and the engagement is complete and all related fees have been paid, the CPA is not obligated to return:
- a. Incorrect. Records provided by the client must always be returned.
 - b. Incorrect. Records prepared by the CPA must be returned if the engagement is complete and all related fees have been paid.
 - c. Incorrect. Supporting records related to the work product must be returned if the engagement is complete and all related fees have been paid.
 - d. **Correct. The CPA's working papers belong to the CPA which may include audit programs and statistical sampling analysis and are not required to be returned to the client.**
12. Which of the following are appropriate ethical safeguards for a CPA in industry?
- a. Incorrect. Strong internal controls is an ethical safeguard.
 - b. **Correct. Open door policy that encourages the reporting of ethical issues represents an important ethical safeguard.**
 - c. Incorrect. Leadership that stresses the importance of ethical behavior is an ethical safeguard.
 - d. Incorrect. Peer review would only apply to CPAs in the practice of public accountancy.

Glossary

This is a glossary of key terms with definitions. Please review any terms with which you are not familiar.

Attest services: These services include an audit, a review of financial statements, or an examination of prospective financial information. Attest services shall not include the issuance of compiled financial statements.

Close relatives: Consists of nondependent children, siblings, and parents.

Commission: Any compensation, including a referral fee, paid by a third party to the licensee and the public accounting firm that employs such licensee, for recommending or referring any product or service to be supplied by another person.

Contingent fees: A fee established for the performance of a service under an arrangement in which no fee will be charged unless a specified finding or result is attained, or in which the amount of the fee is otherwise dependent upon the finding or result of the service.

Direct financial interest: The ownership of stock or other equity shares by a CPA or his/her immediate family.

Ethics: Rules of conduct that apply to a particular group.

Immediate family: Consists of spouse, spousal equivalent and/or dependents.

Independence: A concept that requires the CPA to recognize both actual and apparent conflicts of interest with an attest client.

Indirect financial interest: The ownership of an investment which is not directly controlled by the CPA, but controlled by an intermediary.

Integrity: Refers to the adherence to an ethical code which requires honesty and objective professional judgment.

Joint investment: An investment held by both the CPA and the client, or members of client's management, in a nonclient entity.

Key position: A position that exerts influence over the financial or accounting policies or prepares financial statements of a client. Also included are members of the Board of Directors, chief executive officer, president, chief financial officer, chief operating officer, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer or other equivalent position.

Licensee: An individual who is certified by or registered with the Board and holds a current license to practice.

Objectivity: Refers to being unbiased and not influenced by personal prejudices.

Permitted loans: An automobile loan or lease collateralized by the automobile, loan collateralized by the cash surrender value of an insurance policy, loan fully collateralized by cash deposits or aggregate outstanding balances from credit cards or overdraft reserve accounts that are less than \$10,000 that were obtained under the institution's normal lending procedures, terms, and requirements and must, at all times, be kept current as to all terms.

Working papers: Working papers are the licensee's records of the procedures applied, the tests performed, the information obtained and the pertinent conclusions reached in an audit, review, compilation, tax, special report or other engagement. They include, but are not limited to, audit of other programs, analyses, memoranda, letters of confirmation and representations, abstracts of company documents and schedules or commentaries prepared or obtained by the licensee.

Index

"

"Members of the American Institute of Certified
Public Accountants58

(

(GASB).....52, 53, 67

A

Accounting and Review Services Committee.....52
Acts discreditable53, 69, 70
advertising56
AICPA84
ARSC.....52
ASB52
attest.. 8, 29, 32, 39, 41, 43, 45, 46, 47, 48, 49, 50, 55,
56, 58, 75, 78
Attest46, 48, 78
audit.....32, 84
Audit engagements45
audit or review of a financial statement.....55
Auditing Standards Board.....52

B

Board of Accountancy57

C

certificate82
Circular 230.....13, 43
Code of Professional Conduct 8, 39, 42, 45, 51, 53,
54, 55, 57, 58, 64, 66, 69, 70
commission.....29, 38, 55, 56, 74
Competence67
compilation52, 54, 55, 67, 86
Compilation report.....45
confidential client information56, 57, 59, 76
Confidentiality26
contingent fee32, 36, 54, 55, 59, 77
Contingent fees.....55, 78, 84
Council45, 51, 52, 53, 58, 66, 67
CPA Law37

D

Disclosure of permitted commissions55
due care.....9, 12
Due Professional Care51, 66

E

ethics.....82
Ethics1, 2, 3, 4, 5, 10, 12, 14, 73

F

FASAB52, 53, 67
FASB52, 53, 67
Federal Accounting Standards Advisory Board52, 53,
67
Financial Accounting Standards Board52, 53, 67
firm29, 32, 84
Forensic and Valuation Services Executive
Committee.....52

G

Governmental Accounting Standards Board52, 53, 67

I

IASB52, 53, 67
independence8, 20
integrity.....2, 3, 4, 9, 12, 13, 15
International Accounting Standards Board..52, 53, 67
Interpretations.....39, 58
IRS.....26

L

licensee78
litigation.....57
Loss of confidential client data.....58

M

Management Consulting Services Executive
Committee.....52
moral.....1, 2, 3, 4, 5, 73
morals1

O

objectivity9, 11, 12, 15, 16, 40, 73, 83
omissions of data55
Ownership in a joint investment..... *See* Independence

P

PCAOB.....52
Peer Review.....52
Planning and Supervision.....51, 66
practice of public accountancy9, 24, 44, 77
practitioner.....13
Professional Competence51, 66
Prohibited commissions.....55
Public Company Accounting Oversight Board.....52

R

referral84
referral fee84
retention period.....38, 75

Review engagements	45
Rules	39

S

Society	2
solicitation	56
state CPA society	57
subordinate his or her judgment	9, 11, 40
subordination of judgment	65
<i>Sufficient Relevant Data</i>	51, 66

T

Tax compliance services.....	49
Tax Executive Committee	52
tax return.....	54, 84
TEC	52

U

unsecured loan	<i>See</i> Independence
----------------------	-------------------------

W

work papers	54
working papers	37, 59, 77

Qualified Assessment

Ethics and Professional Conduct for California CPAs

Course # 4160626, Version 2004

Publication/Revision Date:

April 2020

Course Expiration Date

Per AICPA and NASBA Standards (S9-06), QAS Self-Study courses must include an expiration date that is ***no longer than one year from the date of purchase or enrollment.***

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1. Which of the following best describes ethics?
 - a. Rules of conduct that apply to a particular group.
 - b. Values that govern an individual's perception of right and wrong.
 - c. Rules of conduct that are consistent across all groups, professions, and nationalities.
 - d. Ethics are dependent on an individual's viewpoint.
2. Which of the following statements is true regarding professional ethics?
 - a. If the action is legal, it is also ethical.
 - b. Not all professions have the same ethical requirements.
 - c. Professional ethics generally hold professionals to the same or lower ethical standard of the general public.
 - d. Professional ethics will always coincide with individual moral views.
3. To renew a certificate in California _____ hours of continuing education in ethics are required.
 - a. 0.
 - b. 2.
 - c. 4.
 - d. 6.
4. Licensees are required to take a board approved 2-hour regulatory review course every _____ years.
 - a. 4.
 - b. 6.
 - c. 8.
 - d. 10.

5. Which of the following best describes the situation of when a CPA performs a professional service for a client and the CPA has a relationship with another person that could be viewed as impairing the CPA's objectivity?
 - a. Client advocacy.
 - b. Conflict of interest.
 - c. Ethical quandary.
 - d. Independence.
6. Under California regulations and statutes, when should client provided records be returned?
 - a. Upon demand by the client.
 - b. Client provided records are not required to be returned to the client.
 - c. Client provided records are only required to be returned if related fees are paid.
 - d. After a 7-year retention period.
7. If Grace Slick was convicted of a breach of fiduciary responsibility, she must report this fact to the Board in writing within _____ days of the date she became aware of this conviction.
 - a. 30.
 - b. 60.
 - c. 90.
 - d. 365.
8. Which would be an acceptable firm name or designation in California?
 - a. Bill Monroe wants to focus on audit work so he decides to rename his firm from Monroe & Associates to "Sleuth CPAs."
 - b. Jim Thorpe is just starting out as a sole proprietor and to sound more impressive decides to call his firm Thorpe, Thurber, and Associates CPAs.
 - c. Joe Winters is a CPA and a certificated financial planner, and has named his firm Joe Winters CPA, CFP.
 - d. Jill Orsay is 60 years old and has retired her license. Her business cards read Jill Orsay, CPA.

9. Any CPA or firm that accepts a referral fee for recommending or referring any product or service to any person or entity or that pays a referral fee to obtain a client shall disclose _____, in writing, the acceptance or payment of the referral fee, how it was calculated and its amount. It must also explain its role in the recommendation process and then obtain consent in writing.
- a. To the AICPA.
 - b. To the Board of Accountancy.
 - c. To the client.
 - d. The CPA and/or firm does not need to disclose.
10. The licensee's records of the procedures applied, the tests performed, the information obtained and the pertinent conclusions reached in an audit, review, compilation, tax, special report or other engagements are considered:
- a. Working papers.
 - b. Supporting papers.
 - c. Client provided records.
 - d. Client records prepared by the licensee.
11. When may a California CPA release confidential client information?
- a. With the written consent of the client.
 - b. At the CPA's discretion.
 - c. If requested by a successor firm.
 - d. If requested by an attorney.
12. Carole King included a statement that she is licensed by the CBA on her letterhead. To meet the CBA requirements, the font must be _____ point type.
- a. 12.
 - b. 48.
 - c. 51.
 - d. The CBA does not care what point type is used.
13. In California, which of the following is **NOT TRUE** regarding contingent fees?
- a. Contingent fees are prohibited for an audit or review of a financial statement.
 - b. Contingent fees are prohibited for an examination of prospective financial information.
 - c. Contingent fees are prohibited for the preparation of an amended tax return.
 - d. Contingent fees are NOT prohibited for the preparation of an original tax return.

14. Under the AICPA Code of Professional Conduct, if there is a possible conflict of interest but the CPA does not believe that objectivity is compromised, the CPA must:
- a. Withdraw from the engagement or employment.
 - b. Disclose the conflict to the client or employer.
 - c. Disclose the conflict and the safeguards to all parties and obtain their consent .
 - d. Only disclose the conflict if the work to be performed is an audit.
15. Under the AICPA Code of Professional Conduct, which of the following will **NOT** impair independence with respect to an audit client?
- a. An immediate family member in a key position with a client company.
 - b. A direct financial interest in a client company.
 - c. A material indirect financial interest in a client company.
 - d. The performance of tax compliance services for an audit client.
16. Under the AICPA Code of Professional Conduct, which of the following will **NOT** impair independence with respect to an audit client?
- a. Audit fees that are unpaid more than one year from the report date.
 - b. A direct material joint investment.
 - c. Unpaid audit fees from a client in bankruptcy.
 - d. A material indirect ownership in a joint venture with a client.
17. Under the AICPA Code of Professional Conduct, which of the following is **NOT** considered an act discreditable?
- a. Retention of client prepared records when requested by the client.
 - b. Failure to pay personal income taxes.
 - c. Discrimination in employment practices.
 - d. Retention of a CPAs work papers, which include audit programs and analytical review, when there are unpaid fees.
18. Under the AICPA Code of Professional Conduct, which of the following tax services will **NOT** impair independence with respect to an audit client?
- a. Reviewing, approving, and signing the tax return on behalf of the client.
 - b. Preparing an amended tax return that has been signed, reviewed and approved by client management.
 - c. Writing a check from the client's bank account for the tax due related to a tax return.
 - d. Supervising client personnel who prepare the tax return and reviewing and approving the tax return.

19. Under the AICPA Code of Professional Conduct, may a CPA, who is not independent with respect to the client, issue a compilation report?
- a. No, independence is required.
 - b. Yes.
 - c. Yes, but the lack of independence must be disclosed.
 - d. No, but he may issue a review report.
20. Which of the following is a threat that a CPA in business does **NOT** need to consider?
- a. Self-interest.
 - b. Management participation.
 - c. Adverse interest.
 - d. Familiarity.



Answer Sheet
Ethics and Professional Conduct for California CPAs
Course # 4160626, Version 2004
4 CPE Credits

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| 2. ____ | 6. ____ | 10. ____ | 14. ____ | 18. ____ |
| 3. ____ | 7. ____ | 11. ____ | 15. ____ | 19. ____ |
| 4. ____ | 8. ____ | 12. ____ | 16. ____ | 20. ____ |



Course Evaluation

Ethics and Professional Conduct for California CPAs
Course # 4160626, Version 2004

Thank you for taking the time to fill out this course and customer experience evaluation. Your responses help us to build better courses and maintain the highest levels of service. If you have comments not covered by this evaluation, or need immediate assistance, please contact us at 800.822.4194 or wcpe@westerncpe.com.

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