2010

CPA's Guide to Independence and Ethics

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1 800 248 3248
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Preface

Accounting is not just an occupation, it is a profession. The concept of a profession can be explained as a group's collective effort to pursue a learned art with a common calling to act in the spirit of public service for the good of the public. Professionals make a bargain with society: for their promise to serve the public interest, they are granted privileges, such as the exclusive right to perform certain functions, and other special status. For example:

- *Medical professionals* promise to preserve and encourage the public's health and well-being for the exclusive right to provide medical treatment and services.
- *Legal professionals* promise to pursue justice on behalf of the public for the exclusive right to practice law.
- *Accounting professionals* promise to present the truth in a fair and accurate manner for the public's interest for the exclusive right to provide public accounting and attest services.

In addition to presenting the truth in a fair and accurate manner and serving the public interest, accounting professionals have responsibilities to clients, colleagues, and themselves.

The importance of proper ethical behavior by accountants cannot be overstated. As seen in the aftermath of the high-profile accounting scandals of the twenty-first century, an absence of, or decline in, ethics and moral character leads to a loss of public trust. A loss of public trust undermines the very fabric of societal and economic beliefs and actions.

The number and magnitude of alleged unethical actions by CPAs has become alarming in recent times. In one day in April 2009, the following CPA-related items were reported in the national news media:

- The SEC revoked the license of a CPA and filed charges accusing him of running a $67 million Ponzi scheme that defrauded over 125 investors, including family, friends, and accounting clients.
- The Justice Department filed suit against four CPAs, 27 tax preparers, and another individual accusing them of promoting a tax scam that claimed bogus income tax credits totaling more than $7.8 million for sham sales of methane from landfills to more than 1,800 customers.

- A federal grand jury returned an indictment charging a national CPA firm partner with tax charges for attempting to help one of his clients evade income taxes for a number of years by advising his client to reduce salary payments and report such payments as bogus yacht lease payments to another company owned by the taxpayer that were deducted as business expenses.
- The chief financial officer and 10 junior accountants had been implicated and charged along with assisting company leadership and managers in a large international outsourcing company in committing a multibillion-dollar fraud that left the business struggling for survival. The CFO and members of the finance department confessed to such activities as preparing false sales invoices, bank statements, and bank confirmations in an attempt to conceal the fraud that allegedly included falsifying over $1 billion worth of assets on the company's books.

When public trust is lost, previously unspoken or informal conventions of proper behavior are lost; and, when these informal conventions are lost, then government and the public resort to more rules and regulations to restore that trust. Recent evidence of such rules and regulations include:

- Sarbanes-Oxley Act of 2002 (the Act)
- New and more comprehensive American Institute of Certified Public Accountants' (AICPA) ethics interpretations
- New and tougher Government Accountability Office (GAO) independence standards
- Required annual continuing professional education (CPE) in ethics

Additional rules and regulations result in a loss of freedom to apply individual ethics, as accounting professionals acquiesce to allowing others to say what is right and wrong. Ironically, the adoption of more rules and regulations to govern behavior means that accounting professionals have less responsibility for their decisions, which further impedes their ethical development. For rules and regulations to be effective, people must be inclined to follow them and not seek ways around them.

The 2010 Edition has been redesigned to incorporate a more interpretive approach to ethics and compliance with the CPA's code of conduct. In addition to providing standards information and references to code of conduct principles, rules, and interpretations, the

2010 Edition provides the practitioner with useful guidance that addresses independence and other ethics considerations by the type of issue involved. For example, for a specific question on a potential conflict of interest resulting from an employment situation of a relative with a client, the reader would be directed to Chapter 3—"Independence, Integrity, and Objectivity Considerations," where the applicable professional guidance for such conflicts is discussed and applied. The material is presented with the intention of reminding the CPA profession of its importance to public citizens worldwide and to not lose sight of what is essential in the practice of accounting both publicly and in an industry setting.

Chapter 1 discusses business ethics concepts and provides guidance on addressing ethical dilemmas. Chapter 2 provides an overview of the codes of conduct applicable to the accounting and auditing profession and enforcement in the global environment. Chapter 3 reviews various independence considerations applicable to the work of the CPA and visits the topics of integrity, objectivity, and conflicts of interest and the considerations an accountant may face in regard to these matters. Chapter 4 considers due care responsibilities of the accounting professional and compliance with the standards and principles. Chapter 5 stresses the need for the accounting professional to remember the importance of client confidential information and deals with ethical considerations involving contingent fees. Chapter 6 completes the study of CPA ethical responsibilities by reviewing the areas of discreditable acts, professional behavior, and other ethical considerations.

In addition, Appendices 1 through 4 summarize the ethics principles, interpretations, and rulings specific to the ethics rules for each of the primary standard-setting bodies, including the AICPA, the Securities and Exchange Commission (SEC) and Public Accounting Oversight Board (PCAOB), the GAO and the International Federation of Accountants (IFAC). Appendix 5 provides a directory of the CPA Boards of Accountancy and State CPA Societies, and Appendix 6 contains the Joint Ethics Enforcement Program (JEEP) Manual of Procedures.

The 2010 Edition has been updated through the issuance of the following pronouncements:

- AICPA Ethics Interpretation No. 501-8, *Failure to Follow Requirements of Governmental Bodies, Commissions, or Other Regulatory Agencies on Indemnification and Limitation of Liability Provisions in Connection with Audit and Other Attest Services*
- The AICPA *Guide for Complying with Rules 102-505*
- *Government Auditing Standards—July 2007 Revision*
- The GAO *Government Auditing Standards: Implementation Tool—Professional Requirements Tool for Use in Implementing*

Requirements Identified by "Must" and "Should" in the July 2007 Revision of Government Auditing Standards

- PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence* (AICPA, *PCAOB Standards and Related Rules*, Rules of the Board, "Rules")

Acknowledgments

This book was made possible by the efforts of a number of dedicated people who were able to see the necessity of an ethics publication that can serve as both a professional reference document and an interpretive guide within the CPA profession. Debra Rhoades and Jennifer Miller, and many others at CCH provided the encouragement to develop this essential guide. We are blessed to have Sandra Lim and Paul Sobel providing the much-needed editorial support that makes this professional book an accurate and readable work. We would also like to thank our partners, co-workers (Jan Nolde, Donna Fadenrecht, Michelle Huddle, Cassondra Huxman, and Lindsey Moors), friends, and especially our families for the necessary support to complete this edition.

We have approached this project as an opportunity to provide a comprehensive resource for CPAs seeking practical guidance on the issues of independence, other code of conduct rules, and decisions involving ethics, regardless of the standard-setting body involved.

The 2010 Edition has been redesigned to incorporate a more interpretive approach to ethics and compliance with the CPA's code of conduct. In addition to providing standards information and references to code of conduct principles, rules, and interpretations, the 2010 Edition provides the practitioner with more useful and practical interpretive guidance that addresses independence and other ethics considerations by the specific type of issue involved. We hope that this conceptual change and additional material provides practitioners with more useful guidance that promotes ethics and helps address ethical dilemmas in work and in life.

Although the individuals mentioned above played an important role in the preparation of this book, any errors or omissions are the responsibility of the authors. The *CPA's Guide to Independence and Ethics* will continue to evolve as new pronouncements are issued and we strive to better explain business ethics and compliance with the codes of conduct for the accounting professional.

Please send any suggestions for improving the quality of material to the publisher:

Sandra Lim
CCH
76 Ninth Avenue, 7th Floor
New York, NY 10011
sandra.lim@wolterskluwer.com

Mike Crawford, CPA
Oklahoma City, Oklahoma

D. Scot Loyd, CPA
McPherson, Kansas

About the Authors

Michael A. Crawford, CPA, is chairman *emeritus* of Crawford & Associates, P.C., a CPA firm headquartered in Oklahoma City, Oklahoma, that specializes in the practice area of governmental accounting and auditing. He is a past president of the Oklahoma Society of CPAs (OSCPA), an inductee into the Oklahoma Accounting Hall of Fame, a past vice chairman of the Governmental Accounting Standards Advisory Council (GASAC), and past chairman of the GASAC Agenda Committee. Mr. Crawford has been actively involved in the enforcement of professional ethics through his service as a member of the AICPA and OSCPA peer review committees and AICPA Professional Ethics Technical Standards Subcommittee, and as an investigator for the Oklahoma Accountancy Board and a member of its Peer Review Advisory Committee. Mr. Crawford's expertise is recognized both nationally and internationally. He is a frequent lecturer at many national and state conferences and has authored various technical publications for the AICPA.

D. Scot Loyd, CPA, is with Swindoll, Janzen, Hawk & Loyd, LLC (SJHL), a CPA firm headquartered in McPherson, Kansas. Mr. Loyd is partner-in-charge of a diversified governmental practice, relating to states, counties, cities, schools, and other miscellaneous government entities. He has been a contributor to the standard-setting and ethics enforcement processes for all size firms as a member or chairman of several of the AICPA's task forces and committees and the Mid-America Intergovernmental Audit Forum committees, such as the AICPA Government Performance and Accountability Committee (current), AICPA Government Accounting and Auditing Conference Planning Committee (current), Professional Ethics Executive Committee (PEEC) (past member), Partnering for CPA Practice Success (PCPS) Technical Issues Committee (TIC) (past Government A & A Zone chairman), and AICPA Governmental Accounting and Auditing Committee (past member). Mr. Loyd is a frequent speaker at various AICPA and state society conferences and has had more than 65 opportunities to speak on the topic of ethics in the last few years, including a recent Webinar on *Ethics in Work and Life* through the National Association of State Auditors, Comptrollers and Treasurers (NASACT). In January 2009, *Accounting Today* magazine recognized SJHL as one of the "Best Accounting Firms to Work For."

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INTRODUCTION

"Be worthy of the trust that comes with being an accounting professional"

As important as it is for the professional accountant to understand "right from left" in recording the debits and credits of journal entries, it is even more essential for the accountant to understand "right from wrong" in meeting his or her professional responsibilities. Accounting professionals play an important role in society. They have been granted an exclusive right to provide certain services to the public; and in return, have made a promise to present the truth in a fair and accurate manner to protect the public's interest. In meeting the demanding objectives of protecting the public's interest in an ever-changing and complex environment, the accountant often faces issues of ethics and professional conduct that require professional guidance in addition to the application of the individual's personal values.

To serve as a guide to the accounting professional for addressing issues of ethics and professional conduct, the American Institute of Certified Public Accountants (AICPA) has developed its *Code of Professional Conduct* (the Code of Conduct). The Code of Conduct contains principles that form the framework for the development of specific rules of ethical conduct for the accounting professional. The Code of Conduct principles, which also form the framework for this book, include the following topics:

- *Responsibilities*—In carrying out their responsibilities as professionals, members should exercise sensitive professional and moral judgment in all their activities.
- *Public Interest*—Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate a commitment to professionalism.

- *Integrity*—To maintain and broaden public confidence, members should perform all professional responsibilities with the highest sense of integrity.
- *Objectivity and Independence*—A member should maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.
- *Due Care*—A member should observe the profession's technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member's ability.
- *Scope and Nature of Services*—A member in public practice should observe the Principles of the Code of Professional Conduct in determining the scope and nature of services to be provided.

As the public's expectations of the role of the accountant and auditor continue to evolve with the changing business and regulatory environment, a number of professional organizations continue to change their ethics and professional conduct requirements. This is evidenced by the following recent events or actions:

- The issuance of new and more comprehensive ethics frameworks, guidelines, rules, and interpretations by the American Institute of Certified Public Accountants (AICPA), the Public Company Accounting Oversight Board, and the Securities and Exchange Commission;
- Increased involvement by the International Federation of Accountants in designing a broad-based code of professional conduct;
- The introduction of a chapter on ethics in the *Government Auditing Standards, July 2007 Revision* (i.e., the Yellow Book or generally accepted government auditing standards) from the Government Accountability Office; and
- Continued changes to the ethics licensing and continuing education requirements of the state boards of accountancy.

One of the objectives of this publication is to keep the practitioner abreast of this evolving ethics environment, the changes in ethics requirements, and the various codes of professional conduct. Even more importantly, this publication uses practical guidelines, and real life ethical dilemmas and case studies to assist the professional accountant in meeting his or her responsibilities.

RESPONSIBILITIES AND THE PUBLIC INTEREST

First and foremost, the accounting professional must recognize and embrace his or her responsibilities to honor and serve the public's interest—the collective well-being of the community of people and institutions the profession serves. It is only through the collective efforts of all accounting professionals in meeting their professional responsibilities that the traditions of the accounting profession can be maintained and enhanced.

Since the beginning of the profession, accounting professionals have promised to present the truth in a fair and accurate manner for the public's interest. Those who rely on the fair presentation of financial information place a high level of trust upon the work of the certified public accountant, which is vital for the continued effective operation of a free market society. In addition to having responsibilities to present the truth in a fair and accurate manner to serve the public interest, accounting professionals also have responsibilities to clients, colleagues, and themselves, summarized as follows:

- *Responsibilities to the public*—An obligation to act in a way that respects, serves, and honors the public trust and demonstrates a commitment to professionalism.
- *Responsibilities to their clients/employer*—An obligation to professionally serve the client's or employer's needs, to keep clients' records confidential, and, in public practice, to avoid contingent fees and to properly disclose commissions.
- *Responsibilities to their colleagues*—An obligation to avoid discreditable acts, improper client solicitation, and misleading advertising; to cooperate with fellow professionals and self-regulation through the peer review process; and to follow applicable professional standards.
- *Responsibilities to themselves*—An obligation to be true to themselves and avoid decisions that oppose their sense of right and wrong.

Because the scope of the accountant's responsibilities extends to all of these areas, conflicting pressures will often develop among the different responsibilities. For example, while an accounting professional has a duty to serve the needs of the client or employer who pays him or her, the accountant must maintain the integrity and objectivity necessary to place the public's interest ahead of his or her responsibilities to the client or employer when conflicts arise between the needs of the client or employer and the public's interest.

While the professional accountant may feel grounded in strong moral principles, one's moral principles truly only become tested in situations where it is inconvenient to apply them.

OBSERVATION: The Government Accountability Office report titled, *Audits of Public Companies: Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action* (January 8, 2008, No. GAO-08-163) offers some thoughtful reminders of a public company financial statement auditor's responsibilities. The following was extracted from the report as a matter of background to the public company auditor's responsibility to the public as a whole:

> Following the 1929 stock market crash, legislation was passed that required companies seeking to raise funds from the public to provide audited financial statements to their investors. The Securities Act of 1933 and the Securities Exchange Act of 1934 established the principle of full disclosure, which requires that public companies provide full and accurate information to the investing public. Under these federal securities laws, public companies are responsible for the preparation and content of financial statements that are complete and accurate and are presented in conformity with U.S. generally accepted accounting principles. Financial statements, which disclose a company's financial position (balance sheet), stockholders' equity, results of operations (income statement), and cash flows, are an essential component of the disclosure system on which the U.S. capital and credit markets are based.
>
> Federal securities laws also require that public companies have the financial statements they prepare audited by an *independent* public accountant. The *independent* public accountant's audit is critical to the financial reporting process because the audit subjects companies' financial statements to scrutiny on behalf of shareholders and creditors to whom company management is accountable. The auditor is the *independent* link between management and those who rely on the financial statements. The statutory independent audit requirement, in effect, grants a franchise to the nation's public accountants, as an audit opinion on a public company's financial statements must be secured before an issuer of securities can go to market, have the securities listed on the nation's stock exchanges, or comply with the reporting requirements of the securities laws.
>
> Having auditors attest to the reliability of financial statements of public companies is intended to increase public and investor confidence in the fairness of the financial information. Moreover, investors and other users of financial statements expect auditors to bring *integrity, independence, objectivity,* and *professional competence* to the financial reporting process and to prevent the issuance of misleading financial statements. The resulting sense of confidence in companies' audited financial statements, which is key to the efficient functioning of the markets for public companies' securities, can exist only if reasonable investors perceive auditors as *independent* and expert professionals who will conduct thorough audits. In the event that companies are alleged to

have misled the public or presented falsified financial information, the accounting firms that performed those audits are also sometimes included in suits brought by investors or actions pursued by regulators.

INDEPENDENCE

The concept of CPA independence is the cornerstone of the accounting profession as it relates to providing audit and attestation services. If the CPA is not independent, or perceived to be independent, the value of the CPA's work and the achievement of the profession's mission in serving the public's interest will be greatly diminished.

The ethics principle of independence involves not only adherence to rules and regulations established by the various standard-setting and regulatory authorities, but also to the understanding and implementation of certain basic independence concepts. Without understanding and implementing these basic concepts daily in practice, the rules and regulations hold less meaning. The following concepts are paramount to an independence impairment-free environment:

- To "be" independent, the auditor must be intellectually honest.
- To be "recognized" as independent, the auditor must be free from any obligation to or interest in the client or its management.
- Independence rules are merely precepts to guard against the "presumption" of loss of independence. Possession of intrinsic independence is a matter of personal morality, not a set of rules.

OBSERVATION: The CPA should consider both independence of *mind* and *appearance*. Here are some practical definitions the CPA should consider:

- Independence of ***Mind***: The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.
- Independence in ***Appearance***: The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team has been compromised.