

Chapter 3

Multiple Choice

- 3-1. B
- 3-2. A
- 3-3. D
- 3-4. C
- 3-5. A
- 3-6. D
- 3-7. B
- 3-8. C
- 3-9. D
- 3-10. C
- 3-11. A
- 3-12. D
- 3-13. C
- 3-14. A
- 3-15. D
- 3-16. B
- 3-17. D
- 3-18. C
- 3-19. D
- 3-20. A

Discussion Questions

3-21. [LO 1,5] Do you think it is necessary to prohibit all of the services on the “prohibited services” list in order to protect the public interest? Are there any on the list that you would permit, and why?

Student answers may vary, but they should explain why their choices do not:

1. have the potential to put the audit firm in a position of auditing its own work,
2. cause the audit firm to make or advise client decisions that are the responsibility of client management, and
3. require the audit firm to be an advocate for the client.

3-22. [LO 1,5] Should tax services be a “prohibited service” for a firm that is conducting an audit? Consider whether performing more services for a client may increase the audit firm’s knowledge of the client. Also consider whether additional services may make the audit firm more economically dependent on the client.

Performing more services can help an auditor know the client more thoroughly and as a result reduce the possibility of missing something on the audit. However the argument

against tax services is the concern that independence will be compromised on the audit because the auditor wants to retain the fees from the tax engagement. This argument is the same, whether the additional services are tax or consulting services. An additional concern for combining tax and an audit is that aggressive (not illegal) tax positions might need to be disclosed as contingent liabilities. If the auditor has worked on the corporate tax engagement he or she intimately knows the tax positions, opening up the door for conflict with the client regarding disclosure in the financial statements.

3-23. [LO 2] Can you choose the philosophical position discussed in this chapter with which your views are closest? Which one is furthest from your views?

Student answers may vary, but students should reflect on the influences that have shaped his or her personal value structure. Family, community, faith or religion, national culture, laws and courts, as well as personal experiences, all influence the value structures used in every decision.

3-24. [LO 1, 3, 5] Some people have said that auditing is no longer self-regulated because of the Sarbanes Oxley mandated registration and inspection process of the PCAOB, and because the PCAOB now sets auditing standards. Does this loss of some of its self regulation diminish the profession, or does it just increase public confidence? Why?

Student answers may vary, but could focus on issues of quality control and the importance of trust from the view point of clients who contract for accounting services. SOX addresses the issue of quality control standards for firms by requiring the PCAOB to establish standards for the public accounting firms that come under the PCAOB's jurisdiction. The purpose of quality control standards for firms is at least twofold: (1) to provide guidance for firms regarding policies needed for well-functioning practices; and (2) to provide standards against which firms can be compared in a monitoring or an inspection process.

3-25. [LO 4] What moral dilemma have you experienced? (...whether to cheat on a test does not count... too easy!)

Student answers may vary.

3-26. [LO 2] Explain the theory of moral development, including the 3 levels identified by the theory. When auditors are performing their jobs, which level applies to their behavior? Why would it be a problem if this were not the case?

Levels of moral development are descriptive. In other words, one level of moral development is not necessarily better or worse than another. Individuals are theorized to move in one direction through three levels of moral development. Not everyone moves through all the levels. The theory proposes that movement is *only* in one direction. Although some may believe it is better to be at a higher level of moral development, this is a personal judgment. The levels simply describe the way a person makes decisions.

Individuals at the **pre-conventional level** of moral development make decisions in a self-centered way. At a pre-conventional level, the individual makes decisions based on personal consequences. Will I be punished if I am caught? How bad will the punishment be? If I break a rule and do not get caught, how much better will my life be? An example of pre-conventional analysis is someone asking, “Will I be caught if I cheat on an exam or on my income taxes?” The person analyzes whether the possible benefit is worth taking the risk. The pre-conventional level is classified as the earliest level of moral development. Young children begin with this decision framework and later add considerations characteristic of the conventional level.

Individuals at the **conventional level** of moral development consider impacts beyond those that affect them personally. Often they use societal norms such as rules and laws to decide what is right. Conventional-level analysis views following laws as behaving in a moral manner. Someone at the conventional level pays income taxes because the law requires it. Concern for what other people think is important. Someone at the conventional level may also pay taxes because of concern about what friends and family think.

Individuals at the **post-conventional level** engage in abstract analysis of what is right and wrong, often using philosophical positions. The analysis includes questions such as: “Will anyone be hurt as an outcome of my decision? Should I do this because it is a good thing to do, even though it is against the law?” Or, even more complex, “Should I not do this even though the law says I can?”

Auditors, performing their jobs, should operate at the post-conventional level or who will be affected by the decision I make regarding a client’s financial statements. If this were not the case, they would likely make decisions that would benefit themselves as individuals (self-interest) and the entire profession of accounting would be the losers as a result of these actions.

3-27. [LO 3] Explain the difference in the compensation contracts of doctors and their patients and auditors and their clients, and the significance this difference has for auditor independence.

Doctors are expected to be advocates for their patients. Regardless of the source of payment, a doctor is supposed to help the patient. Auditors are NOT supposed to be advocates for their clients – even though the client pays the audit fee. The issue regarding independence is that the auditor must strive to not feel responsible to provide the audit report the client desires just because the client pays the fee.

3-28. [LO 1,3] Assume the auditor has a contract with society. What are the components of that contract? In other words, what does the auditor commit to give and what does the auditor receive?

Auditors as part of a or an occupational group of individuals have a collective identity. They commit to give their knowledge and expertise through adherence to the AICPA’s

Code of Professional Conduct. What auditing professionals receive in return for this commitment to serve the public good through their work, is society's trust which results in prestige, the right to some level of self-governance, and economic reward for their service through monopoly rights to perform audits.

3-29. [LO 5] What do we mean when we use the phrases "independence in fact" and "independence in appearance"? Why does the auditing profession use both phrases? How do both relate to ideal behavior and the rules that govern auditors?

The concept of independence is critical to auditors performing their work objectively and protecting the public interest. Independence is given significant attention in the AICPA Code Rules. In the Principles, the concepts of **independence in fact** and **independence in appearance** are introduced. *Independence in fact* means that the auditor does his or her work objectively without having any bias or predetermined preference regarding the audit conclusions. The difficulty with the *independence in fact* standard of behavior is that no one can be sure of what an auditor is thinking. Therefore, there is a need for visible indicators consistent with an objective state of mind, which describes the *independence in appearance* reason for the independence rule that is part of the AICPA Code.

Problems

3-30. [LO 5] For the follow situations indicate whether a rule of the AICPA Code of Conduct applies, if yes, which rule, whether the rule has been violated, and why or why not.

- a. Walker, CPA, is purchasing a home and has received a large mortgage, under normal lending procedures, with a bank that is an audit client, however, the mortgage amount is material to him.

Rule 101-Interpretation 101A. This would cause an independence violation except that it is an exception covered in 101-5. (101-5 is not presented in the book but can be found on the AICPA Web site.)

- b. Logan, CPA, accepted as an audit client a modeling agency that signs up and places models primarily using internet interactions. Logan has never audited a modeling agency before.

Rule 201A, Professional competence. Logan CPA can take on the engagement as long as the firm can reasonably expect to complete it with professional competence.

- c. Letchworth and Miller, a local CPA firm, advertised that its audits will always save clients money because the increased efficiencies resulting from audit recommendations will be more than the audit fee.

Rule 502, Advertising and other forms of solicitation. This would be a violation because it would be considered misleading and deceptive.

- d. The firm of Masser & Masser disclosed confidential client information during the course of its inspection by the PCAOB.

Rule 301, Confidential client information. Not a violation because the PCAOB is a recognized authoritative investigative body and providing the information falls within applicable laws and regulations.

- e. Jiggs, CPA, always sets audit fees that are contingent on the number of hours it takes to perform the audit.

Rule 302, Contingent fees. Not a violation.

- f. Srygley, CPA pays an attorney, Bill Suttle, a “finder’s fee” if Suttle refers a company to him that becomes an audit client.

Rule 503, Commission and referral fees. (c) It is ok to pay a referral fee as long as you disclose it to the client.

- g. Cutter and Gaspar, CPA, are having some cash shortages because they recently remodeled their offices. Consequently, they issued an unqualified financial statement audit opinion as a result of an integrated audit even though they concluded some of the accounting treatments were not GAAP. They were concerned that if they issued anything other than an unqualified opinion they would lose the client.

Rule 203, Accounting Principles. Violation.

- h. A local CPA firm is named “Best Buy Audits.”

Rule 505, Form of organization and name. Violation.

3-31. [LO 2, 4] Reread the **Auditing in Action** titled “What Should the Health Clinic Do?” in the chapter dealing with the clinic's moral dilemma on whether to accept a large donation from a donor of questionable reputation.

Required:

- (a) Respond to the dilemma explaining what you would do if it was your decision to make.
- (b) Justify or explain why you believe your decision is there right one. There are many potential ramifications from the decision and you should identify the as many as you can in justifying or explaining your decision.
- (c) Identify the underlying ethical philosophy that guided your decision.

Answer:

(a), (b) & (c) Student responses may vary, but should include issues related to the moral development and ethical orientation discussion in the text.

3-32. [LO 2, 5] For the following topics list arguments both in support of and against the topic, basing your arguments on any of the philosophical positions provided in the text. You may use the same or different underpinning philosophies for the different positions.

(a) restrictions prohibiting an auditor from providing auditing and IT installation services to the same company;

The prohibition of providing both services:

A CPA who is performing an audit of a client needs to be independent of installing IT systems for the client in order for users of the audit report to feel comfortable relying on the objectivity of the auditor and his/her opinion and recommendations. In this case, although there may be no coercive or deceptive practices taking place and the client may benefit from the fact that the auditor is in the best position to understand the client's IT needs, independence of the auditor is impaired. Thus, right is whatever is fundamentally "right" regardless of the consequences. To go against that, those who do not believe it is appropriate to make decisions based on a belief in what is fundamentally "right" propose that consequences are important.

(b) restrictions on what auditors may name their firms;

Restrictions on firm names:

According to the AICPA, the name used by an employing firm may not be misleading. For example, a name that indicates a partnership when there is only one owner would be considered misleading. A firm name that includes former owners who have either died or left the firm is not considered misleading. A firm can only label itself as "Members of the American Institute of Certified Public Accountants" if all the CPA owners are members of the AICPA. Thus an argument for Rule 505 here is right for the greatest public good and right is the decision made by the group affected, in this case the accounting profession. Arguing against it, would say that certain individuals or violating the name rule hurts the trust in the profession and allows violators to exercise decision-making power over others.

(c) having PCAOB inspections rather than just AICPA peer reviews for companies that audit public companies.

PCAOB inspections rather than AICPA peer reviews:

Any audit firm that audits a publicly traded company must register and file reports with the PCAOB, and submit to PCAOB inspections. Here right is whatever the law requires.

Disobedience of PCAOB inspections are violations of external regulations and laws. It is also important to recognize that the rules of these organizations may also impact the firms for which members work. Thus, AICPA members work must undergo some type of quality control or peer review in order for the firm's employees to be permitted membership. In this case, right is the decision made by the group of people affected. Disobedience of PCAOB inspections are violations of external regulations and laws. If the firms are not in compliance with the rules, then partners and employees may not be members of the AICPA. The argument for having both is that guiding, influencing, and controlling the professional behavior of auditors and their firms to prevent failure and wrongdoing is a much better system than relying on the courts and laws to deal with compensation, punishment, and other issues after a problem occurs. Arguing against it, would say that certain individuals that do not agree to AICPA peer reviews hurt the trust in the profession and allows violators to exercise decision-making power over others.

3-33. [LO 5] Respond to the following:

- (a) Chris Armas, CPA, is a partner responsible for the audit engagement of Mario Manufacturing. Chris has a dependent daughter who is employed by Mario Manufacturing as a machine operator – a non-financial and non-audit-sensitive position.

Is this a violation of the AICPA Code of Conduct? Explain.

Rule 101-1c. The nature of the job makes the employment not a violation. The daughter is “immediate family” and what she does is the same as if her father did it, but in this case the nature of the employment is not a problem.

- (b) Paul Brent, CPA, is a partner in the CPA firm that audits Keystone, Inc., a closely held corporation. Brent's sister is the chief financial officer of Keystone, Inc. The CPA firm has only one office, so Paul Brent and the partner responsible for the audit work in close contact on a regular basis.

Is this a violation of the AICPA Code of Conduct? Explain.

Yes. A sister is a “close relative.” This is a violation under Interpretation 101 of Rule 101. Paul Brent is a partner in the office in which the lead attest partner primarily practices and in this situation, independence is impaired if a close relative is in a key position with the client. A key position is defined as is having significant accounting functions or responsibility for preparation of the financial statements or the ability to influence the contents of the financial statements. A CFO fits all three descriptions.

- (c) The accounting firm of Jenne & Jenne, CPAs is negotiating a fee with a new audit client. They agree the client will pay \$75,000 if Jenne & Jenne issues a clean unqualified opinion, and \$50,000 if any type of an opinion other than a clean opinion is issued.

Is this a violation of the AICPA Code of Conduct? Explain.

Yes. Rule 302, Contingent fees prohibits a fee arrangement in which the amount the CPA is paid depends on the audit outcome.

(d) Don O’Kroy, CPA is a member of the engagement team that performs the audit of Torok Corporation. Don’s five-year-old daughter, Precious, received ten shares of Torok Corporation’s common stock for her fifth birthday. The stock was a gift from Precious’s grandmother – Don’s wife’s mother.

Is this a violation of the AICPA Code of Conduct? Explain.

Yes. Precious is Don’s immediate family and any stock she owns is the same as if Don owns it. The ten shares of Torok Corporation stock are a direct financial interest and therefore, Don is not independent of Torok Corporation.

3-34. [LO 5] The following are paired lists of terms that have specific meaning within the AICPA Code of Conduct. For each, explain how the pair of terms interacts or contrast regarding their impact on auditor independence:

(a) Direct financial interest: Immediate family

A “covered member” is not independent if he or she has a direct financial interest in the client. If a person meets the definition of immediate family, then any direct financial interest that person has in a company is attributed to the covered member.

(b) Material: Indirect financial interest

If a financial interest is indirect, then the covered member (or his or her immediate family) can hold the financial interest as long as it is not material.

(c) Covered member: Immediate family

Anything a person who is “immediate family” does is attributed to the covered member. The immediate family steps into the shoes of the covered member.

(d) Covered member: Close relative

Actions and holdings of a close relative are generally not as strict – in terms of causing a covered member to not be independent – as are actions and holdings of immediate family. As a generalization, consider whether the covered member is likely to know about the action (such as when a covered member has an important accounting position at a client) or actually knows about the action (such as when a close relative holds stock in a covered members audit client that is material.)

(e) Covered member: Key position

A key position has a specific meaning – in general, a position at a company that is important to the financial information or financial statements. If a covered member, or that member's immediate family or close relatives is in a key position with a company, the covered member is not independent for purposes of an audit engagement.

3-35. [LO 5] Jacoby & Ricks, CPAs is responding to a request for proposal from Z-Berr Industries, a privately-held company located near Milwaukee. Z-Berr is a rapidly-growing company engaged in the manufacture and distribution of bicycle wheels and tires. The company recently expanded its product offerings into the areas of motor scooters and other small vehicles used for sports and recreation.

Because of its recent growth, Z-Berr is in need of a great deal of assistance in improving its financial reporting systems. It indicates that it needs assistance with some non-audit services, including its income tax planning and tax return preparation, computer systems upgrade and the hiring and training of a systems administrator, and implementation of an internal audit function including the hiring and training of internal audit staff. In addition, the company has requested an integrated audit, as it suspects that an initial public offering is on the horizon.

Required:

- (a) Assuming that Jacoby & Ricks desires to bid on Z-Berr's audit engagement, which of the additional non-audit services can the firm include in its proposal? Explain.

Jacoby & Ricks would be permitted to bid on the following non-audit services for its private company audit client:

- a. design or implementation of software systems
- b. internal audit outsourcing
- c. tax planning advisory services
- d. income tax return preparation
- e. hiring and training of employees

These services are not prohibited for CPAs to provide to their privately-held audit clients.

However, given the company's anticipation of an IPO, Jacoby & Ricks should consider that Z-Berr's audited financial statements are likely to become publicly available. Once subject to SEC scrutiny, questions of independence may be raised regarding Jacoby & Ricks' involvement with these non-audit services except as described in (b).

- (b) How would your answer to part (a) change if Z-Berr was already a public company?

If Z-Berr was a public company and an audit client of Jacoby & Ricks, the firm would be prohibited from performing the following non-audit services:

- a. design or implementation of software systems
- b. internal audit outsourcing
- c. making decisions regarding the hiring of employees

Providing tax planning advisory services and income tax return preparation is allowed by SEC independence rules, as well as assisting in the recruiting and training efforts associated with new client personnel.

Any non-audit work would be subject to approval by Z-Berr's audit committee and would be strictly limited by the SEC General Standard of Auditor Independence, including provisions of not creating a conflict of interest, not placing the CPA firm in a position of auditing its own work, not performing any management or employee functions, and not serving in an advocacy role.

3-36. [LO 5] Perrie Brenigen, CPA, is an in-charge accountant for the firm of Duben & Associates. During her four years with Duben & Associates, Brenigen has served on the audit teams for several health care clients. Brenigen recently received an employment offer from one of her audit clients, Health Initiative Partners (HIP). Brenigen is being recruited to work as an associate in HIP's new financial planning department, where her responsibilities would include evaluating investment options and capital expenditure alternatives, assistance with departmental budgeting, and tax planning,

Required:

- (a) If HIP is a public company, will Brenigen be able to accept the position without impairing the independence of Duben & Associates? Explain.
- (b) If Brenigen accepts the new position with HIP, what changes will occur with regard to her obligations under the AICPA Code of Professional Conduct?
- (c) If HIP is a public company, will Brenigen be able to accept the position without impairing the independence of Duben & Associates? Explain.

Answer: (a & c) No, Brenigen cannot accept the position without impairing the independence of Duben & Associates. Brenigen's direct involvement on the audit engagement presents a problem under the 2001 SEC rules that redefined the group of people in an audit firm to whom the independence rules apply. The independence rules apply to all partners and staff who work directly on the audit engagement, managers and partners who provide ten hours or more of non-audit services to the audit client, partners in the audit chain of command, and partners who are located in the same office as the lead partner on the audit engagement.

Brenigen's new role in HIP's financial planning department would not be considered a key position because it does not involve responsibility for significant accounting functions, financial reporting, or the ability to influence the financial statements. According to Section 206 of SOX, an audit firm's independence will be impaired for one year when an auditor on an audit engagement team goes to

work for the audit client in the role of CEO, CFO, chief accounting officer, controller, or any equivalent “key position.”

If Brenigen accepts the new position with HIP, what changes will occur with regards to her obligations under the AICPA Code of Professional Conduct?

Answer: (b) As a CPA, Brenigen will still be obligated to comply with the requirements of the AICPA Code of Professional Conduct. However, as a practitioner in private practice, there are certain provisions of the Code, which will no longer apply to Brenigen if she accepts HIP’s employment offer. While some of the Rules apply to all members of the AICPA (such as Rule 102 regarding integrity and objectivity), other rules apply only to AICPA members who are working in public practice (such as Rule 101 on independence, Rule 301 on confidential client information, Rule 302 on contingent fees, and Rule 502 on advertising).

3-37. [LO 2] Ellison Courtley is a staff accountant for Bronson, Burkes & Hunt, CPAs. During his second year on the audit staff, Ellison becomes quite frustrated with the number of overtime hours required for his job. He dislikes the firm’s policy of rewarding additional vacation time in lieu of overtime pay. Ellison also believes that he is underpaid. One of his roommates works for another CPA firm and earns a salary that is nearly 10% higher than what Ellison is paid by Bronson, Burkes & Hunt.

Ellison developed a plan for taking matters into his own hands and “leveling the playing field” with respect to his compensation. He is maximizing his payout under the firm’s policy of reimbursing job-related expenses. By inflating the mileage on client-related travel, duplicating receipts for parking, and borrowing receipts from his roommates for so-called “overtime meals”, Ellison has been able to increase his take-home pay by about 8%.

Ellison shared his strategy with Shannen Folkes, who works as the staff accountant on some of the same audit engagements with Ellison. Shannen has experienced some of the same frustrations as Ellison with regard to her paycheck, and she knows first-hand that Ellison is a hard worker who is deserving of increased compensation. Yet, Shannen is reluctant to alter her expense report for fear of getting caught. When she expresses her concern to Ellison, he criticizes her for not being a team player. He tries to convince her that there is less chance of getting caught if all of the engagement team members’ expense reports are within a similar range. Besides, Ellison argues that even this elevated level of expense reimbursement does not make up for the firm’s substandard pay structure.

Required:

- (a) Which ethical orientation is Ellison demonstrating? Which level of moral development is exemplified by Ellison’s behavior? Explain.

This is an example of the ethic of rights. Ellison's behavior is protecting his individual right to receive additional compensation. It is also focused on personal advancement. This is also an example of pre-conventional moral development, as it is self-centered. His assessment of whether he will get caught is also representative of this pre-conventional level.

- (b) Assume Shannen is reflecting on Ellison's behavior. In addition to the risk of getting caught, she considers the impact to the firm if all of its associates implemented a similar plan. She also thought about the inequity to those who strictly followed the firm's policies. As a result of these considerations, if Shannen decided to report Ellison's unethical actions to one of the firm's partners, which level of moral development would she be demonstrating? Explain.

If Shannen decided to report Ellison's unethical behavior based on her analysis of the impact on others, this would be characteristic of conventional moral development. Conventional morality considers impacts beyond those that affect them personally. Conventional level analysis views following rules as behaving in a moral manner. Concern for what other people think is also important.

- (c) According to the "greatest good" philosophy, do you think Shannen could be justified in joining Ellison in this method of maximizing expense reimbursements? Present arguments for opposing perspectives under this philosophy.

Assume that a person believes that from a "greatest good" perspective it is right to alter expense reporting in order to earn back some well-deserved compensation. This belief is that stretching the bounds of the firm's policy would be equitable because it would bring many associates to a competitive compensation level. This would justify Shannen in deciding to join Ellison in his expense reporting ploy. On the other hand, another person who also believes in the "greatest good" perspective may hold that the expense tactic is detrimental because it detracts from the firm's ability to pay bonuses or otherwise increase compensation. This, in turn, would further discourage associates, resulting in a less productive workplace that negatively affects everyone in the firm.

3-38. [LO 5] The situations that follow pertain to Rule 101 of the AICPA Code of Professional Conduct as it relates to family relationships. Indicate whether each situation violates the Code and which provisions apply.

- (a) A staff accountant's mother retired from her position as Controller for an audit client. Upon retirement, she was awarded shares of stock, which increased her ownership share to 5%. Her stock ownership is material to her net worth. The staff accountant participates as a member of this client company's audit team.

Violation, due to the material ownership interest of a close relative and the key position of this close relative.

- (b) A CPA manager is a member of the audit team of Hudson Motorworks, Inc. A cousin of the CPA's wife is Hudson's vice president and sales director. This cousin also owns a very small proportion (less than 1%) of the shares of the company's stock.

No violation, due to the assumed remoteness of a relationship with a cousin.

- (c) A CPA manager has a sister who holds a 50% ownership interest in the CPA's audit client. This investment is material to the sister's net worth.

Violation, due to the material ownership interest of a close relative.

- (d) A partner was formerly a shareholder in a company, but upon receiving a request for proposal for the company's current year audit engagement, the partner transferred all shares of stock to her daughter.

Violation, due to direct financial interest in an audit client during the period of the engagement and the ongoing financial interest of an immediate family member.

- (e) A CPA participates in the audit of a vacation resort complex. The CPA's parents own a timeshare in this resort complex, which is material to their net worth.

Violation, due to the material financial interest of close relatives.

- (f) A partner's dependent parent has a minor 5% ownership interest in an audit client of the partner's firm. The audit is conducted by other CPAs in the partner's office, but the partner does not participate in this audit engagement.

Violation, due to the financial interest of an immediate (dependent) family member.

- (g) A CPA manager is married to the CEO of an audit client. The CPA is also a shareholder of this audit client company. The audit is performed by CPAs in the firm's south side office. The CPA manager works in the firm's north side office and therefore is unable to exercise any influence over the audit engagement.

No violation, due to the fact that the CPA cannot influence the audit engagement and is not a partner in the office that conducts the audit.

3-39. [LO 5] Each of the scenarios that follow portrays a possible violation of the AICPA Code of Professional Conduct. Complete the table by checking Yes for any violations of the Code or No if the scenario does not represent a violation.

Scenario	Yes	No
(a). While performing the audit of a retail company, a CPA identified internal control weakness and immediately reported them to the company's audit committee. Corrections were made to the system before the fiscal year-end, resulting in cost savings to the client company. As a gesture of appreciation, the client company rewarded the CPA with a discount card for use on merchandise sold in the company's retail store.	√	
(b) While performing the audit of a manufacturing company, a CPA determined that going concern disclosures were warranted. However, the client has requested a delay in the audit completion, as it argues that its financial condition will improve when it obtains financing. It expects to have a decision on its loan application next week. The application has been filed with a financial institution that is also an audit client of this CPA. The CPA, being aware of the questionable financial status of the manufacturing company, warns the financial institution client of the related risks of extending credit to this company.	√	
(c) A CPA provided extensive management advisory services to her private company audit client, including consultations on possible diversification plans and monitoring of internal controls.		√
(d) A CPA provided extensive management advisory services to his private company audit client, including design and implementation of a financial software system and screening/interviewing candidates for the newly-created position of Chief Information Officer.		√
(e) A CPA Partner developed a friendship with an audit client's CFO. The CPA and CFO purchased a boat together. The boat is material to the personal net worth of both the CPA and the CFO.	√	
(f) A CPA is requested by her public company audit client to perform additional non-audit services. These services included reviewing contract negotiation documents and providing recommendations on approval or denial of the contract.	√	
(g) A CPA provided audit services for a private company. Due to difficulties with cash flow, the client company issued shares of stock to the CPA in payment of its audit fees. The CPA disposed of the stock before commencing the subsequent year audit engagement. The investment income earned for the period of holding the stock is not material to the CPA's personal net worth.	√	

3-40. [LO 5] Birk Dorren, is a partner with the firm Shelby, Dorren & Ruppe, CPAs. Birk serves as the audit partner on the integrated audit engagement for Pundley Fasteners, Inc., a public company.

One week after issuing unqualified opinions on the fairness of Pundley's financial statements and effectiveness of its ICFR, Birk learned that the company was in violation of its loan covenants. Such violation is grounds for the financier to demand immediate payment of the loan, which would likely force the company into bankruptcy. This situation was not disclosed in the financial statements or accompanying footnotes.

Birk approached the client about the situation and suggested that the company's stockholders be notified that the financial statements and audit report could no longer be relied upon due to the misstatements resulting from the omitted information pertaining to the loan covenant violation. Birk indicated that revised financial statements could be available within two weeks, given the company's cooperation.

Pundley's management refused to comply with Birk's request, claiming that the financial statements were, in fact, materially correct. Furthermore, Pundley threatened to file a grievance against Shelby, Dorren & Ruppe if the stockholders are notified of the situation, claiming that the firm would be violating an auditor-client principle of privileged communication if it were to divulge such confidential information.

Required:

- a. What are the requirements of the AICPA Code of Professional Conduct with regard to confidential client information? Is Birk in violation of the Code?

According to Rule 301, confidential client information is not to be disclosed to third parties without the consent of the client company unless it is necessary for the fair presentation of the financial statements. An exception to the rule applies when it is necessary related to reporting on financial statements that are in violation of GAAP. Therefore, Birk would not be in violation of the Code since this situation relates to the exception noted.

- b. What should Dorren do in this case?

Dorren knows that the stockholders rely upon the auditor's report accompanying the financial statements. Therefore, he has a responsibility to inform the stockholders that the financial statements cannot be relied upon, as they do not comply with GAAP. Withholding such information would be considered a violation of the Code under Rule 102 for knowingly misrepresenting facts.

3-41. [LO 5] John Thomas is a certified public accountant. He is the audit partner responsible for auditing the financial statements of Core Technology's U.S. operations for the fiscal year ended December 31, 2010. During all times relevant to this case, Thomas was also a partner with Weiss and Associates, LLP. Core Technology, based in Frankfurt, Germany, is an international advertising and media services conglomerate with offices throughout the world. Kuhn and Dieter is Core Technology's Frankfurt-based auditing firm and issues joint reports with Weiss and Associates, LLP. During the relevant period, Core Technology was a foreign private issuer whose American Depository Receipts were registered with the Securities and Exchange Commission and were listed on the NYSE.

Between October 2010 and May 2011, Thomas engaged in employment discussions with his audit client Core Technology to become the chief accounting officer of the U.S. subsidiary, responsible for the financial reporting Core Technology's U.S. operations. During this period, he signed confirmations required by Weiss and Associates, LLP attesting that he had complied with the auditor independence rules. On March 4, 2011, Thomas informed the managing director of Core that he wanted to complete the year-end audit work before informing his supervisors. In early May 2011, Thomas learned that Core would be sending him an employment contract, so he asked the joint auditing firms Weiss in the U.S. and Kuhn in Germany to be removed from the Core audit on May 10. He accepted the Core offer on May 11. In a May 28 quality control review regarding his employment at Weiss, Thomas' memorandum stated that Core has first approached him about possible employment in early May 2011 and that he promptly stopped working on the Core audit at that time. Kuhn and Dieter filed its Form 20-F for its fiscal year ended December 31, 2010, issued jointly with Weiss and Associates, LLP. The audit report included in the Form 20-F states that the firm of Kuhn and Dieter was independent and had conducted its audit in accordance with PCAOB standards.

Required:

Based on this scenario, what are the violations with respect to the auditing environment and what possible sanctions do you anticipate upon discovery by the SEC?

Answer: Thomas concealed his employment discussions from his CPA firm throughout the audit until he received an employment offer from Core.

Professional independence standards for auditors, as set forth in PCAOB Rule 3600T, AICPA Code of Professional Conduct ET Section 101, and Independence Standards Board Independence Standard No. 3, require an auditor who is considering employment by an audit client promptly to notify his audit firm and remove himself from the audit of that client. Instead, Thomas falsely signed auditor independence confirmations.

Thomas continued to make misrepresentations in his memo for the quality review of his employment.

Both Kuhn and Dieter and Weiss and Associates, LLP audit firms violated SEC standards and PCAOB standard when issuing an audit report with the 20-F, because the report states that they had conducted the audit in accordance with PCAOB standards when it had not. Neither firm conducted the audit in accordance with PCAOB standards because Thomas lacked independence and therefore the audit was not made in accordance with generally accepted auditing standards.

Sanctions include:

Because Thomas caused and willfully aided and abetted Core's violations of Exchange Act Section 13(a) and Rule 13a-1 through his lack of independence, he would be:

- Barred from practicing as a CPA before the SEC.
- Have his CPA license suspended.
- Could be fined.
- Liable for possible civil damages.

Since both accounting firms violated SEC Regulation S-X Rule 2-02(b)(1) related to GAAS and independence, they would be:

- Penalized through sanctions including fines, suspensions, and disciplinary actions of professional accounting Boards.

As such, Core Technology violated Exchange Act Section 13(a) and Rule 13a-1, which require issuers to file annual reports containing financial statements certified by independent public accountants.

The sanction for this could be fines as well as delisting the firm on the NYSE.

3-42. [LO 5] Joseph Newport, CPA, is the engagement partner for the audit of Yonker Plumbing Supplies, Inc. He works for the firm Harrison and Ford, LLP. Harrison's own audit program for this type of engagement, included in the audit work papers, procedures for testing revenue, including, but not limited to, basic audit steps such as sales cutoff testing and the investigation of revenue transactions with related parties. Newport's audit team has identified several potential risks, including Yonker's small and inexperienced accounting staff, the pressures on Yonker to meet budget expectations, and the potential for Yonker's management to manipulate information and improperly recognize revenue. Newport has told his team that billable hours will reach the maximum for this client at the end of the week and does not require the most basic preliminary and analytical procedures to be performed. Newport urges that it's time to move onto the Martin, Inc. audit and an unqualified audit report for 2010 is issued for Yonker, backed by workpapers indicating that most of Harrison's standard audit program was initialed as "not considered necessary," or initialed as "done" without any supporting documentation.

Required:

Based on the scenario, describe what two key AICPA Rules of Conduct have been violated and why?

Answer: Newport (and his team) have most importantly violated AICPA Rules of Conduct 102 and 201. Rule 102 - Integrity and Objectivity – states that 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. In addition, Rule 201 on General Standards states that a member shall comply with the following standards and with any interpretations thereof by bodies designated by Council These include: (1) Professional Competence, whereby a member can only undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence; (2) Due Professional Care, whereby a member exercises due professional care in the performance of professional services; (3) Planning and Supervision, whereby a member adequately plans and supervises the performance of professional service; and (4) Sufficient Relevant Data, whereby a member obtains sufficient relevant data to afford a reasonable basis for conclusions or recommendations

in relation to any professional services performed. More importantly, in all of this case, Newport has failed to exercise professional skepticism.

Activity Assignments

3-43. On the AICPA Web site (www.aicpa.org), find Professional Resources and click on the Peer Review tab. What do the summary say is the purpose of the AICPA's practice monitoring programs?

The AICPA Peer Review Program (Program) is dedicated to enhancing the quality of accounting, auditing and attestation services performed by AICPA members in public practice.

3-44. On the AICPA website, under Professional Resources, find the Code of Professional Conduct. How is the Code organized on the website?

It is found on the drop down menu under Professional Resources, and Professional Ethics/Code of Conduct, then click immediately on Code of Conduct. It states the period of time for which the Web site has been updated, then lists the Sections by number:

- [Introduction](#)
- [Section 50 - Principles of Professional Conduct](#)
- [Section 90 - Rules: Applicability and Definitions](#)
- [Section 100 - Independence, Integrity, and Objectivity](#)
- [Section 200 - General Standards Accounting Principles](#)
- [Section 300 - Responsibilities to Clients](#)
- [Section 400 - Responsibilities to Colleagues](#)
- [Section 500 - Other Responsibilities and Practices](#)
- [ET Appendixes](#)
- [ET Topical Index](#)

3-45. Go to the PCAOB Web site (www.pcaobus.org). Find the inspection section. Find the most receipt inspection reports posted. Read and briefly summarize one of the inspections reports.

Student answers may vary depending on the report.

3-46. On the AICPA Web site, select Professional Resources, then Professional Ethics/Code of Conduct, and click on Professional Ethics. Click on Resources and Tools. Find the Plain English Guide to Independence. What is the purpose of this document? Does it explain differences between the AICPA, PCAOB, and SEC independence standards?

The purpose of the *AICPA Plain English Guide to Independence* is to help you understand your independence requirements under the AICPA Code of Professional Conduct (the code) and, if applicable, other rule-making and standard-setting bodies.

Independence generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We broadly use the term *rules* to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States so you can understand and apply the requirements with greater confidence and ease.

Yes, it explains difference between the three sets of independence standards and give examples, but it does not cover all of the rules.

3-47. Go to the Web site of the Institute of Internal auditors (www.theiia.org). Find the IIA code of ethics Briefly compare the IIA code to the AICPA Code.

Student answers may vary, but as indicated, they both have principles for their members to uphold.

IIA

Principles

Internal auditors are expected to apply and uphold the following principles:

1. Integrity

The integrity of internal auditors establishes trust and thus provides the basis for reliance on their judgment.

2. Objectivity

Internal auditors exhibit the highest level of professional objectivity in gathering, evaluating, and communicating information about the activity or process being examined. Internal auditors make a balanced assessment of all the relevant circumstances and are not unduly influenced by their own interests or by others in forming judgments

3. Confidentiality

Internal auditors respect the value and ownership of information they receive and do not disclose information without appropriate authority unless there is a legal or professional obligation to do so.

4. Competency

Internal auditors apply the knowledge, skills, and experience needed in the performance of internal audit services.

AICPA

The Code of Professional Conduct (Code) was adopted by the AICPA membership to provide guidance and rules to all members—those in public practice, in industry, in government, and in education—in the performance of their professional responsibilities. The Code consists of two sections—(1) the Principles and (2) the Rules. The Principles provide the framework for the Rules, which govern the performance of professional services by members. It also includes:

- *Interpretations of Rules of Conduct* consist of interpretations which have been adopted, after exposure to state societies, state boards, practice units and other interested parties, by the professional ethics division's executive committee to provide guidelines as to the scope and application of the Rules but are not intended to limit such scope or application.
- *Ethics Rulings* consist of formal rulings made by the professional ethics division's executive committee after exposure to state societies, state boards, practice units and other interested parties. These rulings summarize the application of Rules of Conduct and Interpretations to a particular set of factual circumstances.

- 3-48. Go to the Web site for your state's Department of Professional Regulation or Board of Accountancy. Find the CPA exam information. What are the criteria to sit for the CPA exam in your state?

Answers will vary by state.

- 3-49. Rent the movie *John Q* starring Denzel Washington. The movie's plot deals with a child who needs a heart transplant. The child's family does not have insurance and cannot afford the surgery. Focus on the hospital and hospital administrator and look for an ethical dilemma from her perspective. Her first advice is for the family to go home and enjoy the time they have left, since they can't afford the surgery. Her later decision, in the midst of a media fury, is that the hospital is going to donate the surgery. Analyze her decisions based on the benefit to one child and one family, and describe her fiduciary responsibilities and the benefit to the shareholders of the hospital. Do you believe she changed the basis of making her decision as a result of events? In other words, do you think she moved from making the decision for the benefit of stockholders to making it for the benefit of the family and child?

Student answers may vary.