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Chapters 2, 3, 4, 6, 7, 8, 9, and 12 contain sections of the *Professional Code of Conduct* issued by the American Institute of CPAs (© Copyright 2012). Chapter 10 includes the Statements on Standards for Consulting Services (© Copyright 2011). Chapter 11 contains the Statements on Tax Services, Numbers 1-7 (© Copyright 2011). And lastly the AICPA Staff Responses to Inquiries taken from the *Journal of Accountancy* over many years have been reproduced. The AICPA has granted us permission to reprint these items.
One objective of this course is to acquaint the prospective accountant with the American Institute of Certified Public Accountants Code of Professional Conduct and the reasoning, philosophy, and application of that Code. Another objective is to become familiar with the California Accountancy Act and California Accountancy Regulations as well as the rules of the Public Company Accounting Oversight Board and the Securities and Exchange Commission and the Government Accountability Office standards. By satisfactorily completing the course, the participant will be better able to cope with the demands of the profession.

The Education Foundation is indebted to a number of persons who have given generously of their time in the development and current revision of this course. Dr. Alan R. Cerf wrote the original text.

Course revisions have been made by David Reinus, CPA. Along with being a CPA in public practice, David is an Instructor at UCLA Extension where he teaches courses in intermediate and advanced accounting, taxation, and ethics in accounting. He recently developed an Ethics in Accounting course for UCLA Extension to comply with the updated California education requirement. In addition, he has over two decades of experience preparing candidates for the CPA examination, has served as a peer reviewer for the California Society of CPAs, and has been a frequent presenter on accounting and ethics topics at universities throughout California.

Mary Beth Armstrong, a retired professor of accounting at California Polytechnic State University, San Luis Obispo, has been the technical reviewer of the manuscript. She is a former member of CalCPA’s Committee on Professional Conduct and has written another course on ethics for the Foundation.
Educational Goals

Professional Ethics for Certified Public Accountants is designed to ensure that the student knows the rules of the American Institute of Certified Public Accountant’s Code of Professional Conduct, its Statement on Standards for Consulting Services and Statements on Standards for Tax Services. It also exposes them to the rules of the Public Company Accounting Oversight Board and the Securities and Exchange Commission and the standards of the Government Accountability Office. Familiarity with the California Accountancy Act and California Board of Accountancy Regulation is also required. The history, reasoning, philosophy and application of the rules to specific situations helps the CPA see the necessity for the rule. By successfully passing the test that accompanies Professional Ethics for Certified Public Accountants, the CPA is able to demonstrate to regulatory authorities an understanding of these rules and how they are applied in practice.

Syllabus

The course includes the American Institute of Certified Public Accountant’s (AICPA) Code of Professional Conduct: Principles, Rules, Interpretations of the Rules, Ethical Rulings and questions and answers on specific applications of the rules. It also includes the AICPA's Statements on Standards for Tax Services and Statement on Standards for Consulting Services. Sanctions that may be imposed by the AICPA and/or state CPA societies on CPAs who violate these ethics rules are also included. This material includes everything that was effective as of December 31, 2012.

The Public Company Accounting Oversight Board (PCAOB) Rules, Section 3, Part 5, the Securities and Exchange Commission (SEC) Rule 2-01 on auditor’s independence, the Government Accountability Office (GAO) Independence Standards 3.03-3.32, and California's Act and Regulations are also presented.

The material is divided into chapters. Most chapters start with an introduction covering chapter topics followed by the rule, interpretations of the rule, ethical rulings that have been issued with respect to the rule and AICPA staff responses to inquiries concerning the rule. Each chapter has multiple choice review questions. Answers to the questions are given along with references to where the answer can be found in the course material.

Completion of a final test of multiple choice questions is required. Most of the questions use a scenario of a problem or question CPAs may face in their day to day practice.

A passing score is 90% or better, or no more than 5 missed questions.

Instructions

1. Read introductory section for each chapter.

2. Read the rule. Scan the interpretations, rulings and AICPA staff responses to inquiries to see what they cover.

3. Answer the chapter questions. Compare your answers to the answers provided.

4. Take the final examination. Select the best answer, according to the AICPA standards unless another source (e.g., SEC, GAO, California) is specified, to each of the fifty questions.
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Overview: Ethics in Business

*When people are affected, when interests collide and choices must be made between values, ethical considerations are at stake. That means nearly all the time for people in business.* Report of the Business Roundtable, February 1988.

**Business Bashing.** It is not fair nor constructive to condemn or criticize business or even the state of business ethics. The range of practical, social, and ethical problems that face business people and their accountants every day are often more difficult than those facing other professionals and, by and large, business has done well in dealing with them.

**Are Things Worse?** Many people argue that we are in the midst of an ethical crisis. Just as many believe that things are no worse than they ever were. It is difficult to tell. Nevertheless, the number of highly publicized ethical shortfalls in business and politics demonstrates that things are bad enough to warrant concern.

There were always rogues—greedy, selfish people who pursued money and power at all costs—and there always will be. The question is not whether there are bad people or even how many of them, but whether we make them heroes or villains and whether we allow them to become role models for our children. While each new revelation of impropriety is morally significant, the real danger is that we are less and less surprised; we are coming to expect that people will exploit all opportunities for personal gain, abuse their power, and act irresponsibly.

The danger is that each publicized instance of dishonesty, hypocrisy, and selfishness reinforces the notion that “everyone does it,” that “you can’t make it unless you cut corners,” and that “good guys finish last.” There is a great danger that traditional American idealism will give way to a “no holds barred, everyone for himself” philosophy.

**Counter Movement.** There is a need for a strong and concerted response. Business leaders are in an ideal position to lead it. Those who care ought to take the initiative and aggressively assert that things don’t have to be this way.

**Ethics Is Not a Luxury.** Some people think ethics is a luxury, something you can afford only when everything else is going well. Recent history shows us that this is not so. A failure to consider the ethical implications of conduct can greatly compound problems and blind you to obvious solutions. Ethics is not a luxury—it is an essential concern in all personal and business decisions.

**Whose Ethics?** A common question is, “What do you mean by ethics?” Underlying the question is an unspoken suspicion that ethics is basically a matter of personal opinion and that one cannot define ethics without revealing a narrow, dogmatic personal philosophy. This is not so.

**Concern with Right and Wrong.** The “ethics” we should be concerned with is fundamental and vital. It is based on the conviction that it is important to do one’s best to distinguish between right and wrong and always try to do what is right. Webster’s dictionary provides a more formal definition: “ethics is the discipline of dealing with what is good and bad and with moral duty and obligation, a set of moral values or principles.”

Because ethics, like morality, is regarded as a uniquely personal matter, many people are uncomfortable with any movement that might seek to impose on them someone else’s view of right and wrong. After all, one basic principle of American democracy is respect for the beliefs of others.

**Universal Principles.** The general concept of ethics, however, does not dictate nor imply a dogmatic response to specific situations. It merely requires commitment to a core of universal ethical principles common to all religions and secular moral philosophy.
**Golden Rule.** The most fundamental ethical principle is the Golden Rule: “Do unto others as you would have them do unto you.” This rule emanates from the notion that an ethical person is concerned not only with himself, but with the well being of others. Ethical decisions take into account the interests of others. An ethical person consciously avoids harming others and affirmatively helps.

Treating others as you want to be treated is not an exchange or an investment, it is an expression of natural caring, the kind that makes us cry with a stranger’s tragedy and leads us to help those in need.

**Stakeholders.** The most fundamental ethical value then, the one that helps us distinguish right from wrong, is concern and respect for others. Ethical decisions always consider the effect on others. Unethical decisions disregard the human consequences.

**Does It Make a Difference to Talk About Ethics?** If a person has not learned to be ethical in early childhood, is there any chance that he will act ethically as an adult? There is a general assumption that ethical character is “hard wired” into the personality sometime before or during adolescence. This leads to a *myth of unaccountability* — “You can’t change human nature. If someone is not ethical by the time he reaches adulthood, it’s too late to do anything about it.”

Actually, “operational values”—those that guide behavior—are not formed until early adulthood and they are subject to constant change. Until one has to make serious binding choices, it is not necessary to choose and prioritize, to back up espoused beliefs with actions. Moreover, so long as individuals have the capacity to reflect and make value judgments, they can modify their personal ethics and change their behavior.

The prospect of increasing ethical sensitivity and activity is not based on a need to change human nature; most people appreciate the importance of ethics to a worthwhile life; most people want to be “good.” As John Gardner said: “Our problem is not to find better values but to be faithful to those we profess.”

**Decision Making.** Ethical behavior is not simply a matter of character, it is a matter of decision making—ethics are advanced or derogated one decision at a time. The issue is not all or nothing. It is a question of being more ethical more often.

Thus, it is possible to increase ethical behavior if one can influence persons to consistently consider and place a high value on ethical principles in making decisions which affect others. As employers and bosses, you are each in a unique position to exercise such influence.

One’s power to make a difference arises out of the influence you have with a vast network of people. In the *business context*, we have influence as a boss, a subordinate or employee, and a colleague or co-worker. In our *personal lives*, we have influence as parents, spouses, and friends.

The issue is not to have more business ethics, but *more personal ethics*.

**Do Ethics and Business Mix?** Many people think that business and ethics don’t mix. According to Milton Friedman, the only obligation of a business is to make a profit. The Greek poet Horace said, “By right means, if you can, but by any means make money.”

That is like saying the only purpose of human activity is to make a living. With businesses, as with people, much more is involved. John Ruskin had a more affirmative view: “The highest reward for a person’s work is not what they get from it but what they become by it.” And, in 1874, Peter Cooper said: “The object of business is to make money in any honorable manner … The object of life is to do good.”

**Why Business Should Be Concerned With Ethics?** There are two separate reasons why contemporary executives should be concerned with ethics:

1. En**lightened Self-Interest.** A business needs to avoid scandals, keep government off its back, protect itself from internal corruption, avoid fines and penalties, and keep its executives out of jail.

   This is a powerful impetus, but it is *responsive*. It encourages walking the line of propriety, doing only what one has to do, making minimum performance the standard of responsibility. When business decisions are designed to walk the line, the line will inevitably be crossed.
2. **It Is the Right Thing to Do.** The real “bottom line” is not what you make, but who you are. Even if you are not religious, you have to believe that for your life to account for something it has to represent more than the accumulation of material things or the transient value of improved quarterly reports. Every person is an independent moral agent capable of making choices and accountable for the consequences of those choices.

**The Ethics/Law Fallacy**

A common fallacy in discussions about ethics is “If it’s legal, it’s ethical.” Thus, a common response to charges of impropriety is to invoke the law. This legalistic approach to ethics assumes that anything not prohibited by law is, *ipso facto*, proper and ethical. Thus, when it is reported that a politician is not indictable for certain conduct, some treat the decision as a “clean bill of health.” The argument is extended even further when a public official acquitted of a criminal charge (because the prosecutor could not convince a jury beyond a reasonable doubt that a crime was committed) asserts that he or she has, by that fact alone, been absolved of all wrongdoing.

The main error in this approach stems from the implicit assumption that legal standards articulate or establish ethical principles. Although law abidingness is an aspect of the ethical obligation or responsible citizenship (it is generally unethical to break the law), laws and rules do not describe what an ethical person *ought* to do.

**Sources of Ethical Obligation**

**Laws, Professional Standards and In-House Rules**

*Difference between Lawfulness and Ethics.* Laws and rules establish minimal standards of consensus impropriety; they do not define the criteria of ethical behavior. Persons are not “ethical” simply because they act lawfully. One can be dishonest, unprincipled, untrustworthy, unfair, and uncaring without breaking the law.

Ethical persons measure their conduct by basic ethical principles rather than rules; they do not walk the line of propriety; they do more than they have to and less than they are allowed to. Thus, in making personal or occupational decisions, the law is only a minimal threshold describing what is legally possible, it does not address the problem of how we *should* behave.

**Laws.** Business executives and professional accountants and their firms are regulated by an extensive and complicated body of laws which establish obligations that may or may not have an ethical basis. In many cases, the laws impose heavy burdens on business without apparent justification.

Many of the laws and regulations appear to be, and some are in fact, foolish. It is, therefore, tempting to evade certain rules and easy to justify the evasion. Nevertheless, all laws impose an ethical obligation on responsible citizens to either abide by them or openly protest them in an effort to get them changed.

A company that is caught violating even technical laws is generally regarded as unethical and, in addition to the civil and criminal penalties that may be invoked, lawbreaking often causes serious damage to the reputation of the company and executives involved, and to the morale of the company’s employees.

**In-House Rules.** Every company has the right and power to impose standards of behavior which supplement and extend laws and generally accepted professional practices. Much has been written in recent years about “corporate cultures” and how top management, especially the Chief Executive Officer, determines that culture and the general level of ethical sensitivity and commitment down the ranks.

There is little doubt that senior managers who are fully and genuinely committed to uplifting and upholding the ethical quality of corporate behavior can have an enormous impact. Even if they do not change attitudes, and they often do, they can affect conduct by the reward systems they establish and the sanctions they impose and threaten to impose.

**Personal Conscience**

A separate and morally superior source of ethical obligation is the individual’s ethical value system which forms the conscience. Persons judge the propriety of conduct in terms of the ethical standards embedded in their conscience and integrity; self-esteem and self-respect depend on a person’s ability and courage to live up to those standards.
A common excuse made by those who act improperly is that they were required to do so at risk of their job or career. This excuse does not free one of the obligations of conscience and ethical duty since neither popular opinion nor occupational or regional norms of behavior override sincerely held ethical values.

The Executive’s Role As a Teacher

Developing Ethical Consciousness and Commitment

You can’t “teach” ethics to adults. This belief is at the core of cynicism about the ethics movement and attempts to promote the active integration of ethical values in professional and personal decision making. The problem is not to “teach ethics” but to find ways to increase the likelihood that people will act ethically by increasing sensitivity to the ethical implications of conduct and by stimulating the natural desire in most people to do the “right” thing. Employers have many opportunities to promote ethical conduct, and such efforts are worthwhile even if only some people alter their conduct just some of the time.

Opportunity: Young Executives Are in the Process of Development

The early period of a young executive’s career is usually an active one in terms of psychological, emotional and mental development. In this period, basic professional value systems are generally formed or adopted. The kinds of experiences and training provided by employers have great impact on the role that traditional ethical principles will play in the young executive’s daily decision making and conduct.

Contradicting the widely held belief that young adults possess firm and immutable value systems that will dictate the ethical quality of their conduct, recent studies show that major ethical development occurs after adolescence. There are two main reasons: 1) the mental capacity to engage in relatively sophisticated moral reasoning generally does not develop until the late teens and early twenties; 2) people tend to develop and alter functional value systems in response to experiences and opportunities for reflection. Even mature adults are capable of adjusting their value systems, and they usually do so, not by adding new values so much as re-prioritizing existing ones.

Ethical development is demonstrated by a movement from the totally self-centered reasoning of the child to a more complex process that takes into account the interests of others and the advancement of moral principles. Our ability to understand and analyze the ethical implications of our choices tends to develop with age and experience. Many young men and women entering the work force are still very self-centered (often selfish). Their insecurity and desire to succeed also makes them especially susceptible to influences which tend to shape their sense of themselves and their obligations to others.

Ethical Development Is Not a High Priority for Young Professionals

Though most young executives have matured to the point where they are capable of adult level ethical reasoning, they are not usually ready, and they are certainly not eager, to focus on their ethical duties and responsibilities. Instead, they are likely to be preoccupied with personal relationships and the establishment of a professional identity.

Often, young people entering the business world have just emerged from an academic cocoon with a burning desire to acquire money, status, and power—three things of which they have had little or none. They are often heavily burdened with debts and unfulfilled desires acquired in their student days. They want to taste “the good life” and experience some level of prestige. They want to develop personal reputations and advance their careers.

This natural propensity to focus on personal priorities combines with the convenient assumption that business does not reward ethical behavior, to produce a very skeptical view of the role of ethics in advancing career goals. As a result, many people are all too willing to adopt whatever ethical code seems to advance these primary objectives.

Thus, despite occasional lapses of idealism, the eager up-and-comer tends to justify and rationalize the pursuit of self-interest without much regard to the broader social responsibilities of the enterprise and work they are engaged in. Unless those who have authority and influence consciously provide a more affirmative image of business, young businessmen and women will formulate operational professional value systems under circumstances where all the natural pressures generate survival of the fittest, no holds barred philosophy that mocks the notion that a good executive should also be a good person.
Development of an Operational Professional Value System

Nearly everyone enters his or her career with a full complement of values and a fairly well-developed character. Nevertheless, in order to make business decisions, the new executive must prioritize among competing and complementary values to formulate an operational professional value system which may or may not conform to the personal value system.

Since most young people enter the job market with a commitment to be a “good executive,” it is only necessary that each refine his or her concept of what that means. To some, the concept is almost exclusively a function of technical skill and practical judgment. A good executive is smart, shrewd, and capable and doesn’t break the law (though it is acceptable, even desirable, to bend it, or to push it to its limits). A more ethically grounded approach integrates the moral dimension of ethical principles into the concept of good business practice. Under this view, good executives reflect a more positive commitment to ethical principles such as integrity, trustworthiness, respect for others, fairness, and the pursuit of excellence; they are willing to do more than they have to and less than they are allowed to do.

Superiors, colleagues, and mentors who influence the young executive’s ideal of the good businessperson have both a special opportunity and responsibility to inculcate, support and encourage the development of a professional conscience which is based on ethical principles.

Thus, senior executives have access to the developing adult at the ideal time and, consciously or not, they will have an impact on how their junior colleagues view their ethical obligations.

Creating an Ethical Culture

Ethically concerned firms and individuals can take advantage of this special opportunity to influence the development of young executives by consciously creating an environment which tends to inculcate the moral values underlying professional conscience (e.g., integrity, trustworthiness, respect for others, fairness, and the pursuit of excellence) and by developing a “professional culture” which stresses and reveres professional conscience, principled reasoning and ethical decision making.

The ethics of the workplace, as reflected by the statements and actions of the company’s top executives (i.e., the corporate culture), is a major factor in the development of the operational value systems of employees and on the way in which young executives prioritize values in making decisions.

Consciously or not, a company, and particularly the leading executives of that company, will either enhance or diminish ethical incentives and commitment. If those who govern the firm convey the idea that adherence to a high standard of personal and professional ethics is important to the company, and if recognition and success are significantly affected by this attitude, one can be sure that ambitious employees will attempt to reflect the values prized by those who can advance their careers. Moreover, the young executive will tend to emulate those qualities which are associated with the conduct and character of the successful role models, the leaders in the firm.

Actions Speak Louder Than Words

*What executives do, what they believe and value, what they reward and whom, are watched, seen, and minutely interpreted throughout the whole organization. And nothing is noticed more quickly—and considered more significant—than a discrepancy between what executives preach and what they expect their associates to practice.*

---

*Peter Drucker*

Most important, let your ethical example at all times be absolutely impeccable... Be aware also of the signals you send to those around you. Steady harping on the importance of quarterly gains and earnings, for example, rather easily leads people to believe you don’t care much how the results are achieved. *Vernon Loucks*

The values that will be adopted by young executives are the operational ones which control routine and crisis decision making, not aspirational platitudes enunciated in ethical codes or occasional executive messages. It is not that written policies and oral invocations are not valuable. In fact, when they are consistent with the operational values that control corporate conduct, they are quite powerful as means of clarifying and reinforcing the company’s ethical goals. On the other hand, when employees perceive an inconsistency, they will invariably seek to conform to the actual corporate culture and dismiss the statements as hypocritical or unrealistic standards drawn by men with their feet firmly planted in mid-air. One can say, “Do as I say, not as I do,” but no one will.

The true values of a company are reflected in the multitude of small things that the company does or allows to be
done. What it encourages, what it allows, and what it appears to know and not know send clear messages to vigilant employees as to what is really important.

**Recruiting, Hiring and Promotion**

Especially important are the values which are *implicit* in the recruiting and hiring, training, supervision, and promotion of employees. Conscientious efforts to hire and promote people with principles beyond blind loyalty and the willingness to “go along,” people who can be trusted to exercise moral judgment in their work and add luster to the reputation of the firm, are important for several reasons:

1. The company is bound to get and keep more ethical employees than it otherwise would (strongly ethically centered individuals will be drawn to the company simply because of its overt concern with ethics). As the employee base increases, the ethical culture of the organization strengthens and it develops immunities and defenses to the kind of petty and major corruptions that undermine both moral and business aspirations.

2. Such efforts provide convincing evidence that ethical qualities like integrity, honesty and fairness are important qualifications for employment.

3. The efforts themselves establish an image and tone that demonstrates values other than pure financial gain.

**Lead by Example.**

Consider your individual power to degrade or inspire, to crush or nurture all those who look up to you for validation. Remember how many people’s sense of worth is tied to your appraisal of them. *How many times have you touched a life today?*

*Reprinted with permission of Josephson Institute for the Advancement of Ethics, January 1989.*
Introduction

Code of Professional Conduct

Background

The established professions have promulgated codes of ethics, and they have established means to see that the codes are observed by members of the profession. The principal source of information concerning the CPA profession’s ethical standards is the *Code of Professional Conduct* of the American Institute of Certified Public Accountants (AICPA).

*During its over 100-year history the AICPA’s Code has been revised and reworded many times. The present Code of Professional Conduct (Principles and Rules) became effective in 1988. Prior to this revision, the last complete restatement of the Code was in 1973.*

Structure

The Code is entitled the *Code of Professional Conduct.* It has two integral sections: Principles and Rules. Both the Principles and Rules must be approved by the members of the AICPA. Interpretations of the rules and ethics rulings are prepared by the Institute’s Division of Professional Ethics. As the nature of the profession’s work changes, the AICPA Division of Professional Ethics proposes new or revised interpretations or rulings. After an exposure process, the Institute publishes adopted interpretations and rulings in the Journal of Accountancy.

Publication of an interpretation or ruling in the *Journal of Accountancy* constitutes notice to members. Unless the interpretation or ruling specifies a different date, the effective date of the pronouncement is the last day of the month in which it is published in the *Journal.*

There are currently six sources of pronouncements and guidance on this subject published by the AICPA.

The first category of the Code is the Principles. They are goal-oriented and aspirational. They define professional behavior positively and set guidelines to promote greater adherence to professional technical standards and ethical performance requirements.

The second category of the Code is the Rules. Infraction of any of the rules makes a member liable to disciplinary action.

The third category is the Interpretations of Rules. After exposure for 60 to 90 days to state CPA societies and other interested parties, these formal rulings are issued by the AICPA Professional Ethics Executive Committee. The interpretations are intended to provide guidelines on the scope and application of the Rules of Conduct. Members who depart from such guidelines have the burden of justifying such departure in any disciplinary hearing.

The fourth category is Ethics Rulings. After exposure for 60 to 90 days to state CPA societies and other interested parties, these formal rulings are issued by the AICPA Professional Ethics Executive Committee. The rulings summarize the applications of Rules of Conduct and Interpretations to a particular set of facts and circumstances. Members who depart from such rulings in similar circumstances will be requested to justify such departures.

A fifth category of ethical guidance is the *Journal of Accountancy* quizzes, “Test Your Knowledge of Professional Ethics.” These contain Ethics Division staff responses to inquiries from members. These questions and answers follow the same format as Ethics Rulings. They, however, have not been exposed to state societies and other interested parties for comment and they are not formal rulings by the AICPA Professional Ethics Executive Committee.

A footnote to them states:

This quiz is based on responses of the AICPA Professional Ethics Division staff to members’ inquiries. It is not a pronouncement of the Professional Ethics Executive Committee nor does it purport to set forth an official position of the AICPA. In addition, the questions and answers do not address the requirements of other regulatory bodies, such as the state boards of accountancy, Department of Labor, and the Securities and Exchange Commission, whose positions may differ from those of the AICPA.
With the adoption of new independence rules in 2001 a sixth category of examples were posted on the AICPA’s Website. A set of facts is given, “Fact Pattern,” and the effect on independence is shown, “Outcome.”

The status, if any, of the fifth and sixth category of guidance (the questions and answers and the fact pattern and outcome) in any ethics investigation or disciplinary hearing is unclear. One would suspect that even though they do not purport to represent the official position of the AICPA, like the Ethics Rulings, members who depart from these answers in similar circumstances may be requested to justify such departures.

The AICPA Code of Professional Conduct, including principles, rules, interpretations of the rules and ethical rulings, are contained in Volume 2 of the AICPA’s Professional Standards. Every firm in public practice should have in its library the entire Professional Standards service. It may be obtained through the AICPA either in a loose-leaf service that is periodically updated or in annual bound paperback editions. It is also available on the AICPA website (www.aicpa.org).

State Societies of Certified Public Accountants
Almost all state CPA societies have adopted the AICPA Code of Professional Conduct as their own code. Some have issued additional rules, interpretations or rulings. Inquiry should be made of the state societies in the states wherein a member practices as to differences, if any, between their rules and the AICPA rules.

State Boards of Accountancy
The National Association of State Boards of Accountancy (NASBA) has a code of professional conduct that it recommends state boards of accountancy adopt. The NASBA code, although worded differently, is basically compatible with the AICPA Code of Professional Conduct. Many state boards of accountancy have adopted all or portions of the NASBA model code, adapting it in light of their state statutes. The state board code should be reviewed by the CPA for each state he or she practices in.

Coverage
Technically, the rules in the AICPA Code of Professional Conduct apply only to members of the AICPA. Similarly, state society codes of ethics apply only to their members.

A few CPAs have not joined either the AICPA or a state CPA society, falsely believing that they would thus escape the restrictions placed on them by a code of ethics.

However, each state has a State Board of Accountancy or similar governmental body which has adopted a code of professional ethics. Since all CPAs practicing public accounting are governed by their state board of accountancy, no practicing CPA can avoid operating under a code of professional ethics.

In addition, depending on the type of client involved and the services performed, the CPA may be subject to the rules or standards of other bodies such as the Securities and Exchange Commission, Government Accountability Office, Public Company Accounting Oversight Board, Internal Revenue Service, etc.

Public Company Accounting Oversight Board
The Sarbanes-Oxley Act of 2002 called for the creation of the Public Company Accounting Oversight Board. One of its duties is to promulgate ethics rules for publicly held companies. In July 2005, it enacted such rules. They may be found at www.pcaobus.org/rules.

Government Agencies
The Securities and Exchange Commission’s rules on independence, especially in the management consulting area, are more restrictive than the AICPA rules. Members with publicly held clients, or clients likely to go public in the future, should be aware of those rules.

The SEC’s independence rules are in Rule 2-01 of Regulation S-X. They may be found at www.sec.gov/rules/final/33-8183.htm. The Government Accountability Office (GAO) independence rules in the management consulting area are more restrictive than the AICPA rules. Members whose clients are either government entities or recipients of government funds should review these rules. The GAO rules may be accessed at www.gao.gov/govaud/yb/2003/html/chap33.html. Other government agencies, such as the Internal Revenue Service have ethics rules that may in some cases be stricter than the AICPA rules.

International Federation of Accountants
The International Federation of Accountants (IFAC) is an organization of 155 member bodies in 118 countries representing 2,500,000 members. Those members practicing outside of the United States should review the ethics codes of both the IFAC and the country where they are working. The IFAC Code may be found at www.ifac.org/guidance.

Other Codes
Other professional associations of accountants that have adopted their own codes of ethics include the Institute of Management Accountants, the Institute of Internal Auditors, Inc., Association of Government Accountants and Financial Executives Institute.
References
When a CPA has a question concerning ethics and cannot find the answer in the state board code, the society code, or the AICPA Code, interpretations or rulings, the CPA is urged to direct questions directly to these groups. They will answer questions from members. The ethics hotline (1-888-777-7077, option 5, followed by option 2) may be used for inquiries about the AICPA code. Questions may also be e-mailed to the Ethics Division at ethics@aicpa.org.

Questions concerning the SEC’s rules on independence may be addressed to the Office of the Chief Accountant of the SEC, 100 F Street N.E., Washington, DC 20549, (202-551-5300) or e-mailed to oca@sec.gov.

Questions concerning the GAO rules on independence, may be e-mailed to yellowbook@gao.gov. Questions may also be given to the Specialist, Auditing Standards at GAO (202-512-9535).

The AICPA Code of Professional Conduct is the primary basis for this course. A copy of the principles, rules, interpretations of the rules and ethics rulings is included throughout this text for reference.

Enforcement
The Institute’s Code of Professional Conduct derives its authority from the bylaws of the Institute. These bylaws provide that after a hearing a Trial Board may admonish, suspend, or expel a member found guilty of violating any of the bylaws or provisions of the rules of conduct.

The bylaws require that whenever a member is found guilty by a Trial Board, the guilty finding, and the member’s name be published. Currently they are listed on the AICPA website under Disciplinary Actions.

If the AICPA Professional Ethics Executive Committee concludes that a prima facie violation of the Code of Professional Conduct or the bylaws has taken place, but believes the matter is not of sufficient gravity to warrant trial board action, it may direct the member to complete specified continuing professional education courses or to take other remedial or corrective action.
Chapter Questions

1. Which category contains the ethical standards, a violation of which makes a member liable to disciplinary action?
   (a) Ethics Rulings.
   (b) Interpretations of the Rules.
   (c) Rules.

2. The Trial Board may, after a hearing, do two of the three things listed below. Mark the one that the Trial Board cannot do.
   (a) Suspend a member.
   (b) Suspend the member’s CPA certificate.
   (c) Expel a member.

3. Which of the following requires that any changes in them be approved by the members of the AICPA?
   (a) Rules and interpretations of the rules.
   (b) Principles and rules.
   (c) Principles, rules and interpretations of the rules.

4. The results of a guilty finding by a Trial Board will be:
   (a) published by the AICPA, but the member’s name will not be disclosed.
   (b) published by the AICPA, and the member’s name will be disclosed if the Trial Board votes to do so.
   (c) published by the AICPA with the member’s name given.

5. An interpretation or ethics ruling usually becomes effective:
   (a) the first day of the month following the month it is published in the Journal of Accountancy.
   (b) two weeks after it is published in The CPA Letter.
   (c) the last day of the month in which it is published in the Journal of Accountancy.

6. A CPA in public practice ________ avoid operating under a code of professional ethics by choosing not to join either the AICPA or any state CPA society.
   (a) may
   (b) may not
Chapter Answers

1. (c) is the correct answer. *Code of Professional Conduct*, Structure, says that infraction of any of the rules makes a member liable to disciplinary action.
   
   (a) is wrong since members who depart from the guidance in ethical rulings in similar circumstances will be asked to justify such departure. They cannot however be charged with violating a ruling.
   
   (b) is also wrong since a member cannot be charged with violating an interpretation. In a disciplinary hearing where the member was charged with violating a rule, the member would have the burden of justifying any departure from interpretations of that rule.

2. (b) is the correct answer. *Code of Professional Conduct*, Enforcement, says a Trial Board may admonish, suspend or expel a member. The Trial Board has no jurisdiction over a member’s CPA certificate.

3. (b) is correct. *Code of Professional Conduct*, Structure, says that Principles and Rules must be approved by the AICPA members.
   
   (a) is wrong and …
   
   (c) is wrong since interpretations are prepared and issued by the Professional Ethics Executive Committee without obtaining approval by the members.

4. (c) is correct. *Code of Professional Conduct*, Enforcement says that Trial Board convictions must be published with the member’s name disclosed.
   
   (a) is then wrong since the name must be disclosed.
   
   (b) is also wrong since the Trial Board does not have the option of deciding whether or not the member’s name will be disclosed.

5. (c) is correct. *Code of Professional Conduct*, Structure, says that interpretations and rulings are normally effective the last day of the month they are published in the *Journal of Accountancy*.
   
   (a) and (b) are therefore wrong.

6. (b) is correct. *Code of Professional Conduct*, Coverage, says that no CPA practicing public accounting may avoid operating under a code of ethics. The CPA may not join the AICPA or his or her state CPA society and therefore would not be subject to their codes of ethics. The CPA, however, cannot avoid being subject to his or her state board of accountancy’s code of ethics.
Principles

Purpose
The Principles section of the AICPA Code of Professional Conduct contains goal-oriented, positively stated principles that provide the framework for the profession’s technical standards and ethics rules. They prescribe the ethical responsibilities that members should strive to achieve. They are not enforced under their own terms but through underlying rules.

They point out to CPAs the things they must strive for, whether employed in industry, government, not-for-profit organizations, education or public accounting.

A CPA must always

• Exercise sensitive and moral judgments in everything one does.
• Act in a manner that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.
• Perform all professional responsibilities with the highest sense of integrity.
• Maintain objectivity and be free of conflicts of interest.
• Observe the profession’s technical and ethical standards.
• Strive continually to improve one’s competence and the quality of services rendered.

If all CPAs constantly tried to comply with the above, one may wonder whether rules, interpretations of those rules and ethical rulings would be required. What do you think of the following situations? Do you agree with what was done? Do they comply with the spirit of the statement in the Preamble of the Principles which calls for, “an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage”?

1. A management consultant wrote in one of the national accounting publications that
   • Most companies take discounts even if the discount period has passed.
   • Many companies use remote disbursement banks to extend the check-clearing float by one day.

2. A CPA prepared a recently widowed person’s tax return. It was not a complicated return. Time charges amounted to $1,000. He knew that the widow had no concept of what the fee should be for this work. Also, as she was moving out of town, he would not be doing any work for her in the future. The CPA billed her $5,000 for preparing the return.

3. The president of a small manufacturing company that made parts for larger companies found that his company had billed one of its customers for twice the number of parts that had been shipped. The invoice was duly paid and the customer never mentioned it so obviously they did not find the error. The president, since his margin of profit on the part was small, did not issue any credit memo to the customer for the overbilling.

4. A professional staff employee of a public accounting firm does some “moonlighting” after hours and on weekends maintaining the books and preparing tax returns for some small businesses. Rather than buying his own supplies such as legal pads, 8 and 16 column analysis pads, etc., he takes such supplies from the firm’s stockroom.

5. A sole practitioner’s client used to send him copies of all checks written, daily totals of sales, etc. Using this data the CPA then prepared cash receipts and cash disbursement journals, journal entries and a general ledger. He would send the client a monthly financial statement. The practitioner also prepared all the required tax returns.

The client decided to change accountants and asked for copies of the records needed by his new accountant such as depreciation records, journal entries and general ledger. His former accountant sent a bill covering the last quarter’s work that he had completed. This bill was much larger than prior quarters billings. He told his former client that the bill would have to be paid before any copies were given to him.
Further copying charges of $5 per page plus time charges at the rate of $200 per hour for time spent in preparing copies must be paid at the time the copies were handed over. When the former client said he thought those demands were unethical the CPA informed him that the AICPA code permitted him to insist on payment being made before these records were produced.

**Principles and Rules**

A citizen of the United States enjoys certain important rights and duties. A CPA has additional rights and duties. The citizen draws upon the Constitution; the CPA draws upon the AICPA *Code of Professional Conduct* as well.

U.S. citizens live and work with the Constitution. They can amend it from time to time. They can—through the courts—reinterpret and reevaluate their earlier understanding of it. So it is with the AICPA's *Code of Professional Conduct*. The rules and interpretations can be modified to keep them in harmony with the demands of the times.

Some things never change. Although the meaning of such concepts as freedom of the press, of speech, or religion can be modified, the fundamental principles remain intact. Similarly, the fundamental principles underlying the AICPA's *Code of Professional Conduct* do not change.

Independence has always been fundamental to the profession. A CPA expresses an opinion on financial statements. Because these opinions are relied upon by credit grantors, investors, governmental agencies and others, it is essential that the CPA maintain complete independence, giving an opinion based upon his or her own conclusions.

The character traits of integrity and objectivity are very important to an individual engaged in the practice of public accounting. Objectivity refers to a CPA's ability to maintain an impartial attitude on all matters in his or her professional work. The CPA's reputation for independence, integrity and objectivity is at the heart of the profession’s acceptance by the public.

Integrity and objectivity are equally important for the CPA not in public practice. Under the *Code of Professional Conduct*, both the members engaged in public accounting and all other members, whether in industry, government, or education, are charged with maintaining their integrity and objectivity, being free of conflicts of interest, not knowingly misrepresenting facts, not subordinating their judgment to others, and following all of the technical standards.

The Rules provide that a CPA shall not undertake an engagement that he or she cannot reasonably expect to complete with professional competence. Two important aspects of observing technical standards are meeting generally accepted auditing standards and following generally accepted accounting principles in expressing an opinion on financial statements. Accounting principles are promulgated by bodies designated by the American Institute’s Council. A CPA has a responsibility to the client and to the public. The CPA cannot let his or her regard for a client’s interest override the public obligation to maintain independence, integrity and objectivity.

Some rules regulate promotional practices such as advertising and solicitation. Other rules deal with professional operating practices. These control how a CPA firm may be organized and how they may conduct their practice.

A CPA will not practice in the name of another, nor will a CPA allow others to practice in his or her name, unless they are members of the same firm or employees of the same firm.

This overview shows the high standards the accounting profession has set for itself. The independence of the CPA is at the heart of the audit function. The CPA must perform all engagements in a competent manner and strive to improve his or her competence; the CPA must work within generally accepted auditing standards. Clients are attracted primarily through the public esteem of the accounting profession and through personal reputation. The CPA’s relationships with fellow practitioners must be professional. All members, whether or not in public practice, must maintain their integrity and objectivity.

These standards are high, but they are within reach. Thousands of accountants live by these rules and benefit from them. The future of the profession depends on a meaningful code of professional conduct that will be respected and followed by members. To understand the intent of many of the Rules, the certified public accountant should first understand the Principles.
Articles (AICPA)

Composition, Applicability, and Compliance

The Code of Professional Conduct of the American Institute of Certified Public Accountants 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. The Council of the American Institute of Certified Public Accountants is authorized to designate bodies to promulgate technical standards under the Rules, and the bylaws require adherence to those Rules and standards.

The AICPA Code of Professional Conduct was adopted by the 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.

Compliance with the Code of Professional Conduct, as with all standards in an open society, depends primarily on members’ understanding and voluntary actions, secondarily on reinforcement by peers and public opinion, and ultimately on disciplinary proceedings, when necessary, against members who fail to comply with the Rules.

SECTION I—PRINCIPLES

Preamble

Membership in the American Institute of Certified Public Accountants is voluntary. By accepting membership, a certified public accountant assumes an obligation of self-discipline above and beyond the requirements of laws and regulations.

These Principles of the Code of Professional Conduct of the American Institute of Certified Public Accountants express the profession’s recognition of its responsibilities to the public, to clients, and to colleagues. They guide members in the performance of their professional responsibilities and express the basic tenets of ethical and professional conduct. The Principles call for an unswerving commitment to honorable behavior, even at the sacrifice of personal advantage.

Article I—RESPONSIBILITIES

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

As professionals, certified public accountants perform an essential role in society. Consistent with that role, members of the American Institute of Certified Public Accountants have responsibilities to all those who use their professional services. Members also have a continuing responsibility to cooperate with each other to improve the art of accounting, maintain the public’s confidence, and carry out the profession’s special responsibilities for self-governance. The collective efforts of all members are required to maintain and enhance the traditions of the profession.

Article II—THE PUBLIC INTEREST

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

A distinguishing mark of a profession is acceptance of its responsibility to the public. 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 certified public accountants to maintain the orderly functioning of commerce. This reliance imposes a public interest responsibility on certified public accountants. The public interest is defined as the collective well-being of the community of people and institutions the profession serves.

In discharging their professional responsibilities, members may encounter conflicting pressures from among each of those groups. In resolving those conflicts, members should act with integrity, guided by the precept that when members fulfill their responsibility to the public, clients’ and employers’ interests are best served.

Those who rely on certified public accountants expect them to discharge their responsibilities with integrity, objectivity, due professional care, and a genuine interest in serving the public. They are expected to provide quality services, enter into fee arrangements, and offer a range of services—all in a manner that demonstrates a level of professionalism consistent with these Principles of the Code of Professional Conduct.

All who accept membership in the American Institute of Certified Public Accountants commit themselves to honor the public trust. In return for the faith that the public reposes in them, members should seek continually to demonstrate their dedication to professional excellence.

Article III—INTEGRITY

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

Integrity is an element of character fundamental to professional recognition. It is the quality from which the
public trust derives and the benchmark against which a member must ultimately test all decisions.

Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.

Integrity is measured in terms of what is right and just. In the absence of specific rules, standards, or guidance, or in the face of conflicting opinions, a member should test decisions and deeds by asking: “Am I doing what a person of integrity would do? Have I retained my integrity?” Integrity requires a member to observe both the form and the spirit of technical and ethical standards; circumvention of those standards constitutes subordination of judgment.

Integrity also requires a member to observe the principles of objectivity and independence and of due care.

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

Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.

Members often serve multiple interests in many different capacities and must demonstrate their objectivity in varying circumstances. Members in public practice render attest, tax, and management advisory services. Other members prepare financial statements in the employment of others, perform internal auditing services, and serve in financial and management capacities in industry, education, and government. They also educate and train those who aspire to admission into the profession. Regardless of service or capacity, members should protect the integrity of their work, maintain objectivity, and avoid any subordination of their judgment.

For a member in public practice, the maintenance of objectivity and independence requires a continuing assessment of client relationships and public responsibility. Such a member who provides auditing and other attestation services should be independent in fact and appearance. In providing all other services, a member should maintain objectivity and avoid conflicts of interest.

Although members not in public practice cannot maintain the appearance of independence, they nevertheless have the responsibility to maintain objectivity in rendering professional services. Members employed by others to prepare financial statements or to perform auditing, tax, or consulting services are charged with the same responsibility for objectivity as members in public practice and must be scrupulous in their application of generally accepted accounting principles and candid in their dealings with members in public practice.

Article V—DUE CARE
A member should observe the profession’s technical and ethical standards, strive continually to improve competence and the quality of services, and discharge professional responsibility to the best of the member’s ability.

The quest for excellence is the essence of due care. Due care requires a member to discharge professional responsibilities with competence and diligence. It imposes the obligation to perform professional services to the best of a member’s ability with concern for the best interest of those for whom the services are performed and consistent with the profession’s responsibility to the public.

Competence is derived from a synthesis of education and experience. It begins with a mastery of the common body of knowledge required for designation as a certified public accountant. The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a member’s professional life. It is a member’s individual responsibility. In all engagements and in all responsibilities, each member should undertake to achieve a level of competence that will assure that the quality of the member’s services meets the high level of professionalism required by these principles.

Competence represents the attainment and maintenance of a level of understanding and knowledge that enables a member to render services with facility and acumen. It also establishes the limitations of a member’s capabilities by dictating that consultation or referral may be required when a professional engagement exceeds the personal competence of a member or a member’s firm. Each member is responsible for assessing his or her own competence—of evaluating whether education, experience, and judgment are adequate for the responsibility to be assumed.

Members should be diligent in discharging responsibilities to clients, employers, and the public. Diligence imposes the responsibility to render services promptly
and carefully, to be thorough, and to observe applicable technical and ethical standards.

Due care requires a member to plan and supervise adequately any professional activity for which he or she is responsible.

**Article VI—SCOPE AND NATURE OF SERVICES**

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

The public interest aspect of certified public accountants’ services requires that such services be consistent with acceptable professional behavior for certified public accountants. Integrity requires that service and the public trust not be subordinated to personal gain and advantage. Objectivity and independence require that members be free from conflicts of interest in discharging professional responsibilities. Due care requires that services be provided with competence and diligence.

Each of these principles should be considered by members in determining whether or not to provide specific services in individual circumstances. In some instances, they may represent an overall constraint on the nonaudit services that might be offered to a specific client. No hard-and-fast rules can be developed to help members reach these judgments, but they must be satisfied that they are meeting the spirit of the Principles in this regard.

In order to accomplish this, members should

- Practice in firms that have in place internal quality-control procedures to ensure that services are competently delivered and adequately supervised.
- Determine, in their individual judgments, whether the scope and nature of other services provided to an audit client would create a conflict of interest in the performance of the audit function for that client.
- Assess, in their individual judgments, whether an activity is consistent with their role as professionals.
Chapter Questions

1. The accounting profession’s public includes
   (a) Governmental agencies.
   (b) Credit grantors.
   (c) Investors.
   (d) All of the above

2. Compliance with the AICPA Code of Professional Conduct depends primarily on:
   (a) Public opinion and reinforcement of one’s attestation peers.
   (b) Disciplinary proceedings when the code is violated.
   (c) Member’s understanding the code and voluntary compliance with it.

3. The Principles state that a member has responsibility to:
   (a) Colleagues.
   (b) Clients.
   (c) The public.
   (d) All of the above.

4. The Principles in the AICPA Code of Professional Conduct ______ enforceable under their own terms.
   (a) are.
   (b) are not.

5. A distinguishing mark of a profession is:
   (a) Acceptance of its responsibility to the public.
   (b) The esteem with which it is held by the public.
   (c) Its ability to influence legislation.

6. The AICPA Code of Professional Conduct provides guidance and rules for:
   (a) Only members in public practice.
   (b) All members.
   (c) Only members engaged in rendering attestation services.

7. Due care requires a member to:
   (a) Perform work for clients at the lowest cost.
   (b) Perform work for the clients with competence and diligence.
   (c) Complete each year a specified number of hours of Continuing Professional Education courses.
Chapter Answers

1. (d) is the correct answer. As (see Article II) the CPA’s public includes everyone that relies on them. This then would include
   (a) governmental agencies,
   (b) credit grantees and
   (c) investors.

2. (c) is the correct answer. Composition, Applicability and Compliance in the Articles says that compliance with the code, as with all standards in an open society, depends primarily on member’s understanding of the code and voluntary compliance with it.
   (a) is wrong. This section says that reinforcement by one’s peers and public opinion is secondary in obtaining compliance with the code.
   (b) is also wrong since this section says disciplinary proceedings against those that violate the code are the ultimate or final method of obtaining compliance.

3. (d) is correct. The Preamble to the Articles says that members have
   (a) a responsibility to colleagues,
   (b) to clients and
   (c) to the public.

4. (b) is correct. Principles are not enforceable under their own terms as shown in the section Purpose. Principles are goal-oriented and the rules of ethics are made and adopted within that framework.

5. (a) is correct. As stated in Article II, the distinguishing mark of a profession is acceptance of its responsibility to the public.
   (b) The esteem by which it is held by the public will come when it shows its responsibility to the public.
   (c) Influencing legislation may be important to the profession but it is not the distinguishing mark of a profession.

6. (b) is correct. The Code of Professional Conduct provides rules for all members. As stated in the Articles, section Composition, the membership adopted the code to provide guidance and rules for all members—those in public practice, in industry, in government and in education.

7. (b) is correct. Article V requires a member to perform his professional work with competence and diligence.
   (a) The Principles do not address the subject of fees or
   (c) Continuing Professional Education.
### Applicability and Definitions

#### Applicability

The bylaws of the American Institute of Certified Public Accountants (AICPA) require that members adhere to the Rules of the *Code of Professional Conduct*. Members not complying with the rules must be prepared to justify such departures.

All rules apply to all members, no matter what their field of endeavor, government, education, industry, nonprofit or public accounting. Associated members and international associates must also comply with the Rules of the *Code of Professional Conduct*. The only exception is if the wording of a rule indicates that applicability is more limited.

A member in public accounting may also be responsible for the acts of all persons that the member has the authority to control who are associated with him in the practice. A partner may thus be held responsible for a violation of the rules by a professional employee working for him. Also a member may not ask a person that the member can control to perform an act which if he or she performed it would be a violation of the rules. To do so would cause the member to be in violation of the *Code of Professional Conduct*.

Acts by persons that the member cannot control, may impair the member’s independence. Thus a member cannot use the excuse that his or her independence is not impaired because he or she could not control another person’s actions. If in a one-office firm a partner’s brother owns the majority of the stock in one of the firm’s clients, the partner and the firm are not independent of that client. The partner has done nothing to impair the firm’s independence. The action by someone outside of the firm that he or she cannot control has caused the independence impairment.

#### Definitions

In 2001 the AICPA modernized the independence requirements. They were changed from a firm based focus to an engagement team focus. This necessitated some new terms and some revised definitions of terms. Although many of the definitions of words and phrases are used mainly in the independence rules, they do however apply to all sections of the *Code of Professional Conduct*.

**Covered member is a new term.** People who work on engagements for a client and those that are in a position to influence attest work for the client are included in this group. This category also includes partners and managers who provide more than ten hours of nonattest services to the client during the year and all partners in the office of the lead attest engagement partner. The most stringent independence rules apply to these people. The independence rules for others in the firm that are not considered covered members have been made less restrictive especially with respect to stock ownership and loans to and from clients.

Individuals in a position to influence the attest engagement include those that supervise, evaluate the performance or who recommend the compensation of the engagement partner. In almost all firms, this will probably include all successive levels of senior management up through the managing partner of the firm. As one would expect, it also includes all those within the firm that consult with the engagement team on technical or industry matters with respect to the engagement.

Some definitions are different than what one would expect, and thus it is important that any practicing CPA be familiar with them. Immediate family is defined as spouse, spousal equivalent or dependent. Nondependent children and siblings are not considered immediate family. The relative or nonrelative who is a dependent is part of the immediate family. The number of people described as close relatives has been substantially reduced. Under the revised definition it now includes only a parent, sibling or nondependent child.

An attest engagement is defined as any engagement requiring independence. The attest engagement team includes anyone who works on the engagement. The team does not include people who perform only clerical functions such as typing and photocopying.
The period of a professional engagement starts the earlier of when the initial engagement letter is signed or the attest work begins. It does not end until either the client or the member terminates it, or in the case of nonrecurring work a report is issued. The period of the professional engagement for a client where the practitioner annually prepares an audit, review or compilation statement and tax returns is thus continuous without any breaks from year to year until either the member resigns or the client dismisses her or him. It does not end with the issuance of the report and tax returns and commence again at the start of the next year’s work. Whether or not a new engagement letter is received each year would not make any difference in the period of the professional engagement.

An office of the firm is defined as a reasonably distinct subgroup within the firm that serves the same group of clients or works on the same type of matters. The definition stresses that geographic location is not as important as the reporting channels and the regular personnel interactions. A person physically located in office A who continually worked on clients of office B would most likely be considered a member of office B. Similarly two physically separate offices that worked on mutual clients and constantly shared personnel would probably be classified as being one office.

**Conclusion**

The Rules of the *Code of Professional Conduct* apply to all classes of members of the American Institute of Certified Public Accountants. They apply to all fields of practice, industry, public accounting, government, education, nonprofit etc.

In 2001 the definitions used in the *Code of Professional Conduct* were revised and some new definitions promulgated. Some of these new and revised definitions had the effect, especially in the independence area, of changing the rules.
Applicability, Interpretation, Definitions

Applicability

The bylaws of the American Institute of Certified Public Accountants require that members adhere to the Rules of the Code of Professional Conduct. Members must be prepared to justify departures from these rules.

AICPA Interpretation Addressing the Applicability of the AICPA Code of Professional Conduct.

For purposes of the applicability section of the Code, a “member” is a member, associated member, or international associate of the American Institute of CPAs.

1. The Rules of Conduct that follow apply to all professional services performed except
   a. where the wording of the rule indicates otherwise
   b. that a member who is practicing outside the United States will not be subject to discipline for departing from any of the rules stated herein as long as the member’s conduct is in accord with the rules of the organized accounting profession in the country in which he or she is practicing. However, where a member’s name is associated with financial statements under circumstances that would entitle the reader to assume that United States practices were followed, the member must comply with the requirements of rules 202, Compliance With Standards [sec. 202 par. 01], and 203, Accounting Principles.
   c. a member who is a member of a group engagement team (see the clarified SAS Special Considerations—Audits of Group Financial Statements [Including the Work of Component Auditors]) will not be subject to discipline if a foreign component auditor (accountant) departed from any of the ethics requirements stated herein with respect to the audit or review of group financial statements or other attest engagement, as long as the foreign component auditor’s (accountant’s) conduct, at a minimum, is in accord with the ethics and independence requirements set forth in the International Ethics Standards Board for Accountants’ (IESBA’s) Code of Ethics for Professional Accountants, and the members of the group engagement team are in compliance with the rules stated herein.
   d. a member who is a member of a network firm (as defined in paragraph .24 of section 92, Definitions) will not be subject to discipline if a firm within the network (as defined in section 92 paragraph .23) that is located outside the United States (foreign network firm) departed from any of the ethics requirements stated herein, as long as the foreign network firm’s conduct, at a minimum, is in accord with the ethics and independence requirements set forth in the IESBA’s Code of Ethics for Professional Accountants.

2. A member shall not knowingly permit a person, whom the member has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the rules. Further, a member may be held responsible for the acts of all persons associated with him or her in the practice of public accounting whom the member has the authority or capacity to control.

3. A member (as defined in sec. 92 par.21) or a covered member (as defined in sec. 92 par.07) may be considered to have his or her independence impaired, with respect to a client, as the result of the actions or relationships of certain persons or entities, as described in rule 101, and its interpretations and rulings, whom the member or covered member does not have the authority or capacity to control. Therefore, nothing in this section should lead one to conclude that the member’s or covered member’s independence is not impaired solely because of his or her inability to control the actions or relationships of such persons or entities.

Definitions

Definitions of Words and Phrases As Used in the AICPA Code of Professional Conduct

Attest engagement. An attest engagement is an engagement that requires independence as defined in AICPA Professional Standards.

Attest engagement team. The attest engagement team consists of individuals participating in the attest engagement, including those who perform concurring and second partner reviews. The attest engagement team includes all employees and contractors retained by the firm who participate in the attest engagement, irrespective of their functional classification (for example, audit, tax, or management consulting services). The attest engagement team excludes specialists as discussed in SAS No. 73, Using the Work of a Specialist, and individuals who perform only routine clerical functions, such as word processing and photocopying.

Client. A client is any person or entity, other than the member’s employer, that engages a member or a mem-
ber’s firm to perform professional services or a person or entity with respect to which professional services are performed. For purposes of this paragraph, the term "employer" does not include—

- Entities engaged in the practice of public accounting; or
- Federal, state, and local governments or component suits thereof provided the member performing professional services with respect to those entities—
  - Is directly elected by voters of the government or component unit thereof with respect to which professional services are performed; or
  - Is an individual who is (1) appointed by a legislative body and (2) subject to removal by a legislative body; or
  - Is appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.

**Close relative.** A close relative is a parent, sibling, or nondependent child.

**Confidential client information.** Confidential client information is any information obtained from the client that is not available to the public. Information that is available to the public includes, but is not limited to, information

- in a book, periodical, newspaper, or similar publication;
- in a client document that has been released by the client to the public or that has otherwise become a matter of public knowledge;
- on publicly accessible websites, databases, online discussion forums, or other electronic media by which members of the public can access the information;
- released or disclosed by the client or other third parties in media interviews, speeches, testimony in a public forum, presentations made at seminars or trade association meetings, panel discussions, earnings press release calls, investor calls, analyst sessions, investor conference presentations, or a similar public forum;
- maintained by, or filed with, regulatory or governmental bodies that is available to the public; or
- obtained from other public sources.

Unless the particular client information is available to the public, such information should be considered confidential client information.

Members are advised that federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in the *Code of Professional Conduct*.

**Council.** The Council of the American Institute of Certified Public Accountants.

**Covered member.** A covered member is—

- An individual on the attest engagement team;
- An individual in a position to influence the attest engagement;
- A partner or manager who provides nonattest services to the attest client beginning once he or she provides ten hours of nonattest services to the client within any fiscal year and ending on the later of the date (i) the firm signs the report on the financial statements for the fiscal year during which those services were provided or (ii) he or she no longer expects to provide ten or more hours of nonattest services to the attest client on a recurring basis;
- A partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement;
- The firm, including the firm’s employee benefit plans; or
- An entity whose operating, financial, or accounting policies can be controlled (as defined by generally accepted accounting principles (GAAP) for consolidation purposes) by any of the individuals or entities described in (a) through (e) or by two or more such individuals or entities if they act together.

**Financial institution.** A financial institution is considered to be an entity that, as part of its normal business operations, makes loans or extends credit to the general public. In addition, for automobile leases addressed under Interpretation 101-5, “Loans From Financial Institution Clients,” an entity would be considered a financial institution if it leases automobiles to the general public.

**Financial Statements.** A presentation of financial data, including accompanying notes, if any, intended to communicate an entity’s economic resources and/or obligations at a point in time or the changes therein for a period of time, in accordance with generally accepted accounting principles or a comprehensive basis of accounting other than generally accepted accounting principles.

Incidental financial data to support recommendations to a client or in documents for which the reporting is governed by Statements on Standards for Attestation Engagements and tax returns supporting schedules do not, for this purpose, constitute financial statements. The statements, affidavit, or signature of preparers required on tax returns neither constitutes an opinion on financial statements nor requires a disclaimer of such opinion.

**Firm.** A firm is a form of organization permitted by law or regulation whose characteristics conform to resolutions of
the Council of the American Institute of Certified Public Accountants and that is engaged in the practice of public accounting. Firm includes the individual partners thereof except for purposes of applying Rule 101: Independence. For purposes of applying Rule 101, firm includes a network firm when the engagement is either a financial statement audit or review engagement, and the audit or review report is not restricted, as defined by professional standards.

**Holding Out.** In general, any action initiated by a member that informs others of his or her status as a CPA or AICPA-accredited specialist constitutes holding out as a CPA. This would include, for example, any oral or written representation to another regarding CPA status, use of the CPA designation on business cards or letterhead, the display of a certificate evidencing a member’s CPA designation, or listing as a CPA in local telephone directories.

**Immediate family.** Immediate family is a spouse, spousal equivalent, or dependent (whether or not related).

**Individual in a position to influence the attest engagement.** An individual in a position to influence the attest engagement is one who—

a. Evaluates the performance or recommends the compensation of the attest engagement partner;

b. Directly supervises or manages the attest engagement partner, including all successively senior levels above that individual through the firm’s chief executive;

c. Consults with the attest engagement team regarding technical or industry-related issues specific to the attest engagement; or

d. Participates in or oversees, at all successively senior levels, quality control activities, including internal monitoring, with respect to the specific attest engagement.

**Institute.** The American Institute of Certified Public Accountants.

**Interpretations of the rules of conduct.** Pronouncements issued by the division of professional ethics to provide guidelines concerning the scope and application of the rules of conduct.

**Joint closely held investment.** A joint closely held investment is an investment in an entity or property by the member and the client (or the client’s officers or directors, or any owner who has the ability to exercise significant influence over the client) that enables them to control (as defined in FASB ASC 810 Consolidation) the entity or property.

**Key position.** A key position is a position in which an individual:

a. Has primary responsibility for significant accounting functions that support material components of the financial statements.

b. Has primary responsibility for the preparation of the financial statements; or

c. Has the ability to exercise influence over the contents of the financial statements, including when the individual is a member of the board of directors or similar governing body, 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 any equivalent position.

For purposes of attest engagements not involving a client’s financial statements, a key position is one in which an individual is primarily responsible, or able to influence, the subject matter of the attest engagement, as described above.

**Loan.** A loan is a financial transaction, the characteristics of which generally include, but are not limited to, an agreement that provides for repayment terms and a rate of interest. A loan includes, but is not limited to, a guarantee of a loan, a letter of credit, a line of credit, or a loan commitment.

**Manager.** A manager is a professional employee of the firm who has either of the following responsibilities:

a. Continuing responsibility for the overall planning and supervision of engagements for specified clients.

b. Authority to determine that an engagement is complete subject to final partner approval if required.

**Member.** A member, associate member, or international associate of the American Institute of Certified Public Accountants.

**Member in business.** A member employed or engaged on a contractual or volunteer basis in an executive, a staff, a governance, an advisory, or an administrative capacity in such areas as industry, the public sector, education, the not-for-profit sector, or regulatory or professional bodies. This does not include a member while engaged in the practice of public accounting.

**Network.** For purposes of Interpretation No. 101-17, “Networks and Network Firms,” a network is an association of entities that includes one or more firms that (a) cooperate for the purpose of enhancing the firms’ capabilities to provide professional services and (b) share one or more of the following characteristics:

1. The use of a common brand name (including common initials) as part of the firm name

2. Common control (as defined in FASB ASC 810) among the firms through ownership, management, or other means


3. Profits or costs, excluding the following:
   a. costs of operating the association
   b. costs of developing audit methodologies, manuals, and training courses
   c. other costs that are immaterial to the firm
4. Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association’s strategy and are held accountable for performance pursuant to that strategy
5. Significant part of professional resources
6. Common quality control policies and procedures that firms are required to implement and that are monitored by the association

A network may comprise a subset of entities within an association if only that subset of entities cooperates and shares one or more of the characteristics set forth in the preceding list.

**Network Firm.** A network firm is a firm or other entity that belongs to a network, as defined in ET section 92 paragraph .23. This includes any entity (including another firm) that the network firm, by itself or through one or more of its owners, controls (as defined in FASB ASC 810), is controlled by, or is under common control with.

**Normal lending procedures, terms, and requirements.** “Normal lending procedures, terms, and requirements” relating to a covered member’s loan from a financial institution are defined as lending procedures, terms, and requirements that are reasonably comparable with those relating to loans of a similar character committed to other borrowers during the period in which the loan to the covered member is committed. Accordingly, in making such comparison and in evaluating whether a loan was made under “normal lending procedures, terms, and requirements,” the covered member should consider all the circumstances under which the loan was granted, including:

1. The amount of the loan in relation to the value of the collateral pledged as security and the credit standing of the covered member.
2. Repayment terms.
3. Interest rate, including “points.”
4. Closing costs.
5. General availability of such loans to the public.

Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

**Office.** An office is a reasonably distinct subgroup within a firm, whether constituted by formal organization or informal practice, where personnel who make up the subgroup generally serve the same group of clients or work on the same categories of matters. Substance should govern the office classification. For example, the expected regular personnel interactions and assigned reporting channels of an individual may well be more important than an individual’s physical location.

**Partner.** A partner is a proprietor, shareholder, equity or non-equity partner or any individual who assumes the risks and benefits of firm ownership or who is otherwise held out by the firm to be the equivalent to any of the above mentioned.

**Period of the professional engagement.** The period of the professional engagement begins when a member either signs an initial engagement letter or other agreement to perform attest services or begins to perform an attest engagement for a client, whichever is earlier. The period lasts for the entire duration of the professional relationship (which could cover many periods) and ends with the formal or informal notification, either by the member or the client, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period does not end with the issuance of a report and recommence with the beginning of the following year’s attest engagement.

**Practice of public accounting.** The practice of public accounting consists of the performance for a client, by a member or a member’s firm, while holding out as CPA(s), the professional services of accounting, tax, personal financial planning, litigation support services, and those professional services for which standards are promulgated by bodies designated by Council, such as Statements of Financial Accounting Standards, Statements on Auditing Standards, Statements on Standards for Accounting and Review Services, Statements on Standards for Consulting Services, Statements of Governmental Accounting Standards, and Statements on Standards for Attestation Services.

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

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

**Significant influence.** The term significant influence is as defined in Accounting Principles Board Opinion No. 18 and its interpretations.
AICPA Staff Responses to Inquiries

Covered Member

Question: A bank retains a CPA firm to perform an audit. During the period of the professional engagement, a manager in the CPA firm obtains a mortgage from the bank. He works in the same office as the lead partner on the audit but does not provide any services to the bank. Is the firm’s independence impaired?

Answer: No. According to Interpretation 101-1, independence is not impaired unless the manager falls within the definition of a “covered member.” The manager generally would not be considered a covered member since he is not on the attest engagement team and does not provide nonattest services to the client. Therefore, the firm’s independence is not impaired.

Question: A CPA firm performs an audit of a large manufacturing company. One of the firm’s managers, who plans to provide a significant amount of tax services to the company, has a spouse who inherited a small amount of stock in it. The manager does not work in the same office as the lead audit partner. Is the firm’s independence impaired?

Answer: Yes. According to Definitions, the manager is considered a “covered member” because he will provide more than 10 hours of nonaudit services to the company. His spouse is considered “immediate family.” Since Interpretation 101-1 subjects a covered member’s immediate family to the same restrictions as the covered member, with limited exceptions related to employment, the spouse’s ownership of stock in the client would impair the firm’s independence.

Fact Pattern: JJ is the managing partner of a CPA firm and the firm performs an audit of ABC Co.

Outcome: As the firm’s managing partner, JJ is a covered member, and is prohibited from having, among other things, a direct or material indirect financial interest in a client.
Chapter Questions

Situation for answering questions 1-5

Jones & Barnes, a public accounting firm, has offices in Minneapolis, Chicago and 10 other cities. The firm’s executive office and the managing partner are in Chicago. Each office does all the work and issues the audit reports for the clients of that office. Black & Co. is an audit client of the Minneapolis office.

State whether in the following situations the individual would be a “covered member” with respect to the 2001 calendar year audit of Black & Co.

1. Gilbert, a tax partner in the Chicago office
   (a) is a covered member.
   (b) is not a covered member.

2. Jacobs, an audit manager in the Minneapolis office, who does no work on the Black & Co. engagement.
   (a) is a covered member.
   (b) is not a covered member.

3. Larson, a consulting services partner, in the Minneapolis office who has not done any work for Black & Co.
   (a) is a covered member
   (b) is not a covered member

4. Olson, a professional staff person below the rank of manager, who worked for two weeks in 2001 on a nonattest consulting services engagement for Black & Co.
   (a) is a covered member
   (b) is not a covered member

5. Corey, secretary to the Minneapolis office managing partner,
   (a) is a covered member
   (b) is not a covered member

Situation for answering questions 6-10

Porter is a partner in White & Co., CPAs. State whether in the following situations the person would be classified as a member of Porter’s immediate family.

6. Porter’s dependent daughter who is away at college
   (a) is classified as part of Porter’s immediate family
   (b) is not classified as part of Porter’s immediate family

7. An elderly aunt of Porter’s wife lives in a nursing home. Porter and his wife pay the monthly nursing home fees and any other expenses the aunt incurs.
   The aunt
   (a) is classified as part of Porter’s immediate family
   (b) is not classified as part of Porter’s immediate family

8. Porter’s non-dependent son who lives next door to his father
   (a) is classified as part of Porter’s immediate family
   (b) is not classified as part of Porter’s immediate family

9. Porter’s wife who is self-employed and who annually earns twice as much as Porter earns
   (a) is classified as part of Porter’s immediate family
   (b) is not classified as part of Porter’s immediate family

10. Porter and his wife have been for the last year and are continuing this year to support a woman from South America who is attending the local college. She is currently a sophomore and lives in a dormitory on campus. Their support consists of paying for her tuition, books and supplies, board and room and a small amount for spending money. She is one of several students from foreign countries that members of their church have sponsored at the college. She is not related to either Porter or his wife.
    (a) is classified as part of Porter’s immediate family
    (b) is not classified as part of Porter’s immediate family

11. The AICPA Rules of the Code of Professional Conduct apply to which group?
    (a) All AICPA members.
    (b) All CPAs who are licensed to practice.
    (c) All CPAs

12. The Code of Professional Conduct says that with respect to the acts of others:
    (a) a member may be held responsible for compliance with the rule by all persons associated with him in the practice of public accounting who the member has the authority or capacity to control.
    (b) a member has no responsibility for the acts of anyone but himself.
    (c) it is silent on the matter.
13. A member wishes to take an action but is told that it would be against the rules in the Code of Professional Conduct. His secretary then offers to take the action saying to the member, “I will do it since I am not a member of the AICPA and their rules do not apply to me.” The member makes no comment and the secretary does carry out the action. Has the member violated the Code of Professional Conduct?
   (a) Yes.
   (b) No.

14. Which, if any, of the following is not classified as a loan?
   (a) letter of credit
   (b) guarantee of a loan
   (c) line of credit
   (d) loan commitment
   (e) all are classified as loans

Situation for answering questions 15-17

Daman & Co. is a one-office public accounting firm. In each of the following situations state whether the work Daman & Co. is doing would be classified as an attest engagement:

15. Preparing a review report on the financial statements of Blakely Mfg. Co. for the calendar year.
   (a) This is an attest engagement
   (b) This is not an attest engagement

16. Reviewing prior year’s tax returns of Heft & Co. and reporting to Heft’s board of directors the results of such a review. The tax returns were prepared by another accounting firm. This is the first work that Daman & Co. will do for Heft & Co. Daman’s partners hope that this engagement will lead to annual audits or reviews and preparation of tax returns for this company.
   (a) This is an attest engagement
   (b) This is not an attest engagement

17. Preparing income tax returns and a compilation report for Bower’s Restaurant for the calendar year. The compilation report will not disclose a lack of independence.
   (a) This is an attest engagement
   (b) This is not an attest engagement

Situation for answering questions 18-21:

Carson is a partner in a one-office public accounting firm that is located in Illinois. In each of the following cases state whether the individual would be considered a close relative of Carson?

18. Carson’s sister who lives in California
   (a) The sister is a close relative
   (b) The sister is not a close relative

19. Carson’s teenage son who lives at home and who is attending high school
   (a) The son is a close relative
   (b) The son is not a close relative

20. Carson’s father-in-law who lives next door to Carson
   (a) The father-in-law is a close relative
   (b) The father-in-law is not a close relative

21. Carson’s married daughter. She and her husband live and work in New York
   (a) The daughter is a close relative
   (b) The daughter is not a close relative

22. The general counsel for a client ____ considered to have a key position in the client with respect to financial statements issued by the client.
   (a) is
   (b) is not

23. Mead & Mead, LLP is a one-office public accounting firm. Five years ago Wagner Mfg. Co. engaged them to be their public accountants. At that time an engagement letter was received, and two weeks later Mead and Mead began their first work for Wagner Mfg. Co. Each year they have received a new engagement letter from Wagner Mfg. Co. covering their preparation of a review report and the state and federal income tax returns for Wagner Mfg. Co. They expect that this scenario will be repeated this year. The engagement letters are received in early November. The review report is delivered to Wagner Mfg. Co. by the first of March and the income tax returns by March 31 each year. Which of the following statements is correct with respect to the period of the professional engagement(s) Mead and Mead has with Wagner Mfg. Co.?
   (a) Each year’s engagement period runs from the time the annual engagement letter is received until the tax returns and review report for that year have been delivered to Wagner Mfg. Co.
   (b) The engagement period started with the receipt of the first engagement letter and continues uninterrupted to this date.
   (c) Each year’s engagement period starts with the receipt of the engagement letter for that year and ends with the delivery of that year’s review report to Wagner Mfg. Co.
Chapter Answers

1. (b) is correct. (Covered member (d)) includes partners in the office where the attest engagement partner is located. Since Minneapolis does all the work for this client the engagement partner has to be in Minneapolis. Gilbert is in the Chicago office and therefore he is not a covered member.

2. (b) is correct. (Covered member (a)), includes all people that work on the attest engagement team. Thus professional staff that work on the audit are covered members. Since Jacobs does no work on the Black & Co. engagement, he is not a covered member. The fact that he is a manager has no bearing on the answer.

3. (a) is correct. (Covered member (d)) includes all partners in the office where the lead attest engagement partner works. Since Minneapolis does all the work for this client, the lead attest engagement partner has to be in Minneapolis. Larson is a partner in the Minneapolis office, and therefore he is a covered member even though he never works on the Black & Co. engagement.

4. (b) is correct. (Covered member (c)) holds that partners or managers who provide ten hours or more of nonattest services to a client within the year are covered members. Olson however is not a partner or manager, and thus is not a covered member even though he did nonattest services for Black & Co.

5. (b) is correct. (Attest engagement team) does not include those performing routine clerical functions. Thus (Covered member (b)) does not apply to nonprofessional people unless they are in a position where they can influence the attest engagement. Corey, as a secretary, is thus not a covered member.

6. (a) is correct. (Immediate family) says it includes dependents. Even though she is away at college she is still a dependent and thus immediate family.

7. (a) is correct. (Immediate family) says it includes dependents. Since Porter pays all her expenses, she is a dependent and thus a member of his immediate family.

8. (b) is correct. (Immediate family) says it includes one’s spouse, spousal equivalent and dependents. Porter’s son is not dependent on him and is thus not considered immediate family.

9. (a) is correct. (Immediate family) says it includes spouses. Thus it does not matter how much she makes, where she works, etc., Porter’s wife is still classified as immediate family.

10. (a) is correct. (Immediate family) says it includes dependents. Since Porter pays all her expenses she is a dependent, and thus she is classified as immediate family.

11. (a) is correct. (Applicability) section says that the rules apply to all AICPA members.

(b) is wrong because CPAs licensed to practice who do not belong to the AICPA are not subject to AICPA rules.

(c) is also wrong because those CPAs not belonging to the AICPA are not subject to AICPA rules.

12. (a) is correct. (Interpretation addressing the Applicability of the AICPA Code of Professional Conduct) says a member may be held responsible for the acts of others that he has the authority to control.

13. (a) is correct. (Interpretation addressing the Applicability of the AICPA Code of Professional Conduct) says a member shall not knowingly let a person whom the member can control do something for the member that if the member did the same thing would be a violation of the code.

14. (e) is correct. (Loan) says that loans includes

(a) letter of credit,
(b) guarantee of a loan,
(c) line of credit and
(d) loan commitment.

15. (a) is correct. (Attest engagement) is an engagement that requires independence. Since review reports require the member to be independent, preparing the review report for Blakely Mfg. Co. is an attest engagement

16. (b) is correct. (Attest engagement) is an engagement that requires independence. Since reviewing tax returns does not require independence, this is not an attest engagement

17. (a) is correct. (Attest engagement) is an engagement that requires independence. Preparing tax returns does not require independence. Preparing a compilation report requires independence, unless the report discloses a lack of independence, which this one doesn’t. This then is an attest engagement with Bower’s Restaurant.

18. (a) is correct. (Close relative) says that siblings are close relatives. Carson’s sister is his sibling and thus a close relative.
19. (b) is correct. (Close relative) says that nondependent children are close relatives. Carson’s son is a dependent, he lives at home and attends high school. Thus, he is immediate family not a close relative.

20. (b) is correct. (Close relative) says that parents are close relatives. Carson’s father-in-law is not his parent and thus he is not a close relative.

21. (a) is correct. (Close relative) says that nondependent children are close relatives. Carson’s married daughter is obviously not a dependent. Thus she is classified as a close relative.

22. (a) is correct. (Key position) says that those who have the ability to exercise influence over the financial statements have a key position with the entity. It then lists general counsel as one of the positions that have such influence.

23. (b) is correct. (Period of the professional engagement) says it starts with first employment and continues uninterrupted until client dismisses the member or the member resigns. The period of the engagement could thus cover many years.

   (a) and (c) are wrong because though there has been no work done for the client since the last review report and/or tax returns were delivered, Mead & Mead, LLP is still considered to have an ongoing professional engagement with Wagner Mfg. Co.
Independence, Integrity, Objectivity

Independence, Integrity, Objectivity

- **Independence** encompasses an impartiality that recognizes an obligation for fairness not only to management and owners of a business but also to those who may otherwise use the CPA’s report.

- **Integrity** requires the CPA to be honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage.

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

The Independent Attitude

How does public accounting compare with other professions such as law and medicine? One significant difference can be noted. A lawyer’s first duty is to the client; a physician’s, to the patient. When CPAs express an opinion on financial statements, their first duty is to those who rely on the CPAs, i.e., the public.

Why is independence so crucial to the profession? An auditor’s opinion on financial statements would be of little value to clients, credit grantors, investors, government agencies, and the like unless the auditor maintained independence. Suppose a CPA has audited the financial statements of a corporation. The CPA expresses an expert opinion on management’s financial statements. Management is vitally interested in that opinion, of course, but so are the stockholders. Potential investors and others may also rely upon the CPA’s opinion.

In any discussion with a client on a controversial point, the CPA’s mind should be open to the client’s arguments. However, the CPA must maintain absolute integrity and objectivity and not allow his or her objectivity to be impaired. As an independent expert, the CPA performs the unique service of impartiality.

Integrity and Objectivity

Although integrity and objectivity are difficult to measure, both are essential to the profession. Both characteristics are fundamental for reliance on the CPA’s product. Integrity is difficult to judge because any particular fault by omission or commission may be the result of either honest error or lack of integrity. Objectivity is concerned with the CPA’s ability to maintain an impartial attitude. CPAs are exposed to situations that may involve pressure upon their integrity and objectivity. It would be impractical to define all such possible pressures, but one cannot ignore their existence.

The concept of independence should be interpreted as prohibiting relationships likely to impair the CPA’s integrity or impartial judgment. However, independence should not be interpreted so strictly that the CPA cannot perform useful services when the likelihood of impairment is relatively remote.

From another angle, powerful forces and restraints encourage the CPA to withstand pressures on integrity and objectivity. The possibility of legal liability is one such force. Professional discipline of varying degrees, up to the prohibition of the right to practice as a CPA and the loss of reputation, restrains the CPA from submitting to pressures upon his or her integrity and objectivity. As a disciplined professional, the CPA should possess the character traits necessary to withstand possible pressures.

Setting Independence Standards

A former chairman of the Professional Ethics Executive Committee stated, “there are actually two kinds of independence which a CPA must have—Independence in fact and independence in appearance. The former refers to the CPA’s objectivity, the quality of not being influenced in regard to personal advantage. The latter means his/her freedom from potential conflicts of interest, which might tend to shake public confidence in his/her independence in fact.”

In 2005 a Conceptual Framework for AICPA Independence Standards was issued by the Professional Ethics Executive Committee. In drafting Interpretation 101-1, additional interpretations, and ethics rulings which specify certain relationships with clients that will impair independence and others which will not impair independence, the Professional Ethics Executive Committee
uses the risk-based approach described in the Conceptual Framework. Using that, a member’s relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member’s independence. It is unacceptable if it compromises or would be perceived to compromise the member’s professional judgment.

It is not possible to have the rules, interpretations and rulings cover all the possible situations that might impair a member’s independence. In those situations where the matter is not specifically addressed by the rules, interpretations or rulings, members should use this conceptual framework to decide whether independence or the appearance of independence is impaired.

**Ethical Responsibility to the Client, External Accountant, and Others**

No professional, whether doctor, lawyer, or CPA, should allow a judgment about a client to be clouded—not by the client or by anyone else. A lawyer is retained to give legal advice; a doctor, to give medical advice. Sometimes lawyers and doctors must tell their clients things they do not want to hear. It is the professional’s ethical responsibility to do so. The CPA must also give good advice and honest opinions—whether the client likes it or not. Changing an opinion to earn a fee is dishonest and unethical. The extent to which CPAs remain independent is the extent to which they win public trust.

From time to time, a CPA will meet clients, people in government agencies, bankers, and others who hold opinions contrary to his or her own. They may, moreover, be highly qualified to express such opinions. Yet the CPA cannot subordinate his or her judgment to theirs. If the CPA yields to such pressures, the value of his or her opinions is likely to be impaired. It has been said, “There is often as much independence in not being led as in not being driven.”

In many situations, the CPA knows without question that he or she is correct. A CPA should not be driven from his or her position in such cases. But the question of the CPA’s independence goes much deeper. A CPA cannot permit a judgment to be warped in reporting on the fairness of financial statements. The CPA must in every way avoid anything which might impair objectivity or create any bias that could conceivably influence his or her judgment. To this the American Institute of Certified Public Accountants adds:

> In the field of auditing, the CPA is under a responsibility peculiar to his profession and that is to maintain strict independence of attitude and judgment in planning and conducting his examinations and in expressing his opinion on financial statements.

It has become vital to those who rely on financial state-

ments of business enterprises that the statements be reviewed by persons skilled in accounting, whose judgment is uncolored by any interest in the enterprise and upon whom the obligation has been imposed to disclose all material facts.

A member must not misrepresent or fail to disclose material facts to his employer’s external accountant. A member who is a controller, accountant or bookkeeper and deliberately withholds information or misrepresents information to the external accountant is violating the Code of Professional Conduct.

What if the member disagrees with his or her supervisor as to the recording of transactions or the preparation of financial statements? The member believes the supervisor’s instructions are wrong and following them will materially misrepresent facts or fail to disclose material items. What should the member do?

First he should consider whether the method prescribed by the supervisor represents an acceptable alternative method and does not materially misrepresent facts. If the member concludes that the supervisor’s methods are not an acceptable alternative and that following them the records or financial statements will be materially misstated, he should take the matter to higher levels of management.

Finally if the member concludes that appropriate action will not be taken, the member should reconsider his or her continuing relationship with that entity. At this point the member may wish to consult with legal counsel as to the member’s responsibilities, if any, of making disclosures to third parties such as regulatory authorities and the external accountants.

**Serving Clients That Are Competitors**

Mr. Smith, the managing director of a major pharmaceutical company, received a disturbing phone call. It was from his biggest competitor, Mr. Jones. Mr. Jones reported that one of Mr. Smith’s recently hired chemists had just been to see him. The chemist had offered to sell him Mr. Smith’s formula for a new antibiotic. Mr. Jones further reported that he had stalled the chemist by telling him he would think about it. The two competitors agreed on a plan to obtain evidence against the chemist, and the chemist was subsequently prosecuted for theft.

This incident proves the strength of ethical action. Some competitors, however, might not be quite as ethical as Mr. Jones. The point is that industrial espionage exists. The fear of such espionage has become deep-rooted in American industry. It must have occurred to some managers that their competitors’ most valued secrets are in the heads of their auditors, and one company might feel a little uneasy if their CPA is also engaged by a rival company. CPAs today commonly serve without impro-
do not assume the role of management or of an employee conducting the operations of the client’s enterprise. The CPA’s task is to identify feasible alternatives for the client. The client must accept the responsibility for the management decisions; the CPA’s role should remain advisory.

Part of the confusion about consulting services arises because they are not clearly defined. Over the years they have been called management services, management advisory services, consulting services, and currently non-attest services. The confusion is compounded because the profession constantly seeks to maintain a reputation for objectivity. In seeking to build public confidence, practitioners frown upon relationships or actions that might seem to make them lack independence. But no one works in a vacuum, and it is unreasonable to limit activities to the audit function when the CPA is in the best position to advise a client in other areas.

The AICPA has a Division of Management Consulting Services. The Division has issued a statement that serves as a guideline for ethical responsibilities in this area.

The SEC has always maintained that a firm may not do the audit of a publicly held client if they have performed bookkeeping work for that client. They claim that one cannot audit one’s own work and be independent of the client. The SEC has also been proposing for some time that firms that audit publicly held companies should not be allowed to furnish extended audit services or consulting services to those clients. They asserted that at least from an appearance standpoint, there is a lack of independence when a firm provides both consulting work and audit work for the same entity. In light of this, some of the largest public accounting firms have split their firms into two separate entities, one for audit and tax and one for consulting work.

The Sarbanes-Oxley Act of 2002 prohibits accounting firms from furnishing bookkeeping and many consulting services to publicly held clients. The Securities Exchange Commission (SEC) has modified its independence rules to conform to this new law. The law, however, applies solely to the audits of publicly held companies.

The U.S. Government Accountability Office adopted in January 2002 new standards on auditor independence. As stated in a memorandum to managing partners of all firms the changes in these standards were significant, and they impact audits of many governments, non-profit entities and for profit entities that receive federal assistance or participate in federal programs. The new standards restrict consulting and record keeping services that may be performed without impairing the accounting firm’s independence.

There is the potential of a “trickle-down” effect from the SEC and GAO restrictions on non-audit services. Some state boards of accountancy may decide to adopt at least a portion of such restrictions. In cases of litigation against
accountants it may be difficult to convince a judge or jury that independence is not impaired by consulting work for a private company when the SEC has ruled that similar work for a public company would impair independence.

**Bookkeeping**

Does an auditor sacrifice independence by doing original work on a client’s accounting records? Not always. Interpretation 101-3 considers this problem. Members in public practice are sometimes asked to provide manual or automated bookkeeping or data processing services to clients who are of insufficient size to employ an adequate internal accounting staff. Does the performance of basic accounting services, such as manual or automated bookkeeping services, cause a CPA’s audit to be lacking independence in a review of mechanical accuracy? Are the accounting judgments made by the CPA in recording transactions less reliable than if they were made by the same CPA in connection with a subsequent audit?

CPAs are skilled in, and well accustomed to, applying techniques to control mechanical accuracy, and the performance of the record keeping function should have no effect on application of such techniques. Third parties have confidence in a CPA’s accounting judgment in performing an audit. Thus, they should have the same confidence when the CPA’s judgment is applied to the performance of the record keeping.

The appearance of independence is important to the credibility given to the audit function. A CPA who performs accounting functions for an audit client must be careful to retain the appearance that he or she is not virtually an employee and therefore lacking in independence in the eyes of a reasonable observer.

Even though the CPA performs accounting services, the client must still accept the responsibility for the financial statements. A small client may not employ anyone to maintain accounting records. Instead, the client may rely on the CPA.

The AICPA has always held that a member is not allowed to be an employee or take on the role of management conducting the operations of an entity and remain independent of the entity. To strengthen this Interpretation 101-3, Performance of Nonattest Services, requires that client’s management has to agree to make all management decisions, designate a competent employee to oversee the service, evaluate the adequacy and results of the service, and accept responsibility for the results of the service. The member in turn has to be satisfied that the client will be able to meet these criteria. If the client cannot meet them, then providing the services will impair the member’s independence with this client.

Before performing nonattest services, the member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management as appropriate in the circumstances) regarding the following:

a. Objectives of the engagement
b. Services to be performed
c. Client’s acceptance of its responsibilities
d. Member’s responsibilities
e. Any limitations of the engagement

The documentation requirement does not apply to certain routine activities performed by the member such as providing advice and responding to the client’s technical questions as part of the normal client-member relationship.

This interpretation also lists about 60 services that a member might furnish to a client and states whether or not that service would impair independence.

**Tax Services**

Tax services are another area of specialization for CPAs. Can an auditor provide tax services without sacrificing independence? Yes, providing tax services to a client does not normally impair independence with that client.

Transmitting a tax return and related tax payment to a taxing authority would not impair independence if:

a. the member does not have control or custody over the client’s funds and
b. a person designated by the client reviews and approves the tax return and related payment and
c. if required for filing, this person also signs the return.

A member’s preparing, signing and filing a tax return for a client would impair independence with that client unless:

a. The taxing body has procedures allowing a member to sign and file a return on behalf of a client or
b. a person designated by the client, who has authority to sign and file the return, gives the member a signed statement naming the return to be filed, that this person is authorized to sign and file the return, that he/she has reviewed the return and he/she authorizes the member to sign and file the return.

The Sarbanes-Oxley Act of 2002 allows firms auditing publicly held companies to perform tax services such as filing state and federal income tax returns for such clients without impairing independence with those clients. Approval by the client’s audit committee is needed for such work. Other tax services may or may not impair independence with a firm’s publicly held client.
A CPA's opinion in an audit is very much like a judge’s ruling. Yet in representing a client before the Internal Revenue Service, the CPA may seem to be taking sides. Can the CPA be both judge and advocate at the same time? Is this not incompatible? The drafters of the AICPA code have stated that resolving doubt in favor of a client in an advocacy engagement is not considered to impair Integrity or objectivity.

Although the normal roles of lawyers and CPAs differ, they become similar in tax practice. The attitude of the American Bar Association resembles that of the AICPA. Formal Opinion 85-352 July 7, 1985, of the ABA Committee on Professional Ethics says in part:

A lawyer may advise reporting a position on a tax return so long as the lawyer believes in good faith that the position is warranted in existing law or can be supported by a good faith argument for an extension, modification or reversal of existing law and there is some realistic possibility of success if the matter is litigated.

Thus, both the ABA and AICPA take the position that one has no ethical responsibility to argue against one’s client’s interests. The CPA arrives at an opinion through technical competence and professional integrity. The CPA does not sacrifice independence when presenting a client’s return in the most favorable light. The CPA argues in favor of his or her own professional judgment.

Forensic Accounting Services
Expert witness services where a member is engaged to give his/her opinion before a trier of facts, rather than his/her direct knowledge of the disputed facts, impairs independence with the attest client involved. An exception is made if it is a large group of plaintiffs or defendants that includes one or more clients.

Being engaged as a fact witness would not impair independence with the client involved. Here the member is providing factual testimony to the trier of fact. If the trier of fact also asks for the member’s opinion, answering such questions would not impair the member’s independence.

Litigation consulting services where a member gives advice on the facts, issues and strategy but does not testify as an expert witness before a trier of fact would not impair the member’s independence.

Direct Financial Interest
In 2001, the AICPA changed for independence purposes from a firm based focus to an engagement based focus. This change in concept mirrored what the SEC had done in late 2000.

The change is found primarily in Interpretation 101-1. Under both the prior interpretation and the revised interpretation any ownership or commitment to acquire a direct or material indirect financial interest in clients results in a lack of independence.

The difference between the two interpretations lies in who these prohibitions apply to. In the old interpretation they applied to members. Members included, amongst others, all individuals participating in the engagement, all owners of the firm and individuals with a managerial position who were located in an office participating in a significant portion of the engagement.

Under the new interpretation the prohibitions apply to covered members only. Covered members includes, among others, those working on the attest engagement for the client, individuals in a position to influence the attest engagement, partners and managers who have provided a certain amount of nonattest services to the client and all owners and partners located in the office in which the lead attest engagement partner practices.

Under the revised interpretation partners located in other offices in the firm who do not work on the attest engagement and who have no influence on the engagement may now own stock in the attest client. This change has no effect for the one-office firm but represents a significant change for the larger firms with multiple offices and hundreds or even thousands of partners.

There is a limit to the amount of a client’s stock that may be owned by non-covered members. The interpretation says that independence would be impaired if a partner or professional employee or their immediate family or any group of such persons acting together owned more than five percent of the client.

Independence would be impaired because of a direct or material indirect financial interest in an attest client if that interest is held by a covered member’s spouse, spousal equivalent and/or dependent.

Since there is no materiality with respect to direct financial interests, the following investments of as little as one share of stock will impair independence:

1. Any partner or shareholder who—
   a. works on the attest engagement, or
   b. can influence the attest engagement, or
   c. is located in the office in which the lead attest engagement partner practices.

2. Any professional staff persons, including part-time help and interns, who do any work on the attest engagement.

3. Certain other partners and managers who provide nonattest services to the attest client.
4. If the holding of stock by a person would impair independence, the holdings by the spouse of such a person, or someone supported by such a person, would also impair independence. This is true even if the spouse is financially independent or if the individual being supported lives a thousand miles away.

Although direct financial interests held by certain partners and owners, professional staff and managerial employees will not impair independence, such holdings of a client’s securities may cause staffing problems. For this and other reasons, some public accounting firms may have rules that prohibit partners, owners, and certain professional staff members from having any direct financial interests in any of the firm’s audit clients.

The person holding a client’s securities should seriously consider whether the investment is worth being precluded from working on the engagement for that client. If it is one of the larger, more prestigious clients of the office, the CPA may be hindering his or her own advancement in the firm by retaining those securities. Also, the accusation of using insider information may be made. This would be especially true if persons either purchased or sold a client’s securities shortly before the release of the client’s audit report, and the financial statements showed a large increase or decrease in earnings.

Indirect Financial Interests
Immaterial indirect financial interests will not impair independence. Conversely, material indirect financial interests will impair independence. As an example, suppose a covered member owns less than 5 percent of the outstanding shares in a diversified mutual investment fund which holds shares of stocks in clients of the member’s firm. Would the independence of the member’s firm be considered to be impaired with respect to the client enterprises whose stock is held by the fund? Interpretation 101-15 Financial Relationships says that independence would not be impaired in these circumstances. Securities of the covered member’s clients held by the mutual fund in question represent indirect financial interests of the covered member in securities of the clients. However, this indirect interest through owner ship of mutual funds securities by a covered member would not normally be considered to impair the independence of the member’s firm. If the portfolio of the mutual fund was heavily invested in a client’s securities, such indirect financial interest of the covered member could become material and impair the independence of the member’s firm.

Auditor as Trustee or Executor
A covered member may be asked to be the trustee of a trust or to serve as the executor or administrator of an estate. Is the covered member’s independence impaired in these situations? Interpretation 101-1 on Independence states that there would be impairment if, during the period of the professional engagement, the covered member was a trustee of any trust or executor or administrator of any estate if such trust or estate had a direct or material indirect financial interest in the enterprise, and the member individually or with others could make investment decisions for the trust or estate or the trust or the estate owned more than 10 percent of the client’s stock or the value of the client’s stock was more than 10 percent of the total assets of the trust.

Covered members are often asked to be named as executor or trustees under the wills of officers of their clients. Often, in those situations the covered members know that the officer involved owns stock in the client and thus eventually the estate will hold such stock. Technically, the designation of the covered member in the will to be executor or trustee upon the death of the officer does not impair independence; however, actual service in that position upon the death of the officer would impair independence. Immediate resignation of the executor or trustee position upon the death of the officer will cure the independence impairment. Many members feel it is wrong to accept such an appointment when one knows that upon the officer’s death, the member will immediately resign the position. The officer had expected the CPA to be executor or trustee of the estate at the time the will was prepared. To fail to fulfill the function, although possibly not unethical, would be morally wrong in the minds of many.

Executor or trustee positions for relatives and non-clients pose the same problems if the trust holds clients’ securities. Immediate sale of the securities will cure the independence problem. However, such sales to preserve an accountant’s independence with clients may be a violation of the accountant’s fiduciary responsibilities as executor or trustee.

Loans with Clients or Client’s Officers, Directors and Principal Stockholders
Interpretation 101-1 states that independence is impaired if a covered member during the period of the professional engagement had any loan to or from the client or any officer, director or person owning 10 percent or more of the client.

For many years there have been exceptions to this prohibition with respect to certain types of loans from financial institutions. Before Jan. 1, 1992, a member could obtain from a client financial institution without impairing in dependence with that client, a home mortgage, other types of secured loans and loans that were not material to the member or his firm. Effective Jan. 1, 1992, obtaining such a loan from a client financial institution that is an attest client impaired independence with that client.

What about loans that were obtained prior to Jan. 1, 1992, from financial institutions that were and/or are current attest clients? Do these loans which are currently outstanding...
impair a covered member’s independence? No, such loans are “grandfathered” and cause no independence problems provided they meet certain criteria.

Also what about loans that are entered into subsequent to Jan. 1, 1992, with non-attest clients and such loans subsequently end up in the hands of an attest client? Again such loans will be “grandfathered” in, i.e., they will not impair independence with that client provided that they meet the following criteria:

- They were obtained from the financial institution prior to that entity becoming a client requiring independence.
- They were obtained from a financial institution where independence was not required and the loan was subsequently sold to a financial institution where independence is required.
- They were obtained by a person, prior to that person becoming a covered member, from a financial institution where independence is required.

Similar grandfathering exceptions are made for loans obtained prior to Feb. 5, 2001, that met the requirements of previous provisions of the interpretation covering loans, (105-1) and loans obtained between Feb. 5, 2001, and May 31, 2002, that met the requirements of the SEC during that period. “Grandfathered” loans must at all times be current as to all terms.

May a member obtain any type of loan from a financial institution where independence is required without impairing independence with that client? Yes, the following loans by members with such entities are permitted:

- Automobile loans collateralized by the automobiles.
- Leases collateralized by the automobiles.
- Loans fully collateralized by the cash surrender value of an insurance policy.
- Loans fully collateralized by cash deposits at the same financial institution.
- Credit cards with an aggregate balance not paid currently of $10,000 or less.

Any loan whether new or grandfathered that is from a financial institution where independence is required must have been made under normal lending procedures, terms and requirements.

Normal lending procedures, terms and requirements are designed to preclude any favoritism to the member from the client financial institution (Chapter 3, Applicability and Definitions). The general availability of such loans to the public, interest rate including points, closing costs, repayment terms and amount of the loan in relation to the collateral must not show a preference to the member as compared to other borrowers.

In situations where independence is impaired because of financial interests in a client; loans to or from a client or its officers, directors or principal stockholders; or joint investments with a client or its officers, directors or principal stockholders; the impairment may be removed by disposing of the interest, paying the loan, or disposing of the investment if such action is taken prior to the start of the professional engagement.

**Unpaid Fees**

When a client does not pay for an extended period of time, the CPA’s fees for professional services rendered, these amounts due take on some of the characteristics of a loan to the client within the meaning of Interpretation 101-1 on Independence. The AICPA Ethics Division has ruled that independence will be considered impaired if, when the report on the current year is issued, the client has not paid for professional services provided more than one year prior to the date of the current report. Whether or not the client has been billed for such services has no effect on independence. Also converting such fees to a note receivable from the client does not remove the independence impairment.

What can a CPA do in this situation? Must the CPA refuse to do work for the valued client of many years simply because the client has fallen on hard times and is unable to pay all of last year’s fees prior to receiving the report for this year? Some alternatives to be considered are:

1. Delaying the work for this year for a few months in the hope that the client would then be able to pay the prior year’s bill.
2. Renegotiating last year’s fees, i.e., settling those bills for 50 or 75 percent of their face amount.
3. Changing the scope of work this year to a compilation report with a disclaimer based on lack of independence. This is the only type of report the CPA may issue for a non-public company when the CPA is not independent.

**Jointly Held Investments**

Because an auditor is often considered by the client to be knowledgeable in investment matters, opportunities for joint investments may arise. Is an auditor allowed to make a joint investment with a client and still be considered independent? Is a joint investment allowed if it is made with the principal stockholder or a director or officer of the audit client? Interpretation 101-1 on Independence states that a covered member would not be independent if they had a joint closely held investment that was material to the member. What is a joint closely held investment? In Chapter 3, Applicability and Definitions, it is defined as an investment in an entity or property by the member and the client (or the client’s officers or directors, or an owner who can exercise significant
influence over the client) that enables them to control the entity or property. Under Applicability and Definitions, significant influence is as defined in Accounting Principles Board Opinion 18 and its interpretations.

In some cases a member’s firm and a client are jointly furnishing services to a third party. Does this joint participation in a business activity impair independence with the client? Interpretation 101-12, Independence and Cooperative Arrangements With Clients, says that a cooperative arrangement with a client to furnish services to a third party will impair independence if the amounts are material to the firm or the client. Cooperative engagements include—
- Prime or subcontractor arrangements with a client
- Joint venture with a client
- Combining services or products of the firm and the client and then marketing them as a package
- The firm or the client acting as a marketer of the other’s products or services

However, it will not ordinarily be considered a cooperative engagement, and thus not impair independence if the following conditions are met (note that there is no mention of materiality to either the client or the firm in this situation):
- Participation by the client and the firm are governed by separate agreements
- Neither the firm or the client are responsible for the activities of the other
- Neither the client or the firm has the power to act as a representative or agent of the other

Auditor as Officer or Director
A CPA is invited to serve on a corporation’s board of directors. Is the CPA independent if he or she serves as director? Not under Interpretation 101-1 on Independence, which states that the CPA will not be considered independent if during the period covered by the financial statements or during the period of the professional engagement, the CPA was connected with the enterprise as a promoter, underwriter or voting trustee, a director, officer, or employee, or in any capacity equivalent to a member of management. The CPA in this case has to decline the directorship or relinquish the audit. The CPA could not do both and maintain independence. The CPA would, in effect, be reviewing management decisions in which he or she took part as a director. A reasonable observer would likely not consider the CPA to be independent.

Interpretation 101-4—Honorary Directorships and Trusteeships of Not-for-Profit Organization provides an exception to this rule in those cases where the position is honorary and the organization’s activities are limited to those of a charitable, religious, civic or similar nature.

How does one prove that the position is honorary? This same interpretation states that:
- The member does not vote or participate in management functions.
- On letterhead where the member’s name is given his position is identified as honorary.
- On any externally circulated materials where the member is named as a director or trustee his position is identified as honorary.
- The position itself is purely honorary.

The reason for the exception is plain. CPAs often lend their names to worthy causes, and this is an encouraged practice.

In one situation, a CPA’s audit clients included a Boy Scout Council and the Legal Aid Society. He asked the Ethics Committee if his independence would be impaired if he served as a director and assistant treasurer of the United Community Chest, which raises the funds for the support of the Boy Scouts and the Legal Aid Society. The Committee investigated and found that the office of director of the Community Chest exercised no managerial control over the participating organizations. As a result, they held that the CPA would not jeopardize his independence.

Another CPA was asked to serve on the board of directors of a country club that he audited and where he was a member. The Ethics Committee advised him against going on that board. A country club differs from other nonprofit organizations in that it is run strictly for the benefit of its own members. Therefore, he would sacrifice independence to serve on its board and audit its financial statements at the same time. (Note the difference—directorship impairs independence; membership does not.)

In all such cases, the CPA applies the usual test: independence in fact and independence from the point of view of a reasonable observer. In applying the test, the CPA should consider all relevant circumstances.

When independence is impaired because the CPA has served the client as a director, officer, or employee or in any capacity equivalent to a member of management, the impairment covers the period of the financial statements even though the CPA held such a position for only a portion of that period. Also, if the CPA holds such a position during any portion of an engagement or at the time of expressing an opinion, independence is also impaired. To illustrate this, assume a calendar year 2000 audit of a company with the audit completed and signed by March 20, 2001. If the CPA had any of the positions specified above with this company for any time from Jan. 1, 2000, through March 20, 2001, his independence for this audit would be impaired.
What about a multi-office public accounting firm? Could any partner or professional employee be a director or officer of a client without impairing the CPA firm’s independence with that client?

Under rules in effect before May 31, 2002, a professional employee of the firm, who was not located in an office participating in a significant portion of the attest engagement could be an officer or director of a client without impairing the firm’s independence with that client. The rule has been changed, and now the firm’s independence would be impaired if any partner or any professional employee of the firm held a position as an employee, officer or director during the period covered by the financial statements or during the period of the professional engagement.

If an employee of the CPA firm was formerly a director or officer of a client, independence of the CPA firm will not be impaired with that client provided the employee has disassociated himself from the client and does not participate in the engagement for the client covering any period of his or her association with the client.

Family and Dependency Relationships

The term “covered member” in Interpretation 101-1 on Independence includes a covered member’s spouse (whether or not dependent) and dependent persons (whether or not related). Thus, if a covered member’s friend was dependent on the covered member, the friend’s investments would be ascribed to the covered member. If the friend’s investments included securities of clients, independence with those clients would be impaired.

The employment by a client of a covered member’s spouse or a person dependent upon the covered member in a key position would impair independence.

A “key” position is one in which the person has:

- primary responsibility for significant accounting functions that support material components of the financial statements
- primary responsibility for preparing the financial statements
- the ability to exercise influence over the contents of the financial statements. People with this power include the directors, general counsel and those one would assume to have authority over the financial statements such as president, treasurer, controller, etc.

Significant financial interests or business relationships with a member’s client by close relatives may also impair independence even though the relative does not live with the member and is not dependent on the member. Close relatives are defined as non-dependent children, siblings, and parents.

Independence would be impaired if an individual participating on the attest engagement, has a close relative who has a key position with that client or a financial interest in the client that was material to the relative or the financial interest enabled the close relative to exercise significant influence over the client.

Independence would also be impaired if an individual in a position to influence the engagement or any partner in the office in which the lead engagement partner practices has a close relative who has a key position with that client or a financial interest in the client that was material to the relative and which enabled the close relative to exercise significant influence over the client.

Note the difference. Close relatives of persons working on the engagement impair independence if they have a material interest OR can exercise significant influence. Close relatives of others impair independence if they have a material interest AND can exercise significant influence. This latter group could then have a material interest in the client and it would not impair independence if they could not exercise significant influence.

The financial interests and business relationships of all other relatives not defined as close relatives are not normally presumed to impair a member’s independence.

Retired Partners

The investments and business relationships of retired partners with clients will not impair independence with those clients provided the retired partner does not participate in the firm’s business or professional activities, does not appear to be associated with the firm from which he/she retired, payments to him/her for retirement pay and for interest in the firm are not material to the firm and the formula used to compute such payments remains fixed throughout the payout period except for adjustments for inflation.

Political Contributions

Do political contributions affect the appearance of independence? What if all the partners of a firm each gave the maximum amount allowed to one candidate, the candidate wins the election and subsequently awards government contracts for accounting services to that firm? Has the appearance of independence between that firm and the government entity been impaired?

The Professional Ethics Executive Committee has decided not to make any pronouncements prescribing or restricting political contributions made by members.

Litigation

When management of a company threatens or commences litigation against a CPA, independence may or may not be
impaired. The CPA and management may be placed in an adversary position where management is less willing to make complete disclosure to the CPA, and the objectivity of the CPA may be impaired. If litigation is threatened or commenced by management alleging deficiencies in audit work, or if litigation is commenced by the CPA alleging fraud or deceit on the part of management, independence is impaired. Litigation over such matters as billing disputes, tax or management services, will not normally impair independence if the litigation is not material to either the CPA’s firm or the client.

CPAs and their clients may at times be involved in various types of third-party litigation. They may be joint defendants in actions brought by security holders. Normally such litigation will not impair independence with the client. Each situation must be carefully evaluated for existing or potential cross-claims that may be filed by the client, its management or directors. If the cross-claims allege audit deficiencies on the part of the CPA, or the auditor alleges fraud or deceit on the part of current management as a defense, independence may be impaired. Also, if there is a significant risk that a settlement or judgment will be rendered on a cross-claim in an amount material to the client or the CPA firm, independence could be impaired.

Other types of third-party litigation against a CPA by a creditor, security holder or insurance company alleging reliance on financial statements audited by the CPA’s firm in extending credit or insurance to a client will usually not impair the CPA’s independence with that client. This is true even though the litigation is brought in the name of the client such as an insurance company may do under subrogation rights.

If the complainant in the third-party litigation is also a client of the CPA, independence with that complainant client may be impaired if there is a significant risk of settlement in an amount material to the CPA’s firm or the complainant.

Gifts and Entertainment

If a member of the attest engagement team or a member in a position to influence the attest engagement accepts a gift from an attest client, independence is impaired unless the value of the gift is clearly insignificant to the member. Independence would not be impaired if the member accepts entertainment from the attest client. Independence is not impaired if a member offers gifts or entertainment to an attest client.

As to non-attest clients and members not in public practice, unless the gift or entertainment is reasonable in the circumstances, objectivity would be considered to be impaired if a member offers or accepts gifts or entertainment from:

- a client
- an individual in a key position with a client
- an individual owning 10 percent or more of a client
- a customer of a member’s employer
- a vendor of the member’s employer

In all cases where it is deemed acceptable to offer or receive gifts or entertainment, the gift or entertainment must be reasonable in the circumstances. Seven criteria are listed that should be considered in determining whether the gift or entertainment is reasonable in the circumstances. Whether that is sufficient guidance remains to be seen. A pair of tickets to the local baseball team’s game, state university’s football game, or a day’s admission to a golf tournament, when given by a member to the president of the member’s audit client, might be considered reasonable. Would similar tickets to the World Series, the Super Bowl or the Masters Golf Tournament also be considered reasonable?

Conclusion

Independence is basic to the public accounting profession. An independent CPA is not subordinate and practices objectively, with honesty and integrity. In auditing and expressing opinions on financial statements, an independent CPA will avoid any relationship that would impair his or her objectivity. Moreover, the CPA will avoid any relationship that might suggest a conflict of interest to a reasonable observer.

The CPA must not only be independent in fact but must also appear independent to reasonably informed users. CPAs have an ethical responsibility to themselves, their clients, the public, and the government to maintain their independence.

Depending upon the type of client involved, publicly held, privately held or filing with government agencies, the public accountant must review and know the ethics rules on independence of the American Institute of CPAs (AICPA), Public Company Accounting Oversight Board (PCAOB), Securities Exchange Commission (SEC), Department of Labor (DOL), Government Accountability Office (GAO), appropriate state society and state board of accountancy.

Any direct financial interests and material indirect financial interests in a client during the period of the professional engagement or at the time of expressing an opinion will impair a covered member’s independence with that client. Similarly, any loans (with certain exceptions for loans from financial institutions) either to or from a client, its officers, directors, or persons owning ten percent or more of the client, if such loans are outstanding during the period of the professional engagement, will impair a covered member’s independence.

Bookkeeping or write-up services may or may not impair independence. If a CPA is an employee or takes on the role of a member of management, the CPA’s indepen-
dence will be impaired. Material, jointly held investments with clients, their officers, directors or principal stockholders will impair independence. Directorships, except purely honorary directorships with charitable, religious or civic organizations, will impair a CPA’s independence. Activities of completely retired former partners will normally not impair a CPA’s independence, while the investments and business relationships of a CPA’s kin may or may not impair independence. Litigation between a CPA and a client will usually impair independence, while litigation by third parties against either or both a CPA and client will often not impair independence.

**Conceptual Framework for AICPA Independence Standards**

**Introduction**

1. This conceptual framework describes the risk-based approach to analyzing independence matters that is used by the Professional Ethics Executive Committee (PEEC) of the AICPA when it develops independence standards. Under that approach, a member’s relationship with a client is evaluated to determine whether it poses an unacceptable risk to the member’s independence. Risk is unacceptable if the relationship would compromise (or would be perceived as compromising by an informed third party having knowledge of all relevant information) the member’s professional judgment when rendering an attest service to the client. Key to that evaluation is identifying and assessing the extent to which a threat to the member’s independence exists and, if it does, whether it would be reasonable to expect that the threat would compromise the member’s professional judgment and, if so, whether it can be effectively mitigated or eliminated. Under the risk-based approach, steps are taken to prevent circumstances that threaten independence from compromising the professional judgments required in the performance of an attest engagement.

2. Professional standards of the AICPA require independence for all attest engagements. The PEEC bases its independence interpretations and rulings under the AICPA’s Code of Professional Conduct on the concepts in this framework. However, in certain circumstances the PEEC has determined that it is appropriate to prohibit or restrict certain relationships notwithstanding the fact that the risk may be at an acceptable level. For example, the PEEC has determined that a covered member should not own even an immaterial direct financial interest in an attest client.

3. Because this conceptual framework describes the concepts upon which the AICPA’s independence interpretations and rulings are based, it may assist AICPA members and others in understanding those interpretations and rulings. In addition, this conceptual framework should be used by members when making decisions on independence matters that are not explicitly addressed by the Code of Professional Conduct. Under no circumstances, however, may the framework be used to overcome prohibitions or requirements contained in the independence interpretations and rulings.

4. The risk-based approach entails evaluating the risk that the member would not be independent or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being independent. That risk must be reduced to an acceptable level to conclude that a member is independent under the concepts in this framework. Risk is at an acceptable level when threats are at an acceptable level, either because of the types of threats and their potential effect, or because safeguards have sufficiently mitigated or eliminated the threats. Threats are at an acceptable level when it is not reasonable to expect that the threat would compromise professional judgment.

5. The risk-based approach involves the following steps.

   a. Identifying and evaluating threats to independence—Identify and evaluate threats, both individually and in the aggregate, because threats can have a cumulative effect on a member’s independence. Where threats are identified but, due to the types of threats and their potential effects, such threats are considered to be at an acceptable level (that is, it is not reasonable to expect that the threats would compromise professional judgment), the consideration of safeguards is not required. If identified threats are not considered to be at an acceptable level, safeguards should be considered as described in paragraph 5(b).

   b. Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards—Different safeguards can mitigate or eliminate different types of threats, and one safeguard can mitigate or eliminate several types of threats simultaneously. When threats are sufficiently mitigated by safeguards, the threats’ potential to compromise professional judgment is reduced to an acceptable level. A threat has been sufficiently mitigated by safeguards if, after application of the safeguards, it is not reason-
able to expect that the threat would compromise professional judgment.\(^1\)

c. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

**Definitions**

6. Independence is defined as:

   a. *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.

   b. *Independence in appearance*—The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards\(^2\) applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or a member of the attest engagement team had been compromised.

7. This definition reflects the longstanding professional requirement that members who provide services to entities for which independence is required be independent both in fact and in appearance.\(^3\) The state of mind of a member who is independent “in fact” assists the member in performing an attest engagement in an objective manner. Accordingly, independence of mind reflects the long-standing requirement that members be independent in fact.

8. This definition is used as part of the risk-based approach to analyze independence. Because the risk-based approach requires judgment, the definition should not be interpreted as an absolute. For example, the phrase “without being affected by influences that compromise professional judgment” is not intended to convey that the member must be free of any and all influences that might compromise objective judgment. Instead, a determination must be made about whether such influences, if present, create an unacceptable risk that a member would not act with integrity and exercise objectivity and professional skepticism in the conduct of a particular engagement, or would be perceived as not being able to do so by a reasonable and informed third party that has knowledge of all relevant information.

9. *Impair*—For purposes of this framework, impair means to effectively extinguish (independence). When a member’s independence is impaired, the member is not independent.

10. *Threats*—Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether it would be reasonable to expect that the threat would compromise the member’s professional judgment and, if so, the specific safeguards applied to reduce or eliminate the threat, and the effectiveness of those safeguards as described in paragraph 21.

11. Threats might not involve violations of existing interpretations or rulings. For example, the circumstance described in paragraph 18(b) of this framework is permissible in limited instances under current AICPA independence interpretations and rulings.

12. Many different circumstances (or combinations of circumstances) can create threats to independence. It is impossible to identify every situation that creates a threat. However, seven broad categories of threats should always be evaluated when threats to independence are being identified and assessed. They are self-review, advocacy, adverse interest, familiarity, undue influence, financial self-interest, and management participation threats. The following paragraphs define and provide examples, which are not all-inclusive, of each of these threat categories. Some of these examples are the subject of independence interpretations and rulings contained in the Code of Professional Conduct.

13. *Self-review threat*—Members reviewing as part of an attest engagement evidence that results from their own, or their firm’s, nonattest work such as, preparing source documents used to generate the client’s financial statements.

14. *Advocacy threat*—Actions promoting an attest client’s interests or position.\(^4\)

a. Promoting the client’s securities as part of an initial public offering

b. Representing a client in U.S. tax court

15. *Adverse interest threat*—Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.

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\(1\) In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented as required under “Other Considerations” of Interpretation No. 101-1, “Interpretation of Rule 101.”

\(2\) The term safeguards is defined in paragraph 20.

\(3\) Objectivity and Independence, states, “A member in public practice should be independent in fact and appearance when providing auditing and other attestation services.”

\(4\) This threat does not arise from testifying as a fact witness or defending the results of a professional service that the member performed for the client.
16. **Familiarity threat**—Members having a close or long-standing relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client.
   a. A member of the attest engagement team whose spouse is in a key position at the client, such as the client’s chief executive officer
   b. A partner of the firm who has provided the client with attest services for a prolonged period
   c. A member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member’s firm
   d. A member of the firm having recently been a director or officer of the client
   e. A member of the attest engagement team whose close friend is in a key position at the client

17. **Undue influence threat**—Attempts by an attest client’s management or other interested parties to coerce the member or exercise excessive influence over the member.
   a. A threat to replace the member or the member’s firm over a disagreement with client management on the application of an accounting principle
   b. Pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees
   c. A gift from the client to the member that is other than clearly insignificant to the member

18. **Financial self-interest threat**—Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client.
   a. Having a direct financial interest or material indirect financial interest in the client
   b. Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client’s outstanding equity securities
   c. Excessive reliance on revenue from a single attest client
   d. Having a material joint venture or other material joint business arrangement with the client

19. **Management participation threat**—Taking on the role of client management or otherwise performing management functions on behalf of an attest client.
   a. Serving as an officer or director of the client
   b. Establishing and maintaining internal controls for the client
   c. Hiring, supervising, or terminating the client’s employees

20. **Safeguards**—Controls that mitigate or eliminate threats to independence. Safeguards range from partial to complete prohibitions of the threatening circumstance to procedures that counteract the potential influence of a threat. The nature and extent of the safeguards to be applied depend on many factors, including the size of the firm and whether the client is a public interest entity.5 To be effective, safeguards should eliminate the threat or reduce to an acceptable level the threat’s potential to impair independence.

Solely for the purpose of this conceptual framework, the following entities are considered to be public interest entities: (a) all listed entities6 and (b) any entity for which an audit is required by regulation or legislation to be conducted in compliance with the same independence requirements that apply to an audit of listed entities (for example, requirements of the Securities and Exchange Commission, the Public Company Accounting Oversight Board, or other similar regulators or standard setters).6,7

21. 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 or parties that will be subject to the safeguard
   e. How the safeguard is applied
   f. The consistency with which the safeguard is applied

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5. Including entities that are outside the United States whose shares, stock, or debt are quoted or listed on a recognized stock exchange or marketed under the regulations of a recognized stock exchange or other equivalent body.

6. Members may wish to consider whether additional entities should also be treated as public interest entities because they have a large number and wide range of stakeholders. Factors to be considered may include (a) the nature of the business, such as the holding of assets in a fiduciary capacity for a large number of stakeholders; (b) size; and (c) number of employees.

7. Members should refer to the independence regulations of authoritative regulatory bodies when a member performs attest services and is required to be independent of the client under such regulations.
22. There are three broad categories of safeguards. The relative importance of a safeguard depends on its appropriateness in light of the facts and circumstances.

a. Safeguards created by the profession, legislation, or regulation
b. Safeguards implemented by the attest client
c. Safeguards implemented by the firm, including policies and procedures to implement professional and regulatory requirements

23. Examples of various safeguards within each category are presented in the following paragraphs. The examples are not intended to be all-inclusive and, conversely, the examples of safeguards implemented by the attest client and within the firm’s own systems and procedures may not all be present in each instance. In addition, threats may be sufficiently mitigated through the application of other safeguards not specifically identified herein.

24. **Examples of safeguards created by the profession, legislation, or regulation**

   a. Education and training requirements on independence and ethics rules for new professionals
   b. Continuing education requirements on independence and ethics
   c. Professional standards and monitoring and disciplinary processes
   d. External review of a firm’s quality control system
   e. Legislation governing the independence requirements of the firm
   f. Competency and experience requirements for professional licensure

25. **Examples of safeguards implemented by the attest client that would operate in combination with other safeguards**

   a. The attest client has personnel with suitable skill, knowledge, and/or experience who make managerial decisions with respect to the delivery of nonattest services by the member to the attest client
   b. A tone at the top that emphasizes the attest client’s commitment to fair financial reporting
   c. Policies and procedures that are designed to achieve fair financial reporting
   d. A governance structure, such as an active audit committee, that is designed to ensure appropriate decision making, oversight, and communications regarding a firm’s services
   e. Policies that dictate the types of services that the entity can hire the audit firm to provide without causing the firm’s independence to be considered impaired.

26. **Examples of safeguards implemented by the firm**

   a. Firm leadership that stresses the importance of independence and the expectation that members of attest engagement teams will act in the public interest
   b. Policies and procedures that are designed to implement and monitor quality control in attest engagements
   c. Documented independence policies regarding the identification of threats to independence, the evaluation of the significance of those threats, and the identification and application of safeguards that can eliminate the threats or reduce them to an acceptable level
   d. Internal policies and procedures that are designed to monitor compliance with the firm’s independence policies and procedures
   e. Policies and procedures that are designed to identify interests or relationships between the firm or its partners and professional staff and attest clients
   f. The use of different partners and engagement teams that have separate reporting lines in the delivery of permitted nonattest services to an attest client, particularly when the separation between reporting lines is significant.
   g. Training on and timely communication of a firm’s policies and procedures, and any changes to them, for all partners and professional staff
   h. Policies and procedures that are designed to monitor the firm or partner’s reliance on revenue from a single client and, if necessary, cause action to be taken to address excessive reliance
   i. Designating someone from senior management as the person who is responsible for overseeing the adequate functioning of the firm’s quality control system
   j. A means of informing partners and professional staff of attest clients and related entities from which they must be independent
   k. A disciplinary mechanism that is designed to promote compliance with policies and procedures
1. Policies and procedures that are designed to empower staff to communicate to senior members of the firm any engagement issues that concern them without fear of retribution

m. Policies and procedures relating to independence communications with audit committees or others

n. Discussing independence issues with the audit committee or others responsible for the client’s governance

o. Disclosures to the audit committee (or others responsible for the client’s governance) regarding the nature of the services that are or will be provided and the extent of the fees charged or to be charged

p. The involvement of another professional accountant who (1) reviews the work that is done for an attest client or (2) otherwise advises the attest engagement team (This individual could be someone from outside the firm or someone from within the firm who is not otherwise associated with the attest engagement.)

q. Consultation on engagement issues with an interested third party, such as a committee of independent directors, a professional regulatory body, or another professional accountant

r. Rotation of senior personnel who are part of the attest engagement team

s. Policies and procedures that are designed to ensure that members of the attest engagement team do not make or assume responsibility for management decisions for the attest client

t. The involvement of another firm to perform part of the attest engagement

u. The involvement of another firm to reperform a nonattest service to the extent necessary to enable it to take responsibility for that service

v. The removal of an individual from an attest engagement team when that individual’s financial interests or relationships pose a threat to independence

w. A consultation function that is staffed with experts in accounting, auditing, independence, and reporting matters who can help attest engagement teams (1) assess issues when guidance is unclear, or when the issues are highly technical or require a great deal of judgment and (2) resist undue pressure from a client when the engagement team disagrees with the client about such issues

x. Client acceptance and continuation policies that are designed to prevent association with clients that pose an unacceptable threat to the member’s independence

y. Policies that preclude audit partners from being directly compensated for selling nonattest services to the audit client
Independence, Integrity, and Objectivity

Rules, Interpretations, Rulings (AICPA)

Rule 101, 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.

Interpretations Under Rule 101
In performing an attest engagement, a member should consult the rules of his or her state board of accountancy, his or her state CPA society, the Public Company Accounting Oversight Board and the U.S. Securities and Exchange Commission (SEC) if the member’s report will be filed with the SEC, the U.S. Department of Labor (DOL) if the member’s report will be filed with the DOL, the Government Accountability Office (GAO) if law, regulation, agreement, policy or contract requires the member’s report to be filed under GAO regulations, and any organization that issues or enforces standards of independence that would apply to the member’s engagement. Such organizations may have independence requirements or rulings that differ from (e.g., may be more restrictive than) those of the AICPA.

101-1—Interpretation of Rule 101.
Independence shall be considered to be impaired if:

A. During the period of the professional engagement, a covered member
   1. Had or was committed to acquire any direct or material indirect financial interest in the client.
   2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had or was committed to acquire any direct or material indirect financial interest in the client and
      (i) The covered member (individually or with others) had the authority to make investment decisions for the trust or estate, or
      (ii) The trust or estate owned or was committed to acquire more than 10 percent of the client’s outstanding equity securities or other ownership interests, or
      (iii) The value of the trust’s or estate’s holdings in the client exceeded 10 percent of the total assets of the trust or estate.
   3. Had a joint, closely held investment that was material to the covered member.

B. During the period of the professional engagement, a partner or professional employee of the firm, his or her immediate family, or any group of such persons acting together owned more than 5 percent of a client’s outstanding equity securities or other ownership interests.

C. During the period covered by the financial statements, or during the period of the professional engagement, a firm or partner or professional employee of the firm was simultaneously associated with the client as a(n)
   1. Director, officer, or employee, or in any capacity equivalent to that of a member of management;
   2. Promoter, underwriter, or voting trustee, or
   3. Trustee for any pension or profit-sharing trust of the client.

Transition Period for Certain Business and Employment Relationships
A business or employment relationship with a client that impairs independence under interpretation 101-1 C, and that existed as of Nov. 30, 2001, will not be deemed to impair independence provided such relationship was permitted under Rule 101, its interpretations and rulings as of November 30, 2001 and the individual severed that relationship on or before May 31, 2002.

Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client.
A firm’s independence would be impaired if a covered member who was formerly
   1. employed by a client or
   2. associated with a client as a(n) officer, director, promoter, underwriter, voting trustee, or trustee for a pension or profit sharing trust of the client
   a. fails to disassociate himself or herself from the client prior to becoming a covered member. Disassociation includes the following:
      i. Ceasing to participate in all employee health and welfare plans sponsored by the client, unless the client is legally required to allow the covered member to participate in the plan

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1. This provision applies once the individual has terminated their relationship with the client and is no longer employed by, or otherwise associated with, the client. See Interpretation No. 101-1(C) (par. 02) for matters involving a partner or professional employee who is simultaneously employed by, or otherwise associated with, the client and the firm.
(for example, Consolidated Omnibus Budget Reconciliation Act (COBRA)) and the covered member pays 100 percent of his or her portion of the cost of participation on a current basis.

ii. Ceasing to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the client’s defined benefit plans, defined contribution plans, share-based compensation arrangements, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan.

When the covered member does not participate on the attest engagement team or is not in a position to influence the attest engagement, he or she is not required to liquidate or transfer any vested benefits if such an action is not permitted under the terms of the plan or if a penalty significant to the benefits is imposed upon such liquidation or transfer.

iii. Disposing of any direct or material indirect financial interests in the client.

iv. Collecting or repaying any loans to or from the client, except for loans specifically permitted or grandfathered under Interpretation No. 101-5 (par. .07).

v. Assessing other relationships with the client to determine if such relationships create threats to independence that would require the application of safeguards to reduce the threats to an acceptable level.

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

2. As defined in the Financial Accounting Standards Board Accounting Standards Codification glossary under the term share-based payment arrangements.

3. When the member is a former employee of a governmental unit that is one of the sponsors of an employee benefit plan, the member may continue to participate in the governmental plan if his or her current employer is also one of the sponsors of the plan. In such circumstances, a covered member’s participation in the plan will not impair independence, provided that the plan is offered to all employees in comparable employment positions and the covered member has no influence or control over the investment strategy, benefits, or other management activities associated with the plan and is required to continue his or her participation in the plan as a condition of employment. See Ethics Ruling No. 107 (ET section 191.214–215) for further information.

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

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Application of the independence rules to a covered member’s immediate family

A covered member’s immediate family is subject to Rule 101 (par. .01) and its interpretations and rulings. When materiality of a financial interest is identified as a factor affecting independence in these interpretations and rulings, the immediate family member and the covered member’s interests should be combined.

The following exceptions address situations in which independence will not be considered impaired. Notwithstanding the following exceptions, the independence requirement in Interpretation No. 101-1(B) (par. .02) applies.

Permitted Employment

An individual in a covered member’s immediate family may be employed by an attest client in a position other than a key position.

Employee Benefit Plans Other Than Certain Share-Based Arrangements or Nonqualified Deferred Compensation Plans

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a plan that is an attest client or that is sponsored by an attest client, other than a client’s share-based compensation arrangement or nonqualified deferred compensation plan, provided that

a. the plan is offered to all employees in comparable employment positions;

b. the immediate family member does not serve in a position of governance (for example, board of trustees) for the plan; and

c. the immediate family member does not have the ability to supervise or participate in the plan’s investment decisions or in the selection of the investment options that will be made available to plan participants.

An immediate family member of a covered member may hold a direct or material indirect financial interest in an attest client through participation in a plan, provided that

1. the covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement;

2. such investment is an unavoidable consequence of such participation; and

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5. Excluding share-based compensation arrangements and nonqualified deferred compensation plans. [Footnote added by the Professional Ethics Executive Committee, March 2010.]

6. Unavoidable consequence means that the immediate family member has no investment options available for selection, including money market or invested cash options, other than in an attest client. [Footnote added by the Professional Ethics Executive Committee, March 2010.]
3. in the event that a plan option to invest in a nonattest client becomes available, the immediate family member selects such option and disposes of any direct or material indirect financial interests in the attest client as soon as practicable but no later than 30 days after such option becomes available.7

**Share-Based Compensation Arrangements**

**Share-Based Compensation Arrangements Resulting in Beneficial Financial Interests** in Attest Clients

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement, such as an employee stock ownership plan (ESOP), that results in his or her holding a beneficial financial interest in an attest client, provided that

1. the covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement.
2. the immediate family member does not serve as a trustee for the share-based compensation arrangement and does not have the ability to supervise or participate in the selection of the investment options, if any, that are available to participants.
3. when the beneficial financial interests are distributed or the immediate family member has the right to dispose of the shares, the immediate family member
   a. disposes of the shares as soon as practicable but no later than 30 days after he or she has the right to dispose of the shares or
   b. exercises his or her put option to require the employer to repurchase the beneficial financial interests as soon as permitted by the terms of the share-based compensation arrangement.8 Any repurchase obligation due to the immediate family member arising from exercise of the put option that is outstanding for more than 30 days would need to be immaterial to the covered member during the payout period.
4. benefits payable from the share-based compensation arrangement to the immediate family member upon termination of employment, whether through retirement, death, disability, or voluntary or involuntary termination, are funded by investment options other than the employer’s financial interests, and any unfunded benefits payable are immaterial to the covered member at all times during the payout period.

**Share-Based Compensation Arrangements Resulting in Rights to Acquire Shares in an Attest Client**

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement resulting in a right to acquire shares in an attest client, such as an employee stock option plan or restricted stock rights plan, provided that

1. the covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement and
2. the immediate family member exercises or forfeits these rights once he or she is vested and the closing market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days (market period). The exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period. In addition, if the immediate family member exercises his or her right to acquire the shares, he or she should dispose of the shares as soon as practicable but no later than 30 days after the exercise date.11 If the employer repurchases the shares, any employer repurchase obligation due to the immediate family member that is outstanding for more than 30 days would need to be immaterial to the covered member during the payout period.

**Share-Based Compensation Arrangements Based Upon Stock Appreciation**

As a result of his or her permitted employment, an immediate family member of a covered member may participate in a share-based compensation arrangement based on the appreciation of an attest client’s underlying shares, provided that

1. the share-based compensation arrangement (for example, a stock appreciation or phantom stock plan) does not provide for the issuance of rights to acquire the employer’s financial interests.
2. the covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement.
3. the immediate family member exercises or forfeits his or her vested compensation rights if the underlying price of the employer’s shares equals or exceeds

7. When legal or other similar restrictions exist on a person’s right to dispose of a financial interest at a particular time, the person need not dispose of the interest until the restrictions have lapsed. For example, a person does not have to dispose of a financial interest in an attest client if doing so would violate an employer’s policies on insider trading. On the other hand, waiting for more advantageous market conditions to dispose of the interest would not fall within this exception. [Footnote added by the Professional Ethics Executive Committee, March 2010.]

8. See Interpretation No. 101-15 (par. .17) for an explanation of when a financial interest is beneficially owned. [Footnote added by the Professional Ethics Executive Committee, March 2010.]

9. See footnote 7. [Footnote added by the Professional Ethics Executive Committee, March 2010.]

10. See Interpretation No. 101-15 (par. .17) for guidance on stock option plans. [Footnote added by the Professional Ethics Executive Committee, March 2010.]

11. See footnote 7. [Footnote added by the Professional Ethics Executive Committee, March 2010.]
the exercise price for 10 consecutive days (market period). Exercise or forfeiture should occur as soon as practicable but no later than 30 days after the end of the market period.

4. any resulting compensation payable to the immediate family member that is outstanding for more than 30 days is immaterial to the covered member during the payout period.

Nonqualified Deferred Compensation Plan

As a result of his or her permitted employment at an attest client, an immediate family member of a covered member may participate in a nonqualified deferred compensation plan, provided that

1. the covered member neither participates on the attest engagement team nor is in a position to influence the attest engagement;
2. the amount of the deferred compensation payable to the immediate family member is funded through life insurance, an annuity, a trust, or similar vehicle and any unfunded portion is immaterial to the covered member; and
3. any funding of the deferred compensation does not include financial interests in the attest client.

Application of the Independence Rules to Close Relatives

Independence would be considered to be impaired if—

1. An individual participating on the attest engagement team has a close relative who had
   a. A key position with the client; or
   b. A financial interest in the client that:
      (i) The individual knows or has reason to believe was material to the close relative; or
      (ii) Enabled the close relative to exercise significant influence over the client.
2. An individual in a position to influence the attest engagement or any partner in the office in which the lead attest engagement partner primarily practices in connection with the attest engagement has a close relative who had
   a. A key position with the client; or
   b. A financial interest in the client that—
      (i) The individual or partner knows or has reason to believe was material to the close relative; and
      (ii) Enabled the close relative to exercise significant influence over the client.

Grandfathered Employment Relationships

Employment relationships of a covered member’s immediate family and close relatives with an existing at test client that impair independence under this interpretation and that existed as of November 30, 2001, will not be deemed to impair independence provided such relationships were permitted under preexisting requirements of Rule 101 and its interpretations and rulings.

Other Considerations

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

101-2—Employment or Association with Attest Clients.

A firm’s independence will be considered to be impaired with respect to a client if a partner or professional employee leaves the firm and is subsequently employed by or associated with that client in a key position unless all the following conditions are met:

1. Amounts due to the former partner or professional employee for his or her previous interest in the firm and for unfunded, vested retirement benefits are not mate-

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§ In April 2006, the Professional Ethics Executive Committee (PEEC) of the AICPA issued the Conceptual Framework for AICPA Independence Standards (Conceptual Framework) [ET section 100.01], which describes the risk-based approach to analyzing independence matters that is used by PEEC when it develops independence standards. Consequently, this interpretation has been revised in the “Other Considerations” section to reflect the issuance of the Conceptual Framework. Because the Conceptual Framework [ET section 100.01] is effective April 30, 2007, with earlier application encouraged, the revisions made in the “Other Considerations” section of this interpretation are also effective April 30, 2007, with earlier application encouraged. 12. A failure to prepare the required documentation would be considered a violation of Rule 202, Compliance With Standards [ET section 202.01], of the AICPA Code of Professional Conduct. Independence would not be considered to be impaired provided the member can demonstrate that he or she did apply safeguards to eliminate unacceptable threats or reduce them to an acceptable level. [Footnote added, effective April 30, 2006, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010.]
rial to the firm, and the underlying formula used to calculate the payments remains fixed during the payout period. Retirement benefits may also be adjusted for inflation and interest may be paid on amounts due.

2. The former partner or professional employee is not in a position to influence the accounting firm’s operations or financial policies.

3. The former partner or professional employee does not participate or appear to participate in, and is not associated with the firm, whether or not compensated for such participation or association, once employment or association with the client begins. An appearance of participation or association results from such actions as:
   a. The individual provides consultation to the firm.
   b. The firm provides the individual with an office and related amenities (for example, secretarial and telephone services).
   c. The individual’s name is included in the firm’s office directory.
   d. The individual’s name is included as a member of the firm in other membership lists of business, professional, or civic organizations, unless the individual is clearly designated as retired.

4. The ongoing attest engagement team considers the appropriateness or necessity of modifying the engagement procedures to adjust for the risk that, by virtue of the former partner or professional employee’s prior knowledge of the audit plan, audit effectiveness could be reduced.

5. The firm assesses whether existing attest engagement team members have the appropriate experience and stature to effectively deal with the former partner or professional employee and his or her work, when that person will have significant interaction with the attest engagement team.

6. The subsequent attest engagement is reviewed to determine whether the engagement team members maintained the appropriate level of skepticism when evaluating the representations and work of the former partner or professional employee, when the person joins the client in a key position within one year of disassociating from the firm and has significant interaction with the attest engagement team. The review should be performed by a professional with appropriate stature, expertise, and objectivity and should be tailored based on the position that the person assumed at the client, the position he or she held at the firm, the nature of the services he or she provided to the client, and other relevant facts and circumstances. Appropriate actions, as deemed necessary, should be taken based on the results of the review.

Responsible members within the firm should implement procedures for compliance with the preceding conditions when firm professionals are employed or associated with attest clients.

With respect to conditions 4, 5, and 6, the procedures adopted will depend on several factors, including whether the former partner or professional employee served as a member of the engagement team, the positions he or she held at the firm and has accepted at the client, the length of time that has elapsed since the professional left the firm, and the circumstances of his or her departure.\(^\text{13}\)

**Considering Employment or Association With the Client**

When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to seek or discuss potential employment or association with an attest client, or is in receipt of a specific offer of employment from an attest client, independence will be impaired with respect to the client unless the person promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment is no longer being sought. When a covered member becomes aware that a member of the attest engagement team or an individual in a position to influence the attest engagement is considering employment or association with a client, the covered member should notify an appropriate person in the firm.

The appropriate person should consider what additional procedures may be necessary to provide reasonable assurance that any work performed for the client by that person was performed with objectivity and integrity as required under Rule 102. Additional procedures, such as reperformance of work already done, will depend on the nature of the engagement and the individual involved.

### 101-3—Nonattest Services

Before a member or his or her firm (“member”) performs nonattest services (for example, tax or consulting

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13. An inadvertent and isolated failure to meet conditions 4, 5, and 6 would not impair independence provided that the required procedures are performed promptly upon discovery of the failure to do so, and all other provisions of the interpretation are met. [Footnote added, effective April 30, 2003, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

14. A member who performs a compilation engagement for a client should modify the compilation report to indicate a lack of independence if the member does not meet all of the conditions set out in this interpretation when providing a nonattest service to that client (see Statement on Standards for Accounting and Review Services No. 1, Compilation and Review of Financial Statements [AR section 100.19]). [Footnote added, effective December 31, 2003, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
services) for an attest client, the member should determine that the requirements described in this interpretation have been met. In cases where the requirements of this interpretation have not been met during the period of the professional engagement or the period covered by the financial statements, the member’s independence would be impaired, except as noted in the following paragraph.

A member’s independence would not be impaired if the member performed nonattest services that would have impaired independence during the period covered by the financial statements, provided that

a. the nonattest services were provided prior to the period of the professional engagement,

b. the nonattest services related to periods prior to the period covered by the financial statements, and

c. the financial statements for the period to which the nonattest services relate were audited by another firm (or in the case of a review engagement, reviewed or audited by another firm).

Activities Related to Attest Services
Performing attest services often involves communication between the member and client management regarding (a) the client’s selection and application of accounting standards or policies and financial statement disclosure requirements; (b) the appropriateness of the client’s methods used in determining the accounting and financial reporting; (c) adjusting journal entries that the member has prepared or proposed for client management consideration; and (d) the form or content of the financial statements. These communications are considered a normal part of the attest engagement and would not constitute performing a nonattest service subject to this interpretation.

However, the member should exercise judgment in determining whether his or her involvement has become so extensive that it would constitute performing a separate service which would be subject to the interpretation’s General Requirements for Performing Nonattest Services.

Engagements Subject to Independence Rules of Certain Regulatory Bodies
This interpretation requires compliance with independence regulations of authoritative regulatory bodies (such as the Securities and Exchange Commission [SEC], the Government Accountability Office [GAO], the Department of Labor [DOL], the Public Company Accounting Oversight Board [PCAOB], and state boards of accountancy) when a member performs nonattest services for an attest client and is required to be independent of the client under the regulations of the applicable regulatory body. Accordingly, failure to comply with the nonattest services provisions contained in the independence rules of the applicable regulatory body that are more restrictive than the provisions of this interpretation would constitute a violation of this interpretation.

General Requirements for Performing Nonattest Services
1. The member should not assume management responsibilities for the attest client.

2. Before performing nonattest service, the member should determine that the client has agreed to:

a. Assume all management responsibilities.

b. Oversee the service, by designating an individual, preferably within senior management who possesses suitable skill, knowledge, and/or experience. The member should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them. However, the individual is not required to possess the expertise to perform or reperform the services.

c. Evaluate the adequacy and results of the services performed.

d. Accept responsibility for the results of the services.

To avoid assuming management responsibilities when providing nonattest services to the client, the member should be satisfied that management will be able to meet all these criteria, make an informed judgment on the results of the member’s nonattest services, and be responsible for making the significant judgments and decisions that are the proper responsibility of management. In cases in which the client is unable or unwilling to assume these responsibilities (for example, the client cannot oversee the nonattest services provided or is unwilling to carry out such responsibilities due to lack of time or desire), the member’s provision of these services would impair independence.

15. A failure to prepare the required documentation would not impair independence, but would be considered a violation of Rule 202, Compliance With Standards [Rule 202.01], provided that the member did establish the understanding with the client. [Footnote added, effective December 31, 2003, by the Professional Ethics Executive Committee. Footnote revised, January 2005, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
3. Before performing nonattest services, the member should establish and document in writing his or her understanding with the client (board of directors, audit committee, or management, as appropriate in the circumstances) regarding the following:
   a. Objectives of the engagement
   b. Services to be performed
   c. Client’s acceptance of its responsibilities
   d. Member’s responsibilities
   e. Any limitations of the engagement

The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client.  

The preceding general requirements 2–3, do not apply to certain routine activities performed by the member, such as providing advice and responding to the client’s questions as part of the client-member relationship.

Management Responsibilities

If a member were to assume a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce the threat to an acceptable level. It is not possible to specify every activity that is a management responsibility. However, management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources.

Whether an activity is a management responsibility depends on the circumstances and requires the exercise of judgment. Examples of activities that would be considered a management responsibility and would, therefore, impair independence if performed for an attest client include

- setting policies or strategic direction for the client.
- directing or accepting responsibility for the actions of the client’s employees except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
- authorizing, executing, or consummating a transaction, or otherwise exercising authority on behalf of a client or having the authority to do so.
- preparing source documents, in electronic or other form evidencing the occurrence of a transaction.
- having custody of client assets.
- deciding which recommendations of the member or other third parties to implement or prioritize.
- reporting to those in charge of governance on behalf of management.
- serving as a client’s stock transfer or escrow agent, registrar, general counsel, or its equivalent.
- accepting responsibility for the management of a client’s project.
- accepting responsibility for the preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework.
- accepting responsibility for designing, implementing, or maintaining internal control.
- performing ongoing evaluations of the client’s internal control as part of its monitoring activities.

Specific Examples of Nonattest Services

The examples in the following table identify the effect that performance of certain nonattest services for an attest client can have on a member’s independence. These examples presume that the general requirements in the previous section, “General Requirements for Performing Nonattest Services”, have been met and are not intended to be all-inclusive of the types of nonattest services performed by members.

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16. However, upon the acceptance of an attest engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements during the period covered by the financial statements, including the requirement to establish an understanding with the client. [Footnote added, effective October 31, 2004, by the Professional Ethics Executive Committee. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

17. Source documents are the documents upon which evidence of an accounting transaction are initially recorded. Source documents are often followed by the creation of many additional records and reports, which do not, however, qualify as initial recordings. Examples of source documents are purchase orders, payroll time cards, and customer orders. [Footnote renumbered by the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered and revised, September 2003, by the Professional Ethics Executive Committee. Footnote subsequently renumbered by the Professional Ethics Executive Committee, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

18. [Footnote added, effective July 31, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010. Footnote deleted, effective August 31, 2012 by the Professional Ethics Executive Committee]
## Impact on Independence of Performance on Nonattest Services

<table>
<thead>
<tr>
<th>Type of Nonattest Service</th>
<th>Independence Would Not Be Impaired</th>
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</table>
| Bookkeeping               | • Record transactions for which management has determined or approved the appropriate account classification, or post coded transactions to a client’s general ledger.  
• Prepare financial statements based on information in the trial balance.  
• Post client-approved entries to a client’s trial balance.  
• Prepare a reconciliation (for example, bank, accounts receivable, and so forth) that identifies reconciling items for the client’s evaluation.  
• Propose standard, adjusting, or correcting journal entries or other changes affecting the financial statements to the client provided the client reviews the entries and the member is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.  
• Determine or change journal entries, account codings or classification for transactions, or other accounting records without obtaining client approval.  
• Authorize or approve transactions.  
• Prepare source documents.  
• Make changes to source documents without client approval. |                                                                                                  |
| Non tax disbursement      | • Using payroll time records provided and approved by the client, generate unsigned checks, or process client’s payroll.  
• Transmit client-approved payroll or other disbursement information to a financial institution provided the client has authorized the member to make the transmission and has made arrangements for the financial institution to limit the corresponding individual payments as to amount and payee. In addition, once transmitted, the client must authorize the financial institution to process the information.  
• Accept responsibility to authorize payment of client funds, electronically or otherwise, except as specifically provided for with respect to electronic payroll tax payments.  
• Accept responsibility to sign or cosign client checks, even if only in emergency situations.  
• Maintain a client’s bank account or otherwise have custody of a client’s funds or make credit or banking decisions for the client.  
• Approve vendor invoices for payment. |                                                                                                  |
| Benefit plan administration\(^{20}\) | • Communicate summary plan data to plan trustee.  
• Advise client management regarding the application or impact of provisions of the plan document.  
• Process transactions (e.g., investment/benefit elections or increase/decrease contributions to the plan; data entry; participant confirmations; and processing of distributions and loans) initiated by plan participants through the member’s electronic medium, such as an interactive voice response system or Internet connection or other media.  
• Prepare account valuations for plan participants using data collected through the member’s electronic or other media.  
• Prepare and transmit participant statements to plan participants based on data collected through the member’s electronic or other medium.  
• Make policy decisions on behalf of client management.  
• When dealing with plan participants, interpret the plan document on behalf of management without first obtaining management’s concurrence.  
• Make disbursements on behalf of the plan.  
• Have custody of assets of a plan.  
• Serve a plan as a fiduciary as defined by ERISA. |                                                                                                  |


\(^{20}\) When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations, which may be more restrictive, must be followed. [Footnote renumbered by the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered by the Professional Ethics Executive Committee, September 2003. Footnote subsequently renumbered by the Professional Ethics Executive Committee, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.].
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| Investment—advisory or management | • Recommend the allocation of funds that a client should invest in various asset classes, depending upon the client’s desired rate of return, risk tolerance, etc.  
• Perform recordkeeping and reporting of client’s portfolio balances including providing a comparative analysis of the client’s investments to third-party benchmarks.  
• Review the manner in which a client’s portfolio is being managed by investment account managers, including determining whether the managers are (1) following the guidelines of the client’s investment policy statement; (2) meeting the client’s investment objectives; and (3) conforming to the client’s stated investment styles.  
• Transmit a client’s investment selection to a broker-dealer or equivalent provided the client has authorized the broker-dealer or equivalent to execute the transaction. | • Make investment decisions on behalf of client management or otherwise have discretionary authority over a client’s investments.  
• Execute a transaction to buy or sell a client’s investment.  
• Have custody of client assets, such as taking temporary possession of securities purchased by a client. |
| Corporate finance—consulting or advisory | • Assist in developing corporate strategies.  
• Assist in identifying or introducing the client to possible sources of capital that meet the client’s specifications or criteria.  
• Assist in analyzing the effects of proposed transactions including providing advice to a client during negotiations with potential buyers, sellers, or capital sources.  
• Assist in drafting an offering document or memorandum.  
• Participate in transaction negotiations in an advisory capacity.  
• Be named as a financial adviser in a client’s private placement memorandum or offering documents. | • Commit the client to the terms of a transaction or consummate a transaction on behalf of the client.  
• Act as a promoter, underwriter, broker-dealer, or guarantor of client securities, or distributor of private placement memoranda or offering documents.  
• Maintain custody of client securities. |
| Executive or employee search | • Recommend a position description or candidate specifications.  
• Solicit and perform screening of candidates and recommend qualified candidates to a client based on the client-approved criteria (e.g., required skills and experience).  
• Participate in employee hiring or compensation discussions in an advisory capacity. | • Commit the client to employee compensation or benefit arrangements.  
• Hire or terminate client employees. |
| Business risk consulting | • Provide assistance in assessing the client’s business risks and control processes.  
• Recommend a plan for making improvements to a client’s control processes and assist in implementing these improvements. | • Make or approve business risk decisions.  
• Present business risk considerations to the board or others on behalf of management. |
| Information systems–design, installation, or integration | • Install or integrate a client's financial information system that was not designed or developed by the member (e.g., an off-the-shelf accounting package).  
• Assist in setting up the client’s chart of accounts and financial statement format with respect to the client’s financial information system.  
• Design, develop, install, or integrate a client’s information system that is unrelated to the client's financial statements or accounting records.  
• Provide training and instruction to client employees on a information and control system | • Make or approve business risk decisions.  
• Present business risk considerations to the board or others on behalf of management. |
Tax Compliance Services

Tax compliance services addressed by this interpretation are preparation of a tax return, transmit of a tax return and transmittal of any related tax payment to the taxing authority, signing and filing a tax return, and authorized representation of clients in administrative proceedings before a taxing authority.

Preparing a tax return and transmitting the tax return and related tax payment to a taxing authority, in paper or electronic form, would not impair a member’s independence provided the member does not have custody or control over the client’s funds and the individual designated by the client to oversee the tax services:

- Reviews and approves the tax return and related tax payment; and,
- If required for filing, signs the tax return prior to the member transmitting the return to the taxing authority.

However, signing and filing a tax return on behalf of client management would impair independence, unless the member has the legal authority to do so and:

a. The taxing authority has prescribed procedures in place for a client to permit a member to sign and file a tax return on behalf of the client (for example, Form 8879 or 8453), and such procedures meet, at the minimum, standards for electronic return originators and officers outlined in I.R.S. Form 8879; or
b. An individual in client management who is authorized to sign and file the client’s tax return provides the member with a signed statement that clearly identifies the return being filed and represents that:

1. Such individual is authorized to sign and file the tax return;
2. Such individual has reviewed the tax return, including accompanying schedules and statements, and it is true, correct and complete to the best of his or her knowledge and belief; and

3. Such individual authorizes the member or another named individual in the member’s firm to sign and file the tax return on behalf of the client.

Authorized representation of a client in administrative proceedings before a taxing authority would not impair a member’s independence provided the member obtains client agreement prior to committing the client to a specific resolution with the taxing authority. However, representing a client in a court to resolve a tax dispute would impair a member’s independence.

Transition

Independence would not be impaired as a result of the more restrictive requirements of the tax compliance services provisions provided such services are pursuant to engagements commenced prior to February 28, 2007, and completed prior to January 1, 2008, and the member complied with all applicable independence interpretations and rulings in effect on February 28, 2007.

Appraisal, Valuation, and Actuarial Services

Independence would be impaired if a member performs an appraisal, valuation, or actuarial service for an attest client where the results of the service, individually or in the aggregate, would be material to the financial statements and the appraisal, valuation, or actuarial service involves a significant degree of subjectivity.

Valuations performed in connection with, for example, employee stock ownership plans, business combinations, or appraisals of assets or liabilities generally involve a significant degree of subjectivity. Accordingly, if these services produce results that are material to the financial statements, independence would be impaired.

An actuarial valuation of a client’s pension or postemployment benefit liabilities generally produces reasonably consistent results because the valuation does not require a significant degree of subjectivity. Therefore, such services would not impair independence. In addition, appraisal, valuation, and actuarial services performed for nonfinan-

21. For purposes of this interpretation, a tax return includes informational tax forms (for example, estimated tax vouchers, extension forms, and Forms 990, 5500, 1099, and W-2) filed with a taxing authority or other regulatory agencies. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

22. Making electronic tax payments under a taxing authority’s specified criteria or remitting a check payable to the taxing authority and signed by the client would not be considered having custody or control over a client’s funds. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

23. The term court encompasses a tax, district, or federal court of claims, and the equivalent state, local, or foreign forums. [Footnote added, effective July 31, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010.]

24. Examples of such services may include appraisal, valuation, and actuarial services performed for tax planning or tax compliance, estate and gift taxation, and divorce proceedings. [Footnote added, effective December 31, 2003, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
cial statement purposes would not impair independence. However, in performing such services, all other requirements of this interpretation should be met, including that all significant assumptions and matters of judgment are determined or approved by the client and the client is in a position to have an informed judgment on, and accepts responsibility for, the results of the service.

**Forensic Accounting Services**

For purposes of this interpretation, forensic accounting services are nonattest services that involve the application of special skills in accounting, auditing, finance, quantitative methods and certain areas of the law, and research, and investigative skills to collect, analyze, and evaluate evidential matter and to interpret and communicate findings and consist of:

- Litigation services; and
- Investigative services.

Litigation services recognize the role of the member as an expert or consultant and consist of providing assistance for actual or potential legal or regulatory proceedings before a trier of fact in connection with the resolution of disputes between parties. Litigation services consist of the following services:

a. Expert witness services are those litigation services where a member is engaged to render an opinion before a trier of fact as to the matter(s) in dispute based on the member’s expertise, rather than his or her direct knowledge of the disputed facts or events.

b. Litigation consulting services are those litigation services where a member provides advice about the facts, issues, and strategy of a matter. The consultant does not testify as an expert witness before a trier of fact.

25. The definitions of the specific services identified in this interpretation are solely for purposes of this interpretation and are not intended to be used for any other purpose. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

26. In determining whether the member’s services are considered to be expert witness services or fact witness testimony, members should refer to the Federal Rules of Evidence, Article VII, Opinions and Expert Testimony (Rules 701, 702, and 703), and other applicable laws, regulations, and rules. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

27. See advocacy threat as defined in the Conceptual Framework for AICPA Independence Standards (ET section 100-1). However, even though there is an appearance of advocacy, when providing expert witness services, a member must comply with Rule 102, Integrity and Objectivity, which requires that a member maintain objectivity and integrity and not subordinate his or her judgment to others. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

28. The client in this case refers to the party to the litigation on whose behalf the member is providing testimony and not to the law firm that engaged the member on the client’s behalf. If the law firm that engaged the member on behalf of the client is also an attest client of the member, the member should consider the applicability of Interpretation 101-12, “Independence and Cooperative Arrangements with Clients.” [Footnote added, effective July 31, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010.]

29. A fact witness is also referred to as a percipient witness or a sensory witness. Fact witness testimony is based on the member’s direct knowledge of the facts or events in dispute. A fact witness may have obtained his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the member’s role is to provide factual testimony to the trier of fact. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

30. For purposes of complying with general requirement 2, the client may designate its attorney to oversee the litigation consulting services. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

28. The client in this case refers to the party to the litigation on whose behalf the member is providing testimony and not to the law firm that engaged the member on the client’s behalf. If the law firm that engaged the member on behalf of the client is also an attest client of the member, the member should consider the applicability of Interpretation 101-12, “Independence and Cooperative Arrangements with Clients.” [Footnote added, effective July 31, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010.]

29. A fact witness is also referred to as a percipient witness or a sensory witness. Fact witness testimony is based on the member’s direct knowledge of the facts or events in dispute. A fact witness may have obtained his or her direct knowledge of the facts or events in dispute from the performance of prior professional services for the client. As a fact witness, the member’s role is to provide factual testimony to the trier of fact. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

30. For purposes of complying with general requirement 2, the client may designate its attorney to oversee the litigation consulting services. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
The performance of litigation consulting services would not impair independence provided the member complies with the general requirements set forth under this interpretation. However, if the member subsequently agrees to serve as an expert witness, independence would be considered to be impaired.

c. Other services are those litigation services where a member serves as a trier of fact, special master, court-appointed expert, or arbitrator (including serving on an arbitration panel), in a matter involving a client. These other services create the appearance that the member is not independent. Accordingly, if a member serves in such a role, independence would be considered to be impaired. However, independence would not be considered impaired if a member serves as a mediator or any similar role in a matter involving a client provided the member is not making any decisions on behalf of the parties, but rather is acting as a facilitator by assisting the parties in reaching their own agreement.

Investigative services include all forensic services not involving actual or threatened litigation such as performing analyses or investigations that may require the same skills as used in litigation services. Such services would not impair independence provided the member complies with the general requirements set forth under this interpretation.

Transition

Independence would not be impaired as a result of the more restrictive requirements of the forensic accounting services provisions, provided such services are pursuant to engagements commenced prior to February 28, 2007, and the member complied with all applicable independence interpretations and rulings in existence on February 28, 2007.

Internal Audit Assistance Services

Internal audit services involve assisting the client in the performance of its internal audit activities, sometimes referred to as “internal audit outsourcing.” In evaluating whether independence would be impaired with respect to an attest client, the nature of the service needs to be considered.

Assisting the client in performing financial and operational internal audit activities would impair independence unless the member takes appropriate steps to ensure that the client understands its responsibility for directing the internal audit function, including the management thereof. Accordingly, any outsourcing of the internal audit function to the member whereby the member in effect manages the internal audit activities of the client would impair independence.

In addition to the general requirements of this interpretation, the member should ensure that client management:

- Designates an individual or individuals, who possess suitable skill, knowledge, and/or experience, preferably within senior management, to be responsible for the internal audit function;
- Determines the scope, risk, and frequency of internal audit activities, including those to be performed by the member providing internal audit assistance services;
- Evaluates the findings and results arising from the internal audit activities, including those performed by the member providing internal audit assistance services; and
- Evaluates the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures by, among other things, obtaining reports from the member.

The member should also be satisfied that the client’s board of directors, audit committee, or other governing body is informed about the member’s and management’s respective roles and responsibilities in connection with the engagement. Such information should provide the client’s governing body a basis for developing guidelines.

31. However, the member should consider the requirements of Interpretation 102-2, “Conflicts of Interests” [ET section 102.03]. [Footnote added, effective February 28, 2007, by the Professional Ethics Executive Committee. Footnote renumbered by the Professional Ethics Executive Committee, July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

32. For example, a member may assess whether performance is in compliance with management’s policies and procedures, to identify opportunities for improvement, and to develop recommendations for improvement or further action for management consideration and decision making. [Footnote added, effective December 31, 2003, by the Professional Ethics Executive Committee. Footnote renumbered by the revision of interpretation 101-1, March 2010.]


34. [Footnote deleted by the Professional Ethics Executive Committee, January 2005. Footnote renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the Professional Ethics Executive Committee, February and July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
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for management and the member to follow in carrying out these responsibilities and monitoring how well the respective responsibilities have been met.

The member is responsible for performing the internal audit procedures in accordance with the terms of the engagement and reporting thereon. The performance of such procedures should be directed, reviewed, and supervised by the member. The report should include information that allows the individual responsible for the internal audit function to evaluate the adequacy of the audit procedures performed and the findings resulting from the performance of those procedures. This report may include recommendations for improvements in systems, processes, and procedures. The member may assist the individual responsible for the internal audit function in performing preliminary audit risk assessments, preparing audit plans, and recommending audit priorities. However, the member should not undertake any responsibilities that are required, as described above, to be performed by the individual responsible for the internal audit function.

The following are examples of activities (in addition to those listed in the “General Activities” section of this interpretation) that, if performed as part of an internal audit assistance engagement, would impair independence:

- Performing ongoing monitoring activities or control activities (for example, reviewing loan originations as part of the client’s approval process or reviewing customer credit information as part of the customer’s sales authorization process) that affect the execution of transactions or ensure that transactions are properly executed, accounted for, or both, and performing routine activities in connection with the client’s operating or production processes that are equivalent to those of an ongoing compliance or quality control function
- Determining which, if any, recommendations for improving the internal control system should be implemented
- Reporting to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function
- Approving or being responsible for the overall internal audit work plan including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures
- Being connected with the client as an employee or in any capacity equivalent to a member of client management (for example, being listed as an employee in client directories or other client publications, permitting himself or herself to be referred to by title or description as supervising or being in charge of the client’s internal audit function, or using the client’s letterhead or internal correspondence forms in communications)

The foregoing list is not intended to be all-inclusive.

Services involving an extension of the procedures that are generally of the type considered to be extensions of the member’s audit scope applied in the audit of the client’s financial statements, such as confirming of accounts receivable and analyzing fluctuations in account balances, are not considered internal audit assistance services and would not impair independence even if the extent of such testing exceeds that required by generally accepted auditing standards. In addition, engagements performed under the attestation standards would not be considered internal audit assistance services and therefore would not impair independence.

Transition

Independence would not be impaired as a result of the more restrictive requirements of interpretation 101-3, provided the provision of any such nonattest services are pursuant to arrangements in existence on December 31, 2003, and are completed by December 31, 2004, and the member was in compliance with the preexisting requirements of this interpretation.

101-4—Honorary Directorships and Trusteeships of Not-for-Profit Organization

Partners or professional employees of a firm (individual) may be asked to lend the prestige of their names to not-for-profit organizations that limit their activities to those of a charitable, religious, civic, or similar nature by being named as a director or a trustee. An individual who permits his or her name to be used in this manner would not be considered to impair independence under Rule 101 provided his or her position is clearly honorary, and he or she cannot vote or otherwise participate in board or management functions. If the individual is named in letterheads and externally circulated materials, he or she must be identified as an honorary director or honorary trustee.

101-5—Loans from Financial Institution Clients and Related Terminology.

Interpretation 101-1.A.4 [ET section 101.02] provides that, except as permitted in this interpretation, independence shall be considered to be impaired if a covered member has any loan to or from a client, any officer or director of the client, or any individual owning ten percent or more of the client’s outstanding equity securities or other ownership interests. This interpretation describes the conditions a covered member (or his or her immediate family) must meet in order to apply an exception for a “Grandfathered Loan” or “Other Permitted Loan.”

† Terms shown in boldface type upon first usage in this interpretation are defined in ET section 92, Definitions.
Grandfathered Loans
Unsecured loans that are not material to the covered member’s net worth, home mortgages, and other secured loans are grandfathered if:

1. they were obtained from a financial institution under that institution’s normal lending procedures, terms, and requirements,
2. after becoming a covered member they are kept current as to all terms at all times and those terms do not change in any manner not provided for in the original loan agreement,
3. they were:
   a. obtained from the financial institution prior to its becoming a client requiring independence; or
   b. obtained from a financial institution for which independence was not required and were later sold to a client for which independence is required; or
   c. obtained prior to February 5, 2001 and met the requirements of previous provisions of Interpretation 101-5 [ET section 101.07] covering grandfathered loans; or
   d. obtained between February 5, 2001 and May 31, 2002, and the covered member was in compliance with the applicable independence requirements of the SEC during that period; or
   e. obtained after May 31, 2002 from a financial institution client requiring independence by a borrower prior to his or her becoming a covered member with respect to that client

In determining when a loan was obtained, the date a loan commitment or line of credit is granted must be used, rather than the date a transaction closes or funds are obtained.

For purposes of applying the grandfathered loans provision when the covered member is a partner in a partnership:

• a loan to a limited partnership (or similar type of entity) or a general partnership would be ascribed to each covered member who is a partner in the partnership on the basis of their legal liability as a limited or general partner if:

• the covered member’s interest in the limited partnership, either individually or combined with the interest of one or more covered members, exceeds 50 percent of the total limited partnership interest; or

• the covered member, either individually or together with one or more covered members, can control (as defined in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) the general partnership.

• even if no amount of a partnership loan is ascribed to the covered member(s) identified above, independence is considered to be impaired if the partnership renegotiates the loan or enters into a new loan that is not one of the permitted loans described below.

Other Permitted Loans
This interpretation permits only the following new loans and leases to be obtained from a financial institution client for which independence is required. These loans and leases must be obtained under the institution’s normal lending procedures, terms, and requirements and must, at all times, be kept current as to all terms.

1. Automobile loans and leases collateralized by the automobile.
2. Loans fully collateralized by the cash surrender value of an insurance policy.
3. Loans fully collateralized by cash deposits at the same financial institution (e.g., “passbook loans”).
4. Aggregate outstanding balances from credit cards and overdraft reserve accounts that are reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

35. The value of the collateral securing a home mortgage or other secured loan should equal or exceed the remaining balance of the grandfathered loan during the term of the loan. If the value of the collateral is less than the remaining balance of the grandfathered loan, the portion of the loan that exceeds the value of the collateral must not be material to the covered member’s net worth. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010."

36. Changes in the terms of the loan include, but are not limited to, a new or extended maturity date, a new interest rate or formula, revised collateral, or revised or waived covenants. [Footnote added, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]
Related prohibitions that may be more restrictive are prescribed by certain state and federal agencies having regulatory authority over such financial institutions. Broker-dealers, for example, are subject to regulation by the Securities and Exchange Commission.

**101-6—The effect of actual or threatened litigation on independence.**

In some circumstances, independence may be considered to be impaired as a result of litigation or the expressed intention to commence litigation as discussed below:

**Litigation between client and member**

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

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

1. **The commencement of litigation by the present management alleging deficiencies in audit work for the client would be considered to impair independence.**

2. **The commencement of litigation by the covered member against the present management alleging management fraud or deceit would be considered to impair independence.**

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

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

**Litigation by security holders**

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

1. **The existence of cross-claims filed by the client, its management, or any of its directors to protect a right to legal redress in the event of a future adverse decision in the primary litigation (or, in lieu of cross-claims, agreements to extend the statute of limitations) would not normally affect the relationship between client management and the covered member in such a way as to impair independence, unless there exists a significant risk that the cross-claim will result in a settlement or judgment in an amount material to the**

37. Because of the complexities of litigation and the circumstances under which it may arise, it is not possible to prescribe meaningful criteria for measuring materiality; accordingly, the covered member should consider the nature of the controversy underlying the litigation and all other relevant factors in reaching a judgment. [Footnote renumbered and revised, July 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1. Footnote subsequently renumbered by the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-3, February 2007 and July 2007. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010.]

covered member’s firm\textsuperscript{38} or to the client.

2. The assertion of cross-claims against the covered member by underwriters would not generally impair independence if no such claims are asserted by the client or the present management.

3. If any of the persons who file cross-claims against the covered member are also officers or directors of other clients of the covered member, independence with respect to such other clients would not generally be considered to be impaired.

Other third-party litigation

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

If the real party in interest in the litigation (e.g., the insurance company) is also a client of the covered member (“the plaintiff client”), independence with respect to the plaintiff client may be impaired if the litigation involves a significant risk of a settlement or judgment in an amount which would be material to the covered member’s firm\textsuperscript{38} or to the plaintiff client.

Effects of impairment of independence

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

Termination of impairment

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

101-8—Effect on Independence of Financial Interests in Nonclients Having Investor or Investee Relationships With a Covered Member’s Client

Introduction

Financial interests in nonclients that are related in various ways to a client may impair independence. Situations in which the nonclient investor is a partnership are covered in other rulings [ET section 191.138–.139 and .162–.163].

Terminology

The following specifically identified terms are used in this interpretation as indicated:

1. Client. The term client means the person or entity with whose financial statements a covered member is associated.

2. Significant Influence. The term significant influence is as defined in Accounting Principles Board (APB) Opinion 18.

3. Investor. The term investor means (a) a parent, (b) a general partner, or (c) a natural person or corporation that has the ability to exercise significant influence.

4. Investee. The term investee means (a) a subsidiary or (b) an entity over which an investor has the ability to exercise significant influence.

Interpretation

Where a nonclient investee is material to a client investor, any direct or material indirect financial interest of a covered member in the nonclient investee would be considered to impair independence with respect to the client investor. If the nonclient investee is immaterial to the client investor, a covered member’s material investment in the nonclient investee would cause an impairment of independence.
When a client investee is material to a nonclient investor, any direct or material indirect financial interest of a covered member in the nonclient investor would be considered to impair independence with respect to the client investee. If the client investee is immaterial to the nonclient investor, and if a covered member’s financial interest in the nonclient investor allows the covered member to exercise significant influence over the actions of the nonclient investor, independence would be considered to be impaired.

Other relationships, such as those involving brother-sister common control or client-nonclient joint ventures, may affect the appearance of independence. The covered member should make a reasonable inquiry to determine whether such relationships exist, and if they do, careful consideration should be given to whether the financial interests in question would lead a reasonable observer to conclude that the specified relationships pose an unacceptable threat to independence.

In general, in brother-sister common control situations, an immaterial financial interest of a covered member in the nonclient investee would not impair independence with respect to the client-investee, provided the covered member could not exercise significant influence over the nonclient investor. However, if a covered member’s financial interest in a nonclient investee is material, the covered member could be influenced by the non client investor, thereby impairing independence with respect to the client investee. In like manner, in a joint venture situation, an immaterial financial interest of a covered member in the nonclient investor would not impair the independence of the covered member with respect to the client investor, provided that the covered member could not exercise significant influence over the non client investor.

If a covered member does not and could not reasonably be expected to have knowledge of the financial interests or relationship described in this interpretation, independence would not be considered to be impaired under this interpretation.

**101-10—The Effect on Independence of Relationships with Entities Included in the Governmental Financial Statements**

For purposes of this Interpretation, a financial reporting entity’s basic financial statements, issued in conformity with generally accepted accounting principles in the United States of America, include the government-wide financial statements (consisting of the entity’s governmental activities, business-type activities, and discretely presented component units), the fund financial statements (consisting of major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds) and other entities disclosed in the notes to the basic financial statements. Entities that should be disclosed in the notes to the basic financial statements include, but are not limited to, related organizations, joint ventures, jointly governed organizations, and component units of another government with characteristics of a joint venture or jointly governed organization.

**Auditor of Financial Reporting Entity**

A covered member issuing a report on the basic financial statements of the financial reporting entity must be independent of the financial reporting entity, as defined in paragraph 1 of this Interpretation. However, independence is not required with respect to any major or nonmajor fund, internal service fund, fiduciary fund, or component fund financial statements, which is defined within the text of this Interpretation, certain terminology used throughout the Interpretation is specifically defined by the Governmental Accounting Standards Board.

unit or other entities disclosed in the financial statements, where the primary auditor explicitly states reliance on other auditors reports thereon. In addition, independence is not required with respect to an entity disclosed in the notes to the basic financial statements, if the financial reporting entity is not financially accountable for the organization and the required disclosure does not include financial information. For example, a disclosure limited to the financial reporting entity’s ability to appoint the governing board members would not require a member to be independent of that organization. However, the covered member and his or her immediate family should not hold a key position with a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or other entity that should be disclosed in the notes to the basic financial statements.

**Auditor of a Major Fund, Nonmajor Fund, Internal Service Fund, Fiduciary Fund, or Component Unit of the Financial Reporting Entity or Other Entity That Should Be Disclosed in the Notes to the Basic Financial Statements**

A covered member who is auditing the financial statements of a major fund, nonmajor fund, internal service fund, fiduciary fund, or component unit of the financial reporting entity or an entity that should be disclosed in the notes to the basic financial statements of the financial reporting entity, but is not auditing the primary government, should be independent with respect to those financial statements that the covered member is reporting upon. The covered member is not required to be independent of the primary government or other funds or component units of the reporting entity or entities that should be disclosed in the notes to the basic financial statements. However, the covered member and his or her immediate family should not hold a key position within the primary government. For purposes of this Interpretation, a covered member and immediate family member would not be considered employed by the primary government if the exceptions provided for in ET section 92.03 are met. 

**101-11—Modified Application of Rule 101 for Engagements Performed in Accordance with Statements on Standards for Attestation Engagements**

Rule 101, *Independence* [sec. 101 par. .01], and its interpretations and rulings apply to all attest engagements. However, the following exceptions apply when performing engagements to issue reports in accordance with Statements on Standards for Attestation Engagements (SSAEs) when independence is required, or when the member’s compilation report does not disclose a lack of independence:

- Covered members need to be independent with respect to the responsible party(ies). See the following section for specific guidance for agreed-upon procedures (AUP) engagements performed under SSAEs.
- In circumstances in which the individual or entity that engages the member is not the responsible party, covered members need not be independent of that individual or entity. However, consideration should be given to the requirements of Interpretation No. 102-2, “Conflicts of Interest,” under Rule 102, *Integrity and Objectivity* [sec. 102 par. .03], with regard to any relationships that may exist with the individual or entity that engages the member to perform these services.

Nonattest services that would otherwise impair independence under Interpretation No. 101-3 [sec. 101 par. .05] may be provided to the responsible party(ies) when such services do not relate to the specific subject matter of the SSAE engagement, provided that the general requirements of Interpretation No. 101-3 [sec. 101 par. .05] are met.

**AUP Engagements**

When performing an AUP engagement under the SSAEs, only the following covered members and their immediate families are required to be independent with respect to the responsible party(ies) in accordance with Rule 101 [sec.101 par. .01]:

- Individuals participating on the AUP engagement team
- Individuals who directly supervise or manage the AUP engagement partner
- Individuals who consult with the attest engagement team regarding technical or industry-related issues specific to the AUP engagement


42. For purposes of this interpretation, the term subject matter is as defined in the SSAEs. [Footnote added August 2011, effective November 30, 2011]
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In addition, independence would be impaired if the firm had a financial relationship covered by item (A) of Interpretation 101-1 [sec. 101 par. .02] with the responsible party(ies) that was material to the firm.

Independence will not be impaired if the general requirements of Interpretation No. 101-3 [sec. 101 par. .05] are not met when the member is also providing nonattest services, unless such services relate to the specific subject matter of the AUP engagement.

101-12—Independence and Cooperative Arrangements with Clients.
Independence will be considered to be impaired if, during the period of a professional engagement a member or his or her firm had any cooperative arrangement with the client that was material to the member’s firm or to the client.

Cooperative Arrangement—A cooperative arrangement exists when a member’s firm and a client jointly participate in a business activity. The following are examples, which are not all inclusive, of cooperative arrangements:

- a. Prime/subcontractor arrangements to provide services or products to a third party
- b. Joint ventures to develop or market products or services
- c. Arrangements to combine one or more services or products of the firm with one or more services or products of the client and market the package with references to both parties.
- d. Arrangements to combine one or more services or products of the firm with one or more services or products of the client and market the package with references to both parties.
- e. Distribution or marketing arrangements under which the firm acts as a distributor or marketer of the client’s products or services, or the client acts as the distributor or marketer of the products or services of the firm.

Nevertheless, joint participation with a client in a business activity does not ordinarily constitute a cooperative arrangement when all the following conditions are present:

- a. The participation of the firm and the participation of the client are governed by separate agreements, arrangements or understandings
- b. The firm assumes no responsibility for the activities or results of the client and vice versa.
- c. Neither party has the authority to act as the representative or agent of the other party.

In addition, the member’s firm should consider the requirements of Rule 302 and Rule 503.

101-14—The Effect of Alternative Practice Structures on the Applicability of Independence Rules
Because of changes in the manner in which members are structuring their practices, the AICPA’s professional ethics executive committee (PEEC) studied various alternatives to “traditional structures” to determine whether additional independence requirements are necessary to ensure the protection of the public interest.

In many “nontraditional structures,” a substantial (the nonattest) portion of a member’s practice is conducted under public or private ownership, and the attest portion of the practice is conducted through a separate firm owned and controlled (as defined in Financial Accounting Standards Board [FASB] Accounting Standards Codification [ASC] 810, Consolidation) by the member. All such structures must comply with applicable laws, regulations, and Rule 505, Form of Organization and Name [ET section 505.01]. In complying with laws, regulations, and Rule 505 [ET section 505.01], many elements of quality control are required to ensure that the public interest is adequately protected. For example, all services performed by members and persons over whom they have control must comply with standards promulgated by AICPA Council-designated bodies, and, for all other firms providing attest services, enrollment is required in an AICPA-approved practice-monitoring program. Finally, and importantly, the members are responsible, financially and otherwise, for all the attest work performed. Considering the extent of such measures, PEEC believes that the additional independence rules set forth in this interpretation are sufficient to ensure that attest services can be performed with objectivity and, therefore, the additional rules satisfactorily protect the public interest.

Rule 505 [ET section 505.01] and the following independence rules for an alternative practice structure (APS) are intended to be conceptual and applicable to all structures where the “traditional firm” engaged in attest services is closely aligned with another organization, public or private, that performs other professional services. The following paragraph and the chart below provide an example of a structure in use at the time this interpretation was developed. Many of the references in this interpretation are to the example. PEEC intends that the concepts expressed herein be applied, in spirit and in substance, to variations of the example structure as they develop.

The example APS in this interpretation is one where an existing CPA practice (“Oldfirm”) is sold by its owners to another (possibly public) entity (“PublicCo”).

‡ Terms shown in boldface type upon first usage in this interpretation are defined in ET section 92, Definitions. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-1.]
PublicCo has subsidiaries or divisions such as a bank, insurance company or broker-dealer, and it also has one or more professional service subsidiaries or divisions that offer to clients nonattest professional services (e.g., tax, personal financial planning, and management consulting). The owners and employees of Oldfirm become employees of one of PublicCo’s subsidiaries or divisions and may provide those nonattest services. In addition, the owners of Oldfirm form a new CPA firm (“Newfirm”) to provide attest services. CPAs, including the former owners of Oldfirm, own a majority of Newfirm (as to vote and financial interests). Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space and equipment; the performance of back-office functions such as billing and collections; and advertising. Newfirm pays a negotiated amount for these services.

**APS Independence Rules for Covered Members**

The term covered member in an APS includes both employed and leased individuals. The firm in such definition would be Newfirm in the example APS. All covered members, including the firm, are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety. For example, no covered member may have, among other things, a direct financial interest in or a loan to or from an attest client of Newfirm.

Partners of one Newfirm generally would not be considered partners of another Newfirm except in situations where those partners perform services for the other Newfirm or where there are significant shared economic interests between partners of more than one Newfirm. If, for example, partners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be partners of both Newfirms for purposes of applying the independence rules.

**APS Independence Rules for Persons and Entities Other Than Covered Members**

As stated above, the independence rules normally extend only to those persons and entities included in the definition of covered member. This normally would include only the “traditional firm” (Newfirm in the example APS), those covered members who own or are employed or leased by Newfirm, and entities controlled (as defined in FASB ASC 810) by one or more of such persons. Because of the close alignment in many APSs between persons and entities included in covered member and other persons and entities, to ensure the protection of the public interest, PEEC believes it appropriate to require restrictions in addition to those required in a traditional firm structure. Those restrictions are divided into two groups:

1. **Direct Superiors.** Direct Superiors are defined to include those persons so closely associated with a partner or manager who is a covered member, that such persons can directly control the activities of such partner or manager. For this purpose, a person who can directly control is the immediate superior of the partner or manager who has the power to direct the activities of that person so as to be able to directly or indirectly (e.g. through another entity over which the Direct Superior can exercise significant influence) derive a benefit from that person’s activities. Examples would be the person who has day-to-day responsibility for the activities of the partner or manager and is in a position to recommend promotions and compensation levels. This group of persons is, in the view of PEEC, so closely aligned through direct reporting relationships with such persons that their interests would seem to be inseparable. Consequently, persons considered Direct Superiors, and entities within the APS over which such persons can exercise significant influence are subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

2. **Indirect Superiors and Other PublicCo Entities.** Indirect Superiors are those persons who are one or more levels above persons included in Direct Superior. Generally, this would start with persons in an organization structure to whom Direct Superiors report and go up the line from there. PEEC believes that certain restrictions must be placed on Indirect

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45. For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of Interpretation 101-1. Footnote subsequently renumbered by the revision of Interpretation 101-2, April 2003. Footnote subsequently renumbered by the revision of Interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of Interpretation 101-3, July 2004. Footnote subsequently renumbered by the revision of Interpretation 101-4, April 2006. Footnote subsequently renumbered by the revision of Interpretation 101-3, February 2007 and July 2007. Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC. Footnote renumbered by the revision of Interpretation 101-1, March 2010. Footnote subsequently renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]
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Superiors, but also believes that such persons are sufficiently removed from partners and managers who are covered persons to permit a somewhat less restrictive standard. Indirect Superiors are not connected with partners and managers who are covered members through direct reporting relationships; there always is a level in between. The PEEC also believes that, for purposes of the following, the definition of Indirect Superior also includes the immediate family of the Indirect Superior.

PEEC carefully considered the risk that an Indirect Superior, through a Direct Superior, might attempt to influence the decisions made during the engagement for a Newfirm attest client. PEEC believes that this risk is reduced to a sufficiently low level by prohibiting certain relationships between Indirect Superiors and Newfirm attest clients and by applying a materiality concept with respect to financial relationships. If the financial relationship is not material to the Indirect Superior, PEEC believes that he or she would not be sufficiently financially motivated to attempt such influence particularly with sufficient effort to overcome the presumed integrity, objectivity and strength of character of individuals involved in the engagement.

Similar standards also are appropriate for Other PublicCo Entities. These entities are defined to include PublicCo and all entities consolidated in the PublicCo financial statements that are not subject to Rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

The rules for Indirect Superiors and Other PublicCo Entities are as follows:

A. Indirect Superiors and Other PublicCo Entities may not have a relationship contemplated by Interpretation 101-1.A [ET section 101.02] (e.g., investments, loans, etc.) with an attest client of Newfirm that is material. In making the test for materiality for financial relationships of an Indirect Superior, all the financial relationships with an attest client held by such person should be aggregated and, to determine materiality, assessed in relation to the person’s net worth. In making the materiality test for financial relationships of Other PublicCo Entities, all the financial relationships with an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo. In addition, any Other PublicCo Entity over which an Indirect Superior has direct responsibility cannot have a financial relationship with an attest client that is material in relation to the Other PublicCo Entity’s financial statements.

B. Further, financial relationships of Indirect Superiors or Other PublicCo Entities should not allow such persons or entities to exercise significant influence over the attest client. In making the test for significant influence, financial relationships of all Indirect Superiors and Other PublicCo Entities should be aggregated.

C. Neither Other PublicCo Entities nor any of their employees may be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director or officer.

D. Except as noted in C above, Indirect Superiors and Other PublicCo Entities may provide services to an attest client of Newfirm that would impair independence if performed by Newfirm. For example,

47. For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the revision of interpretation 101-2, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-3, July 2007. Footnote revised, June 2009, to reflect conforming changes necessary due to the issuance of FASB ASC. Footnote renumbered by the revision of interpretation 101-1, March 2010. Footnote subsequently renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]
trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not subject to rule 101 [ET section 101.01] and its interpretations and rulings in their entirety.

Other Matters
1. An example, using the chart below, of the application of the concept of Direct and Indirect Superiors would be as follows: The chief executive of the local office of the Professional Services Subsidiary (PSS), where the partners of Newfirm are employed, would be a Direct Superior. The chief executive of PSS itself would be an Indirect Superior, and there may be Indirect Superiors in between such as a regional chief executive of all PSS offices within a geographic area.

2. PEEC has concluded that Newfirm (and its partners and employees) may not perform an attest engagement for PublicCo or any of its subsidiaries or divisions.

3. PEEC has concluded that independence would be considered to be impaired with respect to an attest client of Newfirm if such attest client holds an investment in PublicCo that is material to the attest client or allows the attest client to exercise significant influence over PublicCo.

4. When making referrals of services between Newfirm and any of the entities within PublicCo, a member should consider the provisions of Interpretation 102-2, Conflicts of Interest [ET section 102.03].

Alternative Practice Structure (APS) Model

### 101-15—Financial Relationships

#### Financial Interests

Interpretation 101-1 states that independence shall be considered to be impaired if, during the period of the professional engagement, a covered member had or was committed to acquire any direct or material indirect financial interest in the client. When reviewing this interpretation, the covered member should also refer to Interpretation 101-1 for the application of rule 101 and its interpretations and rulings to the covered member’s immediate family and close relatives.

This interpretation provides definitions of direct and indirect financial interests and further guidance on whether various types of financial interests should be considered to be direct or indirect financial interests and provides certain limited exceptions under which a covered member could hold a direct or material indirect financial interest in an attest client without being considered to have impaired his or her independence.

#### Definitions

A **financial interest** is an ownership interest in an equity or a debt security issued by an entity, including rights and obligations to acquire such an interest and derivatives directly related to such interest.

A **direct financial interest** is a financial interest:

1. Owned directly by an individual or entity (including those managed on a discretionary basis by others); or

2. Under the control of an individual or entity (including those managed on a discretionary basis by others); or

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48. For purposes of this Interpretation, significant influence means having the ability to exercise significant influence over the financial, operating or accounting policies of the entity, for example by (1) being connected with the entity as a promoter, underwriter, voting trustee, general partner or director, (2) being in a policy-making position such as chief executive officer, chief operating officer, chief financial officer or chief accounting officer, or (3) meeting the criteria in FASB ASC 323-10-15 to determine the ability of an investor to exercise such influence with respect to an entity. The foregoing examples are not necessarily all-inclusive. [Footnote added, November 2002, to reflect conforming changes necessary due to the issuance of FASB ASC. Footnote renumbered by the revision of interpretation 101-1, April 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, September 2003. Footnote subsequently renumbered by the revision of interpretation 101-3, July 2004. Footnote subsequently renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010. Footnote subsequently renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]

49. When used herein, the term control includes situations where the covered member, individually or acting together with his or her firm or with other partners or professional employees of his or her firm, has the ability to exercise such control. [Footnote renumbered by the revision of interpretation 101-1, April 2006. Footnote subsequently renumbered by the revision of interpretation 101-1, March 2010. Footnote subsequently renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]
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3. Beneficially owned through an investment vehicle, estate, trust, or other intermediary when the beneficiary:
   a. Controls the intermediary; or
   b. Has the authority to supervise or participate in the intermediary’s investment decisions.

An indirect financial interest is a financial interest beneficially owned through an investment vehicle, estate, trust, or other intermediary when the beneficiary neither controls the intermediary nor has the authority to supervise or participate in the intermediary’s investment decisions.

A financial interest is beneficially owned when an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.

Unsolicited Financial Interests

Independence would not be considered to be impaired if an unsolicited financial interest in a client is received, such as through gift or inheritance, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the covered member has knowledge of and the right to dispose of the financial interest. In addition, when the covered member becomes aware that he or she will receive or has received a material direct or material indirect financial interest in a client requiring independence but does not have the right to dispose of the financial interest, independence would be considered to be impaired unless the covered member does not participate on the attest engagement team and disposes of the financial interest as soon as practicable but no later than 30 days after the right to dispose exists.

Mutual Funds

The ownership of shares in a mutual fund is considered to be a direct financial interest in the mutual fund. The underlying investments of a mutual fund are considered to be indirect financial interests.

If the mutual fund is diversified, if a covered member’s ownership of 5 percent or less of the outstanding shares of the mutual fund would not be considered to constitute a material indirect financial interest in the underlying investments.

If a covered member owns more than 5 percent of the outstanding shares of a diversified mutual fund, or if the mutual fund is not diversified, the covered member should evaluate the underlying investments of the mutual fund to determine whether the covered member holds a material indirect financial interest in any of the underlying investments.

For example, if a non-diversified mutual fund owns shares-in attest client Company A, and

- The mutual fund’s net assets are $10,000,000;
- The covered member owns 1 percent of the outstanding shares of the mutual fund, having a value of $100,000; and
- The mutual fund has 10 percent of its assets invested in Company A

The indirect financial interest of the covered member in Company A is $10,000 and this amount should be measured against the covered member’s net worth (including the net worth of his or her immediate family) to determine if it is material.

Retirement, Savings, Compensation, or Similar Plans

Depending upon the facts and circumstances, investments held in a retirement, savings, compensation, or similar plan may be considered a covered member’s direct or indirect financial interests as follows:

- Investments held by a retirement, savings, compensation, or similar plan sponsored by a covered member’s firm would be considered direct financial interests of the firm.
- If a covered member or his or her immediate family member self-directs the investments in a retirement, savings, compensation, or similar plan or has the ability to supervise or participate in the plan’s investment decisions, the investments held by the plan would be considered direct financial interests of the covered member. Otherwise, the underlying plan investments would be considered indirect financial interests of the covered member.
- Allocated shares held in an employee stock ownership plan (ESOP) would be considered indirect financial interests of the covered member.

50. To determine if the mutual fund is diversified, the covered member should refer to (1) the mutual fund’s prospectus to see if the prospectus discloses that the fund is not diversified or (2) Section 5(f)(1) of the Investment Company Act of 1940.
51. [Footnote deleted and renumbered by the Professional Ethics Executive Committee, March 2010. Footnote subsequently renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]
financial interests that are beneficially owned until such time as the covered member or his or her immediate family has the right to dispose of the financial interest. Once the participant has the right to dispose of the financial interest, the financial interest is considered a direct financial interest.

- Rights to acquire equity interests, restricted stock awards, or other share-based compensation arrangements are considered direct financial interests, regardless of whether such financial interests are vested or exercisable.

The following examples illustrate these concepts:

1. If a covered member or his or her immediate family member is a trustee of a retirement, savings, compensation, or similar plan or otherwise has the authority to supervise or participate in the plan’s investment decisions (including through the selection of investment managers or pooled investment vehicles), the underlying investments would be considered to be direct financial interests of the covered member.

2. If investments in a defined contribution plan are participant directed, whereby a covered member or his or her immediate family member selects his or her underlying plan investments or selects from investment alternatives offered by the plan, the underlying investments would be considered to be direct financial interests of the covered member.

3. If investments in a defined contribution plan are not participant directed and the covered member or his or her immediate family member has no authority to supervise or participate in the plan’s investment decisions, the underlying investments would be considered to be indirect financial interests of the covered member.

A covered member who is the account owner of a Section 529 prepaid tuition plan is considered to have a direct financial interest in the plan but not in the investments of the plan because the credits purchased represent an obligation of the state or educational institution to provide the education regardless of the investment performance of the plan or the cost of the education at the future date.

A covered member who is the account owner of a Section 529 savings plan is considered to have a direct financial interest in both the plan and the investments of the plan because he or she decides in which sponsor’s Section 529 savings plan to invest and prior to making the investment has access to information about the plan’s investments.

If a covered member invests in a Section 529 savings plan that does not hold financial interests in an attest client at the time of the investment, but the plan subsequently invests in an attest client, the covered member should (1) transfer the account to another sponsor’s Section 529 savings plan or (2) transfer the account to another account owner who is not a covered member. However, when the transfer of the account will result in a penalty or tax that is significant to the account, the covered member may continue to own the account until the account can be transferred without significant penalty or tax, provided the covered member does not participate on the attest engagement team and is not in a position to influence the attest engagement.

A covered member who is a beneficiary of a Section 529 account is not considered to have a financial interest in the plan or the investments of the plan because he or she does not own the account or possess any of the underlying benefits of ownership and the beneficiary’s only interest is to receive distributions from the account for qualified higher education expenses if and when they are authorized by the account owner.

Before becoming engaged to perform an attest engagement for a government or governmental entity that sponsors a Section 529 plan, covered members that are account owners of a Section 529 plan should consider the guidance in Interpretation 101-10, The Effect on Independence of Relationships With Entities Included in the Governmental Financial Statements [ET section 101.12].

Section 529 Plans

Section 529 plans are sponsored by states or higher education institutions, and may be prepaid tuition plans or savings plans. Both types of plans are established by an account owner for the benefit of a single beneficiary. The account owner may change the beneficiary at any time to another individual who is related to the previous beneficiary.

Also refer to ethics ruling No. 107 (ET section 191.214–.215), and the “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client,” “Application of the Independence Rules to a Covered Member’s Immediate Family,” and “Application of the Independence Rules to Close Relatives” sections of Interpretation No. 101-1 (par. .02).

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Also refer to ethics ruling No. 107 (ET section 191.214–.215), and the “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client,” “Application of the Independence Rules to a Covered Member’s Immediate Family,” and “Application of the Independence Rules to Close Relatives” sections of Interpretation No. 101-1 (par. .02).
**Trust Investments**

When a covered member is a grantor of a trust, the trust and the underlying investments held by the trust are considered to be direct financial interests if the covered member retains the right to amend or revoke the trust, or otherwise has the authority to control the trust or to supervise or participate in the trust’s investment decisions. However, where the covered member does not have the authority to amend or revoke the trust or to supervise or participate in the trust’s investment decisions, he or she is not considered to have a financial interest in the trust or the underlying investments held by the trust.

When a covered member is a beneficiary of a trust, the trust is considered to be a direct financial interest of the covered member and the underlying investments held by the trust are considered to be indirect financial interests of the covered member. However, if the covered member controls the trust or supervises or participates in the investment decisions of the trust, the underlying investments held by the trust are considered to be direct financial interests of the covered member.

In a blind trust, the grantor is also the beneficiary, but does not supervise or participate in the trust’s investment decisions during the term of the trust. However, the investments will ultimately revert to the grantor, and the grantor usually retains the right to amend or revoke the trust. Therefore, both the blind trust and the underlying investments held in a blind trust are considered to be direct financial interests of the covered member.

**Partnerships**

The ownership of a general or limited partnership interest is considered a direct financial interest in the partnership. The financial interests held by a partnership are considered to be direct financial interests of a covered member if the covered member is a partner because the covered member is in a position to control the partnership or to supervise or participate in the partnership’s investment decisions.

The financial interests held by a limited partnership are considered to be indirect financial interests of a covered member who is a limited partner as long as the covered member does not control the partnership or supervise or participate in the partnership’s investment decisions. However, if the covered member has the ability to replace the general partner or has the authority to supervise or participate in the partnership’s investment decisions, the financial interests of the partnership would be considered to be direct financial interests of the covered member.

**Limited Liability Companies**

The ownership of an interest in a limited liability company (LLC) is considered a direct financial interest in the LLC.

In an LLC, members who are managers control the LLC and have the authority to supervise or participate in the LLC’s investment decisions. Accordingly, if a covered member is a manager of the LLC, the financial interests of the LLC are considered to be direct financial interests of the covered member. If a covered member is a member but not a manager of the LLC, the covered member should look to the operating agreement of the LLC to determine whether he or she can control the LLC or has the authority to supervise or participate in the investment decisions of the LLC. If the covered member does not control the LLC, or have the authority to supervise or participate in the LLC’s investment decisions, the financial interests held by the LLC would be considered to be indirect financial interests of the covered member.

**Insurance Products**

An insurance policy obtained from a stock or mutual insurance company that does not offer the policy holder an investment option is not considered to be a financial interest. Accordingly, if a covered member owns an insurance policy issued by an attest client, independence is not considered to be impaired, provided the policy does not offer the policy holder an investment option and the policy was purchased under the insurance company’s normal terms, procedures, and requirements. If a mutual insurance company begins the demutualization process, covered members who hold an insurance policy from the company should refer to the guidance contained in the “Unsolicited Financial Interests” section of this Interpretation.

Some insurance policies offer an investment option whereby the policy owner may choose to invest part of the cash value in a variety of underlying investments. The underlying investments of this type of insurance policy are considered to be a financial interest, and the covered member should apply the guidance in this interpretation to determine whether the underlying investments are direct or indirect financial interests. For example, if the covered member has the ability to select the underlying investments or the authority to supervise or participate in the investment decisions and the cash value of the insurance policy is invested in a mutual fund, the mutual fund is considered to be a direct financial interest and the underlying investments of the mutual fund are considered to be indirect financial interests.
101-17—Networks and Network Firms

General
To enhance their capabilities to provide professional services, firms frequently join larger groups, which typically are membership associations that are separate legal entities that are otherwise unrelated to their members. The associations facilitate their members’ use of association services and resources; they do not themselves typically engage in the practice of public accounting or provide professional services to their members’ clients or to other third parties. Firms and other entities in the association cooperate with the firms and other entities that are members of the association to enhance their capabilities to provide professional services. For example, a firm may become a member of an association in order to refer work to, or receive referrals from, other association members. That characteristic alone would not be sufficient for the referrals from, other association members. That characteristic alone would not be sufficient for the association to constitute a network or for the firm to be considered a network firm. However, an association would be considered a network under this interpretation if one or more additional characteristics of a network are shared, in addition to cooperation among member firms [ET section 92.23]. These additional characteristics are discussed further in this interpretation.

A network firm is required to be independent of financial statement audit and review clients of the other network firms if the use of the audit or review report for the client is not restricted, as defined by professional standards. For all other attest clients, consideration should be given to any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level. The independence requirements apply to any entity within the network that meets the definition of a network firm [ET section 92.24].

Whether an association is a network and whether an entity is a network firm should be applied consistently by all members of the association. Due consideration should be given to what a reasonable and informed third party would be likely to conclude after weighing all the specific facts and circumstances. The determination that a firm or other entity or an association of firms or other entities meets the definition of a network firm and a network, as herein defined, is solely for purposes of this interpretation and should not be used or relied upon in any other context. In particular, the determination of whether a firm or other entity is a network firm or an association of firms or other entities is a network for purposes of defining legal responsibilities from one firm to the other, or to third parties, is beyond the scope of this interpretation. The definitions contained herein should not be used or relied upon for that purpose.

Characteristics of a Network

Sharing Common Brand Name
When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the members of the association or entities controlled (as defined in Financial Accounting Standards Board [FASB] Accounting Standards Codification [ASC] 810, Consolidation) by members of the association share the use of a common brand name or share common initials as part of the firm name, the association is considered to be a network.

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 a 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.”

Sharing Common Control
When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the entities within the association are under common control (as defined by FASB ASC 810) with other firms in the association through ownership, management, or other means (for example, by contract), it is considered to be a network. 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.

Sharing Profits or Costs
When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the firms share profits or costs, the association is considered to be a network.

53. Members may review the implementation guidance issued by the Ethics Division regarding this Interpretation No. 101-17. This guidance may be found on the AICPA website. [Footnote renumbered August 2011 by revision of Interpretation 101-11, effective November 2011.]
However, the sharing of immaterial costs or costs related to operating the association does not by itself create a network. In addition, the sharing of costs related to the development of audit methodologies, manuals, and training courses does not by itself create a network. Further, an arrangement between a firm and an otherwise unrelated entity to jointly provide a service or develop a product does not by itself create a network.

**Sharing Common Business Strategy**

When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the entities within the association share a common business strategy, the association is considered to be a network. Sharing a common business strategy involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the association’s strategy and are 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. An entity is not considered to be a network firm merely because it cooperates with another entity solely to market professional services or respond jointly to a request for a proposal for the provision of a professional service.

**Sharing Significant Professional Resources**

When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the entities within the association share a significant part of professional resources, it is considered to be a network.

Professional resources include

- common systems that enable firms to exchange information, such as client data, billing, and time records;
- partners and staff;
- technical departments to consult on technical or industry specific issues, transactions, or events for assurance engagements;
- audit methodology or audit manuals; and
- training courses and facilities.

The determination of whether the shared professional resources are significant should be made based on both qualitative and quantitative factors.

When the entities within the association do not share a significant amount of human resources or significant client information (for example, client data, billing, and time records) and have the ability to make independent decisions regarding technical matters, audit methodology, training, and the like, the entities are not considered to be sharing a significant part of professional resources. When the shared professional resources are limited to a common audit methodology, audit manuals, training courses, or facilities, and when they do not include a significant amount of human resources or client or market information, the shared professional resources are not considered significant. However, when the shared professional resources involve the exchange of client information or personnel, such as when staff are drawn from a shared pool, or a common technical department is created within the association to provide participating firms with technical advice that the firms are required to follow, a reasonable and informed third party is more likely to conclude that the shared professional resources are significant. An entity generally is not deemed a network because it occasionally uses personnel of another member firm to assist with an engagement, such as observing a client’s physical inventory count.

**Sharing Common Quality Control Policies and Procedures**

When the association is formed for the purpose of cooperating to enhance the firms’ capabilities to provide professional services and when the entities within the association are required to follow common quality control policies and procedures monitored by the association, it is considered to be a network. Monitoring is the process comprising an ongoing consideration and evaluation of the firms’ systems of quality control, the objective of which is to enable the association to obtain reasonable assurance that the firms’ systems of quality control are designed appropriately and operating effectively.

**101-18—Application of the Independence Rules to Affiliates**

**Introduction**

Financial interests in, and other relationships with, entities that are related in various ways to a financial statement attest client may impair independence. This interpretation provides guidance on which entities should be considered an affiliate of a financial statement attest client and subject to the independence provisions of the AICPA Code of Professional Conduct. This interpretation does not apply to a financial statement attest client that would be covered by interpretation 101-10 [sec. 101 par. .12].

**Definitions**

The following specifically identified terms are used in this interpretation as indicated:

**Affiliate.** The following entities should be considered affiliates of a financial statement attest client:

- an entity (for example, subsidiary, partnership, or LLC) that a financial statement attest client can control.
b. An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.

c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

e. A sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both.

f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

g. The sponsor of a single employer employee benefit plan financial statement attest client.

h. Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

i. An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multi-employer plan.

j. An investment adviser, general partner, or trustee of an investment company financial statement attest client (fund) if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

**Significant influence.** The term *significant influence* is as used in FASB ASC 323-10-15.

**Application of the Independence Rules to Affiliates**

When a client is a financial statement attest client, members should apply the independence provisions of the AICPA Code of Professional Conduct applicable to the client to its affiliates, except in the following situations:

a. A covered member may have a loan to or from an individual who is an officer, a director, or a 10 percent or more owner of an affiliate of a financial statement attest client unless the covered member knows or has reason to believe that the individual is in such a position with such an affiliate. If the covered member knows or has reason to believe that the individual is an officer, a director, or a 10 percent or more owner of such an affiliate, the covered member should evaluate the effect that the relationship would have on the member’s independence by applying the Conceptual Framework for AICPA Independence Standards [sec. 100-1].

b. A member or his or her firm may provide prohibited nonattest services to entities described under subparagraphs (c)–(j) of the definition of affiliate, as defined in the previous “Definitions” section, provided that it is reasonable to conclude that the services do not create a self-review threat with respect to the financial statement attest client because the results of the nonattest services will not be subject to financial statement attest procedures. For any other threats that are created by the provision of the nonattest services that are not at an acceptable level (in particular, those relating to management participation), such threats should be eliminated or reduced to an acceptable level by the application of safeguards.

c. A firm will only have to apply conditions (1)–(6) of Interpretation No. 101-2, “Employment or Association With Attest Clients” [sec. 101 par. .04], if the former employee, by virtue of his or her employment at an entity described under subparagraphs (c)–(j) of the definition of affiliate, as defined in the previous “Definitions” section, would put the employee in a key position with respect to the financial statement attest client. Individuals in a position to influence the attest engagement and on the attest engagement team who are considering employment with an affiliate of a financial statement attest client will still need to report consideration of employment to an appropriate person in the firm and remove themselves from the financial statement attest engagement, even if the position with the affiliate is not a key position.

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**Control(s) (led).** The term *control(s) (led)* is as used in FASB ASC 810 for commercial entities and FASB ASC 958-805-20 for not-for-profit entities.

**Financial statement attest client.** An entity whose financial statements are audited, reviewed, or compiled when the member’s compilation report does not disclose a lack of independence.
d. Immediate family members and close relatives of a covered member may be employed at an entity described under subparagraphs (c)–(j) of the definition of affiliate, as defined in the previous “Definitions” section, in a key position, provided that the position does not put them in a key position with respect to the financial statement attest client.

**Other Considerations**

A member must expend best efforts to obtain the information necessary to identify a financial statement attest client’s affiliates. If, after expending best efforts, a member is unable to obtain the information to determine which entities are affiliates of a financial statement attest client, the member is required to (a) discuss the matter, including the potential impact on independence, with those charged with governance; (b) document the results of that discussion and the efforts taken to obtain the information; and (c) obtain written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the client’s affiliates.

**Effective Date**

This interpretation will be effective for engagements covering periods beginning on or after January 1, 2014. Early implementation is allowed.

**101-19—Permitted Employment With Client Educational Institution**

Partners or professional employees of a firm may seek employment as an adjunct faculty member of an educational institution. Partners or professional employees of a firm who provide these types of services to an educational institution that is a client of the firm would not be considered to impair independence with respect to the educational institution, provided that the partner or professional employee

a. does not hold a key position at the educational institution;
b. does not participate on the attest engagement team;
c. is not an individual in a position to influence the attest engagement;
d. is employed by the educational institution on a part-time and nontenure basis;
e. does not participate in any employee benefit plans sponsored by the educational institution, unless participation is required; and
f. does not assume any management responsibilities or set policies for the educational institution.

Upon termination of such employment, the partner or professional employee should comply with the requirements of the “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With A Client” section of Interpretation No. 101-1 [sec. 101 par. .02].

**Rule 102, Integrity and Objectivity**

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

**Interpretations under Rule 102—Integrity and Objectivity**

**102-1—Knowing misrepresentations in the preparation of financial statements or records.**

A member shall be considered to have knowingly misrepresented facts in violation of Rule 102 when he or she knowingly—

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

**102-2—Conflicts of interest.**

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

Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments under Rule 101, its interpretations and rulings cannot be eliminated by such disclosure and consent. The following are examples, not all-inclusive, of situations that should cause a member to consider whether or not the client, employer, or other ap-
appropriate parties could view the relationship as impairing the member’s objectivity:

- A member has been asked to perform litigation services for the plaintiff in connection with a lawsuit filed against a client of the member’s firm.
- A member has provided tax or personal financial planning (PFP) services for a married couple who are undergoing a divorce, and the member has been asked to provide the services for both parties during the divorce proceedings.
- In connection with a PFP engagement, a member plans to suggest that the client invest in a business in which he or she has a financial interest.
- A member provides tax or PFP services for several members of a family who may have opposing interests.
- A member has a significant financial interest, is a member of management, or is in a position of influence in a company that is a major competitor of a client for which the member performs management consulting services.
- A member serves on a city’s board of tax appeals, which considers matters involving several of the member’s tax clients.
- A member has been approached to provide services in connection with the purchase of real estate from a client of the member’s firm.
- A member refers a PFP or tax client to an insurance broker or other service provider, which refers clients to the member under an exclusive arrangement to do so.
- A member recommends or refers a client to a service bureau in which the member or partner(s) in the member’s firm hold material financial interest(s).

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

**102-3—Obligations of a member to his or her employer’s external accountant.**

Under Rule 102, a member must maintain objectivity and integrity in the performance of a professional service. In dealing with his or her employer’s external accountant, a member must be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts. This would include, for example, responding to specific inquiries for which his or her employer’s external accountant requests written representation.

**102-4—Subordination of judgment by a member.**

Rule 102 prohibits a member from knowingly misrepresenting facts or subordinating his or her judgment when performing professional services. Under this rule, if a member and his or her supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions, the member should take the following steps to ensure that the situation does not constitute a subordination of judgment.54

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

2. If the member concludes that the financial statements or records could be materially misstated, the member should make his or her concerns known to the appropriate higher level(s) of management within the organization (for example, the supervisor’s immediate superior, senior management, the audit committee or equivalent, the board of directors, the company’s owners). The member should consider documenting his or her understanding of the facts, the accounting principles involved, the application of those principles to the facts, and the parties with whom these matters were discussed.

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

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

**102-5—Applicability of Rule 102 to members performing educational services.**

Educational services (for example, teaching full- or part-time at a university, teaching a continuing professional education course, or engaging in research and scholarship) are professional services as defined in ET section 92.30, and are therefore subject to rule 102. Rule 102

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54. A member in the practice of public accounting should refer to the Statements on Auditing Standards. For example, see SAS No. 22, Planning and Supervision [AU section 311], which discusses what the auditor should do when there are differences of opinion concerning accounting and auditing standards.
provides that the member shall maintain objectivity and integrity, shall be free of conflicts of interest, and shall not knowingly misrepresent facts or subordinate his or her judgment to others.

102-6—Professional services involving client advocacy.
A member or a member’s firm may be requested by a client—
1. To perform tax or consulting services engagements that involve acting as an advocate for the client.
2. To act as an advocate in support of the client’s position on accounting or financial reporting issues, either within the firm or outside the firm with standard setters, regulators, or others.

Services provided or actions taken pursuant to such types of client requests are professional services [ET section 92.30] governed by the Code of Professional Conduct and shall be performed in compliance with Rule 201, General Standards [ET section 201.01], Rule 202, Compliance With Standards [ET section 202.01], and Rule 203, Accounting Principles [ET section 203.01], and interpretations thereof, as applicable. Furthermore, in the performance of any professional service, a member shall comply with rule 102 [ET section 102.01], which requires maintaining objectivity and integrity and prohibits subordination of judgment to others. When performing professional services requiring independence, a member shall also comply with rule 101 [ET section 101.01] of the Code of Professional Conduct.

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

Ethics Rulings on Independence, Integrity, and Objectivity

2. Association Membership
Question: Would independence be considered to be impaired if a member joined a trade association that is a client of the firm?
Answer: Independence would not be considered to be impaired provided the member did not serve as an officer, director, or in any capacity equivalent to that of a member of management.

8. Member Providing Advisory Services
Question: A member provides extensive advisory services for a client. In that connection, the member attends board meetings, interprets financial statements, forecasts and other analyses, counsels on potential expansion plans and on banking relationships. Would independence be considered to be impaired under these circumstances?
Answer: Independence would not be considered to be impaired because the member’s role is advisory in nature.

11. Member Designated to Serve as Executor or Trustee
Question: A member has been designated to serve as an executor or trustee of the estate of an individual who owns the majority of a client’s stock. Would independence be considered to be impaired with respect to the client?
Answer: The mere designation of a covered member as executor or trustee would not be considered to impair independence. However, if a covered member actually served in such capacity, independence would be considered to be impaired.

14. Member on Board of Federated Fund-Raising Organization
Question: A member serves as a director or officer of a United Way or similar federated fund-raising organization (the organization). Certain local charities receive funds from the organization. Would independence be considered to be impaired with respect to such charities?
Answer: Independence would be considered to be impaired if any partner or professional employee of the firm served as a director or officer of the organization and the organization exercised managerial control over the local charities (See ethics ruling No. 93 [ET section 191.186–.187] under rule 101 [ET section 101.01] for additional guidance.)

17. Member of Social Club
Question: Would independence be considered to be impaired if a covered member belongs to a social club (for example, country club, tennis club) that requires him or her to acquire a pro rata share of the club’s equity or debt securities?
Answer: As long as membership in a club is essentially a social matter, a covered member’s association with the club would not impair independence because such equity or debt ownership would not be considered to be a direct financial interest within the meaning of rule 101 [ET section 101.01]. Also see interpretation 101-1.C [ET section 101.02].

20. Member Serving on Governmental Advisory Unit
Question: A member serves on a citizens’ committee which is studying possible changes in the form of a county government that the firm audits. The member also
serves on a committee appointed to study the financial status of a state. Would independence be considered to be impaired with respect to a county in that state?

**Answer:** Independence would not be considered to be impaired with respect to the county through the member’s service on either committee.

**21. Member as Director and Auditor of an Entity’s Profit Sharing and Retirement Trust**

**Question:** A member serves in the dual capacity of director of an entity and auditor of the financial statements of that entity’s profit sharing and retirement trust (the trust). Would independence be considered to be impaired with respect to the trust?

**Answer:** Service as director of an entity constitutes participation in management functions that affect the entity’s trust. Accordingly, independence would be considered to be impaired if any partner or professional of the firm served in such capacity.

**31. Performance of Services for Common Interest Realty Associations (CIRAs), Including Cooperatives, Condominium Associations, Planned Unit Developments, Homeowners Associations, and Timeshare Developments**

**Question:** A member belongs to a common interest realty association (CIRA) as the result of the ownership or lease of real estate. Would independence be considered to be impaired with respect to the CIRA?

**Answer:** Independence would be considered to be impaired if a covered member was a member of a CIRA unless all of the following conditions are met:

a. The CIRA performs functions similar to local governments, such as public safety, road maintenance, and utilities.

b. The covered member’s annual assessment is not material to either the covered member or the CIRA’s operating budgeted assessments.

c. The liquidation of the CIRA or the sale of common assets would not result in a distribution to the covered member.

d. The CIRA’s creditors would not have recourse to the covered member’s assets if the CIRA became insolvent.

Also see interpretation 101-1.C [ET section 101.02] for additional restrictions related to associations with a client.

If the member has a relationship with a real estate developer or management company that is associated with the CIRA, see interpretation 102-2 [ET section 102.03] for guidance.

**38. Member as Co-Fiduciary with Client Bank**

**Question:** A member serves with a client bank in a co-fiduciary capacity with respect to an estate or trust. Would independence be considered to be impaired with respect to the bank or the bank’s trust department?

**Answer:** Independence would not be considered to be impaired provided the assets in the estate or trust were not material to the total assets of the bank and/or the bank’s trust department.

**41. Financial Services Company Client Has Custody of a Member’s Assets**

**Question:** A financial services company client (for example, insurance company, investment adviser, broker-dealer, bank, or other depository institution) has custody of a member’s assets (other than depository accounts), including retirement plan assets. Would independence be considered to be impaired?

**Answer:** If a covered member’s assets were held by a financial services company client, independence would not be considered to be impaired provided the services were rendered under the company’s normal terms, procedures, and requirements and any of the covered member’s assets subject to the risk of loss were immaterial to the covered member’s net worth. Risk of loss may include losses arising from the bankruptcy of or defalcation by the client but would exclude losses due to a market decline in the value of the assets. When considering the materiality of assets subject to the risk of loss, the covered member should consider the following:

- Protection provided by state or federal regulators (for example, state insurance funds)
- Private insurance or other forms of protection (for example, the Securities Investor Protection Corporation) obtained by the financial services company to protect the assets
- Protection from creditors (for example, assets held in a pooled separate account)

For guidance dealing with depository accounts, see ethics ruling No. 70 [ET section 191.40 and .141].

**52. Unpaid Fees**

**Question:** A client of the member’s firm has not paid fees for previously rendered professional services. Would independence be considered to be impaired for the current year?

**Answer:** Independence is considered to be impaired if, when the report on the client’s current year is issued, billed or unbilled fees, or a note receivable arising from such fees, remain unpaid for any professional services provided more than one year prior to the date of the report.

This ruling does not apply to fees outstanding from a client in bankruptcy.

**60. Employee Benefit Plans—Member’s Relationship with Participating Employer**

**Question:** A member has been asked to audit the financial statements of an employee benefit plan (the plan)
that may have one or more participating employer(s). Would independence be considered to be impaired with respect to the plan if the member had financial or other relationships with a participating employer?

Answer: Independence would be considered to be impaired with respect to the plan if any partner or professional employee of the firm had significant influence over such employer, was in a key position with the employer, or was associated with the employer as a promoter, underwriter, or voting trustee.

When auditing plans subject to the Employee Retirement Income Security Act (ERISA), Department of Labor (DOL) regulations must be followed. Currently, DOL regulations are more restrictive than the position in this ruling.

64. Member Serves on Board of Organization for Which Client Raises Funds

Question: A member serves on the board of directors of an organization. A fund-raising foundation functions solely to raise funds for that organization. Would independence be considered to be impaired with respect to the fund-raising foundation?

Answer: Independence would be considered to be impaired with respect to the fund-raising foundation if any partner or professional employee of the firm served on the organization’s board of directors. However, if the directorship were clearly honorary (in accordance with ET section 101.06, Honorary directorships and trusteeships of not-for-profit organization), independence would not be considered to be impaired.

65. Use of the CPA Designation by Member Not in Public Practice

Question: A member who is not in public practice wishes to use his or her CPA designation in connection with financial statements and correspondence of the member’s employer. The member also wants to use the CPA designation along with employment title on business cards. Is it permissible for the member to use the CPA designation in these manners?

Answer: Yes. However, if the member uses the CPA designation in a manner to imply that he or she is independent of the employer, the member would be knowingly misrepresenting facts in violation of rule 102 [ET section 102.01]. Therefore, it is advisable that in any transmittal within which the member uses his or her CPA designation, he or she clearly indicate the employment title. In addition, if the member states affirmatively in any transmittal that a financial statement is presented in conformity with generally accepted accounting principles, the member is subject to rule 203 [ET section 203.01].

67. Servicing of Loan

Question: Would the mere servicing of a loan by a client financial institution impair independence with respect to the client?

Answer: No.

69. Investment with a General Partner

Question: A private, closely held entity is the general partner and controls (as defined in Generally Accepted Accounting Principles) limited partnership A. The member has a material financial interest in limited partnership A. The member’s firm has been asked to perform an attest engagement for a new limited partnership B, which has the same general partner as limited partnership A. Would independence be considered to be impaired with respect to limited partnership B?

Answer: Because the general partner has control over limited partnership A, the covered member would be considered to have a joint closely held investment with the general partner, who has significant influence over limited partnership B, the proposed client. Accordingly, independence would be considered to be impaired with respect to limited partnership B if the covered member had a material investment in limited partnership A.

70. Member’s Depository Relationship with Client Financial Institution

Question: A member maintains checking or savings accounts, certificates of deposit, or money market accounts at a client financial institution. Would these depository relationships impair independence?

Answer: If an individual is a covered member, independence would not be considered to be impaired provided that:

- The checking accounts, savings accounts, certificates of deposit, or money market accounts were fully insured by the appropriate state or federal government deposit insurance agencies or by any other insurer; or
- The uninsured amounts, in the aggregate, were not material to the net worth of the covered member. (When insured amounts were considered material, independence would not be considered impaired provided the uninsured balance was reduced to an immaterial amount no later than 30 days from the date the uninsured amount becomes material.)

A firm’s depository relationship would not impair its independence provided that the likelihood of the financial institution experiencing financial difficulties was considered to be remote.

71. Use of Nonindependent CPA Firm on an Engagement

Question: Firm A is not independent with respect to a client. Partners or professional employees of Firm A are participating on Firm B’s attest engagement team for that client. Would Firm B’s independence be considered to be impaired?
**72. Member on Advisory Board of Client**

**Question:** Would service on a client’s advisory board impair independence?

**Answer:** Independence would be considered to be impaired if any partner or professional employee of the firm served on the advisory board unless all the following criteria are met: (1) the responsibilities of the advisory board are in fact advisory in nature; (2) the advisory board has no authority to make nor does it appear to make management decisions on behalf of the client; and (3) the advisory board and those having authority to make management decisions (including the board of directors or its equivalent) are distinct groups with minimal, if any, common membership.

**75. Member in Client Credit Union**

**Question:** Does membership in a client credit union impair independence?

**Answer:** A covered member’s association with a client credit union would not impair independence provided all of the following criteria are met:

1. The covered member individually qualifies to join the credit union (other than by virtue of the professional services provided to the client).
2. Any deposits with the credit union meet the conditions specified in interpretation 101-1.A.4 [ET section 101.02] and are made under normal lending procedures, terms, and requirements (see interpretation 101-5 [ET section 101.07]).
3. Any deposits with the credit union meet the conditions specified in ruling No. 70 [ET section 191.140–141] under rule 101 [ET section 101.01].

Partners and professional employees may be subject to additional restrictions as described in interpretation 101-1.B. [ET section 101.02].

**81. Member’s Investment in a Limited Partnership**

**Question:** A member is a limited partner in a limited partnership (LP), including a master limited partnership. A client is a general partner in the same LP. Is independence considered to be impaired with respect to (1) the LP, (2) the client, and (3) any subsidiaries of the LP?

**Answer:**

a. A covered member’s LP interest in the LP is a direct financial interest in the LP that would impair independence under Interpretation No. 101-1.A.1 [ET section 101.02].

b. The LP is an investee of the client because the client is a general partner in the LP. Therefore, under Interpretation No. 101-8 [ET section 101.10], if the investment in the LP were material to the client, a covered member’s financial interest in the LP would impair independence. However, if the client’s financial interest in the LP were not material to the client, a covered member’s immaterial financial interest in the LP would not impair independence.

c. If the covered member is a limited partner in the LP, the covered member is considered to have an indirect financial interest in all subsidiaries of the LP. If the indirect financial interest in the subsidiaries were material to the covered member, independence would be considered to be impaired with respect to those subsidiaries under Interpretation No. 101-1.A.1. [ET section 101.02].

If the covered member or client general partner, individually or together, can control the LP, the LP would be considered a joint closely held investment under ET section 92.17.

**82. Campaign Treasurer**

**Question:** A member serves as the campaign treasurer of a mayoral candidate. Would independence be considered to be impaired with respect to (1) the political party with which the candidate is associated, (2) the municipality of which the candidate may become mayor, or (3) the campaign organization?

**Answer:** Independence would not be considered to be impaired with respect to the political party or municipality. However, if any partner or professional employee of the firm served as campaign treasurer, independence would be considered to be impaired with respect to the campaign organization.

**85. Bank Director**

**Question:** May a member in public practice serve as a director of a bank?

**Answer:** Yes; however, before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.

These implications fall into two categories:

1. Confidential Client Information—Rule 301 [ET section 301.01] provides that a member in public practice shall not disclose any confidential client information without the specific consent of the client. This ethical requirement applies even though
failure to disclose information may constitute a breach of the member’s fiduciary responsibility as a director.

2. **Conflicts of Interest—Interpretation 102-2 [ET section 102.03]** provides that a conflict of interest may occur if a member performs a professional service (including service as a director) and the member or his or her firm has a relationship with another entity that could, in the member’s professional judgment, be viewed by appropriate parties as impairing the member’s objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from all appropriate parties, performance of the service shall not be prohibited.

In view of the above factors, it is generally not desirable for a member in public practice to accept a position as bank director where the member’s clients are likely to engage in significant transactions with the bank. If a member is engaged in public practice, the member should avoid the high probability of a conflict of interest and the appearance that the member’s fiduciary obligations and responsibilities to the bank may conflict with or interfere with the member’s ability to serve the client’s interest objectively and in complete confidence.

The general knowledge and experience of CPAs in public practice may be very helpful to a bank in formulating policy matters and making business decisions; however, in most instances, it would be more appropriate for the member as part of the member’s public practice to serve as a consultant to the bank’s board. Under such an arrangement, the member could limit activities to those which did not involve conflicts of interest or confidentiality problems.

91. **Member Leasing Property to or From a Client**

**Question:** Would independence be considered to be impaired if a member leased property to or from a client?

**Answer:** Independence would not be considered to be impaired if the lease meets the criteria of an operating lease (as described in Generally Accepted Accounting Principles), the terms and conditions set forth in the lease agreement are comparable with other leases of a similar nature and all amounts are paid in accordance with the terms of the lease. Independence would be considered to be impaired if a covered member had a lease that meets the criteria of a capital lease (as described in Generally Accepted Accounting Principle) unless the lease is in compliance with Interpretations 101-1.A.4 [ET section 101-02] and 101-5 [ET section 101.07], because the lease would be considered to be a loan to or from the client.

92. **Joint Interest in Vacation Home**

**Question:** A member has a joint interest in a vacation home with a client (or one of the client’s officers or directors, or any owner who has the ability to exercise significant influence over the client). Would the vacation home constitute a “joint closely held investment” as defined in ET section 92.17?

**Answer:** Yes. The vacation home, even if solely intended for the personal use of the owners, would be considered a joint closely held investment as defined in ET section 92.17 if it meets the criteria described in the aforementioned definition.

93. **Service on Board of Directors of Federated Fund-Raising Organization**

**Question:** A member serves as director or officer of a local United Way or similar organization that operates as a federated fund-raising organization from which local charities receive funds. Some of those charities are clients of the member’s firm. Does the member have a conflict of interest under Rule 102?

**Answer:** Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member’s professional judgment, be viewed by the client or other appropriate parties as impairing the member’s objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from the appropriate parties, performance of the service shall not be prohibited. (If the service being provided is an attest engagement, consult Ethics Ruling No. 14 [ET section 191.027-.028] under Rule 101 [ET section 101.01].)

94. **Indemnification Clause in Engagement Letters**

**Question:** A member or firm proposes to include in engagement letters a clause that provides that the client would release, indemnify, defend, and hold the member (and his or her partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Would the inclusion of such an indemnification clause in engagement letters impair independence?

**Answer:** No.

95. **Agreement with Attest Client to Use ADR Techniques**

**Question:** Alternative dispute resolution (ADR) techniques are used to resolve disputes (in lieu of litigation) relating to past services, but are not used as a substitute for the exercise of professional judgment for current services. Would a predispute agreement to use ADR techniques between a member or his or her firm and a client cause independence to be impaired?

**Answer:** No. Such an agreement would not cause independence to be impaired since the member (or the firm) and the client would not be in threatened or actual positions of material adverse interests by reason of threatened or actual litigation.
96. Commencement of ADR Proceeding

**Question:** Would the commencement of an alternative dispute resolution (ADR) proceeding impair independence?

**Answer:** Except as stated in the next sentence, independence would not be considered to be impaired because many of the ADR techniques designed to facilitate negotiations and the actual conduct of those negotiations do not place the member or his or her firm and the client in threatened or actual positions of material adverse interests. Nevertheless, if a covered member and the client are in a position of material adverse interests because the ADR proceedings are sufficiently similar to litigation, ethics Interpretation 101-6 [ET section 101.08] should be applied. Such a position would exist if binding arbitration were used.

98. Member’s Loan From a Nonclient Subsidiary or Parent of an Attest Client

**Question:** A member has obtained a loan from a nonclient. The member’s firm performs an attest engagement for the parent or a subsidiary of the nonclient. Does the loan from the nonclient subsidiary or parent impair independence?

**Answer:** A covered member’s loan, that is not a “grandfathered” or “permitted” loan under Interpretation 101-5, [ET section 101.07] from a nonclient subsidiary would impair the member’s independence with respect to the client parent. However, a loan from a nonclient parent would not impair independence with respect to the client subsidiary as long as the subsidiary is not material to its parent.

99. Member Providing Services for Company Executives

**Question:** A member has been approached by a company, for which he or she may or may not perform other professional services, to provide personal financial planning or tax services for its executives. The executives are aware of the company’s relationship with the member, if any, and have also consented to the arrangement. The performance of the services could result in the member recommending to the executive actions that may be adverse to the company. What rules of conduct should the member consider before accepting and during the performance of such an engagement?

**Answer:** Before accepting and during the performance of the engagement, the member should consider the applicability of Rule 102, Integrity and Objectivity [ET section 102.01]. If the member believes that he or she can perform the personal financial planning or tax services with objectivity, the member would not be prohibited from accepting the engagement. The member should also consider informing the company and the executives of possible results of the engagement. During the performance of the services, the member should consider his or her professional responsibility to the clients (that is, the company and the executives) under Rule 301–Confidential Client Information [ET section 301.01].

100. Actions Permitted When Independence Is Impaired

**Question:** If a member or a member’s firm (member) was independent when its report was initially issued, may the member re-sign the report or consent to its use at a later date when his or her independence is considered to be impaired?

**Answer:** Yes. A member may re-sign the report or consent to its use at a later date when independence is considered to be impaired, provided that no post-audit work is performed by the member during the period of impairment. The term “post-audit work,” in this context, does not include inquiries of successor auditors, reading of subsequent financial statements, or such procedures as may be necessary to assess the effect of subsequently discovered facts on the financial statements covered by the member’s previously issued report.

102. Indemnification of a Client

**Question:** As a condition to retaining a member or his or her firm to perform an attest engagement, a client or prospective client requests that the member (or the firm) enter into an agreement providing, among other things, that the member (or the firm) indemnify the client for damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or in directly, to client acts. Would entering into such an agreement impair independence?

**Answer:** Yes. Such an agreement would impair independence under Interpretation 101-1.A [ET section 101.02] and Interpretation 101-1.C [ET section 101.02].

106. Member Has Significant Influence Over an Entity That Has Significant Influence Over a Client

**Question:** Would independence be considered to be impaired if a member or his or her firm had significant influence, as defined in Applicability and Definitions, [ET section 92.31] over an entity that has significant influence over a client?

**Answer:** Independence would be considered to be impaired if any partner or professional of the firm had significant influence over an entity that has significant influence over a client. By having such influence over the nonclient entity, the partner or professional employee would also be considered to have significant influence over the client.


107. Participation in Health and Welfare Plan Sponsored by Client

**Question:** A member participates in or receives benefits from, an employee benefit plan (plan) that is a client or
is sponsored by a client. Would independence be considered to be impaired with respect to the client sponsor or the plan?

**Answer:** A covered member’s participation in a plan that is a client or is sponsored by a client would impair independence with respect to the client sponsor and the plan, except when the covered member is:

- permitted by the “Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated With a Client” section of Interpretation No. 101-1 to continue his or her participation in the plan or
- an employee of a governmental organization that is required by law or regulation to audit a plan sponsored by a governmental unit. In such circumstances, a covered member’s participation in the plan will not impair independence, provided that the plan is offered to all employees in comparable employment positions and the covered member
  - is not associated with the plan in any capacity prohibited by Interpretation No. 101-1(C);
  - has no influence or control over the investment strategy, benefits, or other management activities associated with the plan; and
  - is required to participate in the plan as a condition of employment.

In addition, a covered member’s independence would not be impaired if he or she receives benefits as a result of an immediate family member’s participation in a plan that is permitted by the “Application of the Independence Rules to a Covered Member’s Immediate Family” section of Interpretation No. 101-1 (ET section 101.02).

110. Member Is Connected With an Entity That Has a Loan to or From a Client

**Question:** A member is associated with an entity as an officer, director, or a shareholder who is able to exercise significant influence over an entity. That entity has a loan to or from a client of the member’s firm. Would independence be considered to be impaired with respect to the client?

**Answer:** If a covered member has control over the entity (as defined in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) the existence of a loan to or from the client would impair independence unless the loan from the client is specifically permitted under interpretation 101-5 [ET section 101.07].

If any partner or professional employee of the firm is connected with the entity as an officer, director, or shareholder who is able to exercise significant influence over the entity, but is unable to control the entity, he or she should consider interpretation 102-2 [ET section 102.03].

Interpretation 102-2 provides that a conflict of interest may occur if a member performs a professional service for a client and the member or his or her firm has a relationship with another entity that could, in the member’s professional judgment, be viewed by the client or other appropriate parties as impairing the member’s objectivity. If the member believes that the professional service can be performed with objectivity, and the relationship is disclosed to and consent is obtained from such client and other appropriate parties, the rule shall not operate to prohibit the performance of the professional service.

When making the decision as to whether to perform a professional service and in making disclosure to the appropriate parties, the member should consider Rule 301, Confidential Client Information [ET section 301.01].

111. Employee Benefit Plan Sponsored by Client

**Question:** A member or his or her firm provides asset management or investment services that may include having custody of assets, performing management functions, or making management decisions for an employee benefit plan (the plan) sponsored by a client. Would independence be considered to be impaired with respect to the plan and the client sponsor?

**Answer:** The performance of investment management or custodial services for a plan would be considered to impair independence with respect to the plan. Independence would also be considered to be impaired with respect to the client sponsor of a defined benefit plan if the assets under management or in the custody of the member are material to the plan or the client sponsor.

Independence would not be considered to be impaired with respect to the client sponsor of a defined contribution plan provided the member does not make any management decisions or perform management functions on behalf of the client sponsor or have custody of the sponsor’s assets.

112. Use of a Third-Party Service Provider to Assist a Member in Providing Professional Services

**Question:** A member in public practice uses an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) or an individual not employed by the member (a third-party service provider) to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients. Does Rule 102, Integrity and Objectivity [ET section 102.01] require the member to disclose the use of the third-party service provider to the client?
Answer: Yes. The concept of integrity set forth in Rule 102, Integrity and Objectivity [ET section 102.01] and Article III, Integrity [ET section 54] requires a member to be honest and candid. Clients might not have an expectation that a member would use a third-party service provider to assist the member in providing the professional services. Accordingly, before disclosing confidential client information to a third-party service provider, a member should inform the client, preferably in writing, that the member may use a third-party service provider. This disclosure does not relieve the member from his or her obligations under ethics ruling No. 1 [ET section 391.001-002] under Rule 301, Confidential Client Information [ET section 301.01]. If the client objects to the member’s use of a third-party service provider, the member should provide the professional services without using the third-party service provider or the member should decline the engagement.

A member is not required to inform the client when he or she uses a third-party service provider to provide administrative support services (for example, record storage, software application hosting, or authorized e-file tax transmittal services) to the member.

See ethics ruling No. 12 [ET section 291.023–.024] under Rule 201, General Standards [ET section 201.01], and Rule 202, Compliance With Standards [ET section 202.01]; and ethics ruling No. 1 [ET section 391.001–.002] under Rule 301, Confidential Client Information [ET section 301.01], for additional responsibilities of the member when using a third-party service provider.

113. Acceptance or Offering of Gifts or Entertainment

Question: Would objectivity or integrity be considered to be impaired if a member offers or accepts gifts or entertainment to or from a client (or an individual in a key position with a client or an individual owning 10 percent or more of the client’s outstanding equity securities or other ownership interests), or a customer or vendor of the member’s employer (or a representative of the customer or vendor)?

Answer: Objectivity would be considered to be impaired unless the gift or entertainment is reasonable in the circumstances.

The member should exercise judgment in determining whether gifts or entertainment would be considered reasonable in the circumstances. Relevant facts and circumstances would include, but are not limited to—

- The nature of the gift or entertainment
- The occasion giving rise to the gift or entertainment
- The cost or value of the gift or entertainment
- The nature, frequency, and value of other gifts and entertainment offered or accepted
- Whether the entertainment was associated with the active conduct of business either directly before, during, or after the entertainment
- Whether other clients, customers, or vendors also participated in the entertainment
- The individuals from the client, customer, or vendor and the member’s firm or employer who participated in the entertainment

In addition, a member would be presumed to lack integrity if he or she accepted or offered gifts or entertainment that he or she knew or was reckless in not knowing would violate the member, client, customer, or vendor’s policies or applicable laws and regulations.

See Ethics Ruling No. 114, “Acceptance or Offering of Gifts and Entertainment to or From an Attest Client,” [ET section 191.228–229] under rule 101 [ET section 101.01] for guidance applicable to the offer or acceptance of gifts or entertainment to or from an attest client.

114. Acceptance or Offering of Gifts and Entertainment to or From an Attest Client

Question: Would independence be considered to be impaired if a member or the member’s firm offers or accepts gifts or entertainment to or from an attest client, an individual in a key position with an attest client, or an individual owning 10 percent or more of the attest client’s outstanding equity securities or other ownership interests (collectively, an attest client)?

Answer: Independence would be considered to be impaired if the member’s firm or a member on the attest engagement team or in a position to influence the attest engagement accepts a gift from an attest client, unless the value is clearly insignificant to the recipient. Independence would not be considered to be impaired if a covered member accepts entertainment from an attest client, provided the entertainment is reasonable in the circumstances.

Independence would not be considered to be impaired if a covered member offers gifts or entertainment to an attest client, provided the gift or entertainment is reasonable in the circumstances.

See Ethics Ruling No. 113, “Acceptance or Offering of Gifts or Entertainment” [ET section 191.226–227] under rule 102 [ET section 102.01] for criteria a member should consider in determining whether the gifts or entertainment would be considered reasonable in the circumstances.
AICPA Staff Responses to Inquiries

Family Relationships

Question: A small manufacturing company has asked a CPA firm to perform an audit. The company’s controller is the engagement partner’s mother-in-law. Would the firm be considered independent for purposes of accepting the audit engagement?

Answer: Yes. The firm would be considered independent because the engagement partner’s mother-in-law (the company’s controller) is not considered a close relative or immediate family under the new independence rules.

Question: A partner’s dependent son works as an inventory clerk during the summer months for an audit client of the firm. The partner is located in the office in which the lead audit engagement partner practices. Is the firm independent?

Answer: Yes. The firm would be considered independent. Although the partner’s dependent son is part of her “immediate family,” the son is not employed in a “key position” with the client.

Fact Pattern: BB is a partner in a CPA firm who supervises the engagement partner assigned to the audit of ABC Co.

Outcome: Since BB is able to influence the ABC audit, BB’s spouse may not hold a key position with ABC. In addition, BB’s spouse may not have any direct or material indirect financial interests in ABC.

Fact Pattern: CC is the concurring review partner for ABC Co.’s audit engagement. CC’s mother owns shares in ABC that are material to her net worth and of which CC has knowledge.

Outcome: Independence would be considered impaired because CC participates in the ABC audit engagement and has knowledge of her close relative’s material investment in ABC.

Fact Pattern: DD oversees quality control activities for the Boston office of a CPA firm that performs a review engagement for ABC Co. DD’s brother is a 6 percent share holder of ABC, and the investment is material to his worth.

Outcome: Independence would not be considered impaired because even though his brother’s investment is material, it would presumably not allow him to exercise significant influence over ABC.

Question: A sole proprietor’s sister serves as an honorary director of a local charity. In light of the sister’s position, would the sole proprietor be considered independent with respect to the local charity?

Answer: Yes, if the sister qualifies as an honorary director as detailed in the code. To qualify, the sister cannot vote or otherwise participate in charity board or management functions and, if named in letterhead and externally circulated materials, the sister must be identified as an honorary director. (Members themselves may serve as honorary directors of charitable, religious or civic not-for-profit organizations without impairing independence with respect to those organizations as long as the conditions contained in Interpretation 101-4, “Honorary Directorships and Trusteeships of Not-for-Profit Organizations,” are met.)

Question: The sister of a partner in a one-office CPA firm is the chief financial officer of a review client. Would this relationship impair the firm’s independence?

Answer: Yes, because the sister is connected with the client in a position that would allow her to exercise significant influence over the client and the partner is located in the firm office that performs the engagement.

Investments

Question: A multi-office CPA firm has been asked to perform an audit of a company, and the engagement will be handled by the Jersey City, N.J., office. Three firm managers, who work in a separate office, pooled their money to purchase the company’s stock. After the purchase, each owns 2% of that company’s outstanding common stock. The audit would not involve any members of the managers’ office. Is the firm independent to perform the engagement?

Answer: No. The firm is not considered to be independent. In accordance with Interpretation 101-1B, independence is impaired if, during the period of the professional engagement, a partner or professional employee of the firm, his or her immediate family or any group of such persons acting together own more than 5 percent of a client’s outstanding equity securities or other ownership interests.

Question: A partner in a one-office firm owns stock in a corporation considering engaging the firm to perform an audit. The partner does not wish to sell the stock and instead proposes to place the stock in a blind trust. Would this remove the impairment of independence caused by the partner’s direct financial interest in the potential audit client?

Answer: No, the partner’s independence would be impaired whether or not the financial interest is placed in a blind trust. Members’ blind trusts cannot hold direct or material indirect financial interests in clients for which the members perform services requiring independence.

Question: A member and his or her client are considering investing in a business together. The member would own 25 percent of the business and the client would own 50 percent. If the member’s investment in the business would be material to his or her net worth, would independence be impaired with respect to the client?
Answer: Yes. If the member’s investment in the business is material to his or her net worth, independence would be considered impaired. Because the member and the client together can control the business (as defined in Financial Accounting Standards Board Statement No. 94, “Consolidation of All Majority-Owned Subsidiaries”), materiality to the client is not considered.

Fact Pattern: FF is a staff person in a CPA firm’s Houston office and owns 10 percent of ABC Co.’s outstanding common stock. The CPA’s firm’s Dallas office performs an audit of ABC. FF provides no services to ABC and is not able to influence the engagement.

Outcome: Since prohibitions on financial interests of more than 5 percent of an attest client’s equity securities (or other ownership interests) apply to all firm personnel, FF’s financial interest would impair independence.

Question: A member who is sole proprietor, has contributed amounts into an insurance contract that offers several investment options. In aggregate, the amounts are immaterial to his net worth. The member can choose the companies in which this contract will invest. Would the independence of the member be impaired if the contract invested in a client requiring independence?

Answer: Yes. Since the member has the ability to direct the investment, he would be considered to have a direct financial interest in the client.

Question: A CPA firm performs an audit of a large manufacturing company. One of the firm’s managers, who plans to provide a significant amount of tax services to the company, has a spouse who inherited a small amount of stock in it. The manager does not work in the same office as the lead audit partner. Is the firm’s independence impaired?

Answer: Yes. The manager is considered a “covered member” because he will provide more than ten hours of non-audit services to the company. His spouse is considered “immediate family.” Since Interpretation 101-1 subjects a member’s immediate family to the same restrictions as the covered member, with limited exceptions related to employment, the spouse’s ownership of stock in the client would impair the firm’s independence.

Question: A partner in a multi-office CPA firm owns 2% of a potential audit client. The engagement would be performed by an office with which he is not associated. The partner would not provide any services to the client nor be in a position to influence the engagement team. Is the firm independent to perform the audit?

Answer: Yes. The firm would be considered to be independent. According to Interpretation 101-1, independence is not impaired unless the partner falls within the definition of a “covered member.” He is not considered a covered member since he would provide no professional services to the client, is not in a position to influence the attest engagement and is not located in the office in which the lead attest engagement partner practices in connection with the engagement.

Board and Other Positions
Question: A manager in a multi-office CPA firm serves on the board of directors of a potential review client. The manager would not be assigned to provide services to the client nor located in the office that would perform the engagement. Is the firm independent to perform the review?

Answer: No. The firm is not independent. Even though the manager is not considered a “covered member,” Interpretation 101-1C prohibits any partner or professional employee of the firm from serving as a director, officer or employee or in any capacity equivalent to that of a member of management with respect to the client.

Question: A CPA firm is considering hiring the controller of one of its audit clients as a part-time independent contractor during tax season. She would help prepare tax returns for other clients of the CPA firm, all of which are nonattest clients. The firm has two offices, and she would be working out of the one that does not provide any services to her primary employer. If she is hired, would the CPA firm’s independence be impaired with respect to that client?

Answer: Yes. The independent contractor would be considered a professional employee of the firm since she would provide professional services to the firm’s clients. In accordance with Interpretation 101-1C, the firm’s independence would be impaired since, during the period of the engagement, a professional employee of the firm would be associated simultaneously with the client as an employee.

Question: A partner of a firm is a church member and has been asked to perform an audit of the church’s financial statements. Would the partner’s church membership cause an impairment of independence?

Answer: No, provided the partner does not act in any capacity as a member of church management or an employee.

Question: A partner plans to retire from a firm and join the board of directors of one of the firm’s audit clients. Would the firm remain independent with respect to the client if the firm continues to provide the partner with office space and secretarial assistance after retirement?

Answer: No. When a former partner takes a position of significant influence, such as a directorship, with a client for which services requiring independence are provided, the firm can no longer supply the partner with office space and related amenities. Consult Interpretation 101-2 for further guidance.
Question: A one-office CPA firm employs an independent contractor for part-time tax preparation during “busy season.” The independent contractor is the controller of one of the firm’s audit clients but does not perform any tax services related to his or her employer. Is the firm’s independence impaired?

Answer: Yes. The independent contractor is deemed to be a member of the firm for purposes of independence; therefore, independence is impaired.

Fact Pattern: VV is a tax manager in a CPA firm that provides annual review services to ABC Co. ABC offers VV a seat on its board of directors. VV provides no services to ABC and is not in a position to influence the engagement.

Outcome: Since prohibitions on certain business associations such as board memberships apply to all firm personnel, VV’s service on ABC’s board would impair independence.

Question: A member of the AICPA serves on the board of directors of a nonpublic corporation. Would it be permissible for the member to issue a review report on this corporation’s financial statements?

Answer: Interpretation 101-1.C.1 provides that independence is considered impaired if during the period covered by the financial statements, during the period of the professional engagement or at the time of expressing an opinion, the member was connected with the enterprise as a director. Therefore, the member is not considered independent with respect to the nonpublic corporation and may not issue a review report.

Question: A member is employed by company A. Its sole shareholder owns 100% of company B and 65% of company C. The member was asked by his employer to audit the financial statements of companies B and C. Would the member be independent if he or she did so?

Answer: No.

Question: A member is employed in a federated fund-raising organization’s internal audit department. Is the member independent to audit organizations that receive funds from his or her employer?

Answer: No.

Question: A member employed full or part time on the faculty of a university was asked to audit the financial statements of the Student Senate Fund. Is he or she independent if the university is responsible for the fund’s collections and disbursements?

Answer: No. A member is not independent if he or she audits management functions performed by his or her employer.

Question: CPA & Co.’s independence is considered impaired with respect to Company B in accordance with Rule 101. Can an owner, partner, or shareholder of CPA & Co. establish a sole proprietorship to perform services requiring independence for Company B?

Answer: No. An owner, partner or shareholder of a CPA firm who is not independent with respect to an entity would not be independent of that entity, even as a sole practitioner.

Question: A member is a trustee of a life insurance trust for an audit client’s stockholder. The trust’s only asset is an insurance policy and the cash proceeds will go to the client’s children. Is the member’s independence impaired with respect to the client?

Answer: No. A member is permitted to be the trustee of the life insurance trust without impairing independence with respect to a client, as long as the trust does not have, nor is committed to acquire, a direct or material indirect financial interest in the client upon the stockholder’s death.

Question: May a member serve as trustee for a client’s pension or profit-sharing trust without impairing independence with respect to the client?

Answer: No. Independence will be impaired with respect to a client if the member serves as trustee for a client’s pension or profit-sharing trust during the period covered by the client’s financial statements, during the period of the professional engagement or at the time of expressing an opinion.

Question: Is a member’s independence impaired with respect to an enterprise’s pension or profit-sharing trust if the member serves on the enterprise’s board of directors?

Answer: Yes. The member’s independence would be impaired with respect to the pension or profit-sharing trust since, as a director of the enterprise, the member is involved in management functions that affect the plan.

**Loans**

Question: On May 1, 2001, a one-office firm issued an audit report on a client’s December 31, 2000, financial statements. On May 15, 2000, a partner of the firm lent money to the client company’s president, who agreed to fully repay the loan before the firm began planning fieldwork for the audit of the financial statements for the year ended December 31, 2001. Is the firm considered to be independent with respect to the client if the loan was fully repaid before fieldwork planning began?

Answer: No. Independence is considered to be impaired if a covered member has made a loan to a client company’s officer during the period of the professional engagement or at the time an opinion is expressed. The period of a professional engagement starts when the member begins to perform professional services requiring independence and ends with the notification of that professional relationship’s termination by the member or the client.
Question: A member has a loan from a client financial institution that meets the requirements for a “grandfathered” loan under Ethics Interpretation 101-5. Periodically, the bank requires the member to submit financial statements and other information in order to renew this loan. Does such action constitute renegotiation, thus affecting the grandfathered status of the loan?

Answer: Yes; if the renewal requires a reevaluation of a member’s creditworthiness it is considered to be a renegotiation of the original loan and is no longer considered “grandfathered” under Interpretation 101-5.

Question: A bank retains a CPA firm to perform an audit. During the period of the professional engagement, a manager in the CPA firm obtains a mortgage from the bank. He works in the same office as the lead partner on the audit but does not provide any services to the bank. Is the firm’s independence impaired?

Answer: No. According to Interpretation 101-1, independence is not impaired unless the manager falls within the definition of a “covered member.” The manager generally would not be considered a covered member since he is not on the attest engagement team and does not provide nonattest services to the client. Therefore, the firm’s independence is not impaired.

Nonattest Services

Question: A member is performing an audit for a client. May the member also issue monthly compilation reports without impairing his or her independence?

Answer: Yes; a member may issue both monthly compilation reports and perform an audit for the same client. Performance of compilation services does not impair a member’s independence.

Question: If a member accepts the responsibility of signing checks for a client in emergency situations but never performs such activity, is independence impaired?

Answer: Yes. The acceptance of such responsibility impairs the member’s independence.

Question: A member has been asked to perform payroll preparation services for an audit client, which include preparing and signing payroll checks using either a laser printer or a client-provided signature stamp. The member also is responsible for mailing the checks to employees or authorizing a transfer of funds from a client bank account to employees’ bank accounts. Would such services impair the member’s independence?

Answer: Yes. If the member has the authority to sign client checks or has custody of a client’s signature via either laser printer or signature stamp, his or her independence would be impaired. Likewise, if a member is given the authority to transfer client funds from one bank account to another or from a client bank account to an employee’s bank account, independence would be impaired.

However, payroll preparation services, in general, normally would not impair independence provided the member meets the requirements identified in Interpretation 101-3.

Question: Do tax return preparation services for a client impair independence with respect to the client or any entity owned or operated by the client?

Answer: No.

Question: A small nonpublic entity with only a part-time bookkeeper engages a member to perform accounting services. On a monthly basis, the member classifies, codes and enters cash receipts and disbursements into the client’s computerized general ledger. The client has asked the member to provide a review report on the financial statements for the period for which the member provided accounting services. Is the member’s independence considered to be impaired?

Answer: Yes. By classifying and coding transactions, the member is considered to be performing management functions; therefore, independence would be considered to be impaired. If, however, the client determines or approves the account classifications and transaction coding, independence would not generally be considered to be impaired. (See Interpretation 101-3 of Rule 101.)

Note: For the following questions, it is assumed that the member is in compliance with all applicable provisions of Interpretation 101-3 (e.g., the general requirements) unless specifically identified otherwise.

Question: A member records journal entries while performing monthly bookkeeping services without obtaining client approval. Would independence be impaired?

Answer: Yes. In order for the member to maintain his or her independence, the client must review and approve the journal entries and the member should be satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

Question: During the course of providing monthly bookkeeping services, the member receives invoices from the client, indicating approval for payment and identifying the appropriate general ledger accounts to record the transaction. The member prepares the client’s checks for payment of those invoices, records the transactions in the client’s general ledger system and returns the checks to the client for approval and signature. The member does not have signature authority over the client’s checking account. Would independence be impaired?

Answer: No, because management determined and approved the appropriate account classifications, approved the invoices for payment and reviewed and signed the prepared checks.
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Question: During the course of providing monthly bookkeeping services, the member discusses with client management the need to record recurring journal entries (for example, depreciation expense) each month in the general ledger. The client approves the recurring journal entries and makes any necessary decisions (for example, useful lives of the assets). The member then records these entries in the client’s general ledger each month. Would independence be impaired?

Answer: No, because the client understands the general nature of the journal entries and the impact they have on its financial statements.

Question: A client records all disbursements in its checkbook and identifies the type of expense (for example, telephone, rent) on the checkbook stubs. During the course of providing monthly bookkeeping services, the member assigns the general ledger account number based on the type of expense indicated by the client and records these payments in the client’s accounting system. Would independence be impaired?

Answer: No, because the member would not be considered to be coding transactions.

Question: A member is engaged to perform an audit, review or compilation of a client’s financial statements. During the course of the audit, review or compilation the member proposes audit adjustments to the financial statements. Examples of these entries include the current tax accrual and deferred tax assets or liabilities and the amount of depreciation and amortization necessary for the current year. The client reviews these entries and understands the impact on its financial statements and records the adjustments identified by the member. Would the proposal of such entries constitute a nonattest bookkeeping service subject to Interpretation 101-3?

Answer: No, because the member would not be considered to be performing recurring audit services.

Question: A member is engaged to perform an audit for a client who records all transactions on a cash basis in its general ledger. During the audit process, the member identifies all appropriate journal entries required to convert the client’s general ledger to an accrual basis as part of the member’s audit of the client’s financial statements. Would independence be impaired?

Answer: Yes, because the member is performing a nonattest bookkeeping service subject to Interpretation 101-3.

Question: The member prepares a bank reconciliation of a client’s bank account in connection with monthly bookkeeping services. The client reviews and approves the bank reconciliation. Would independence be impaired?

Answer: No, because the client reviews and approves the bank reconciliation and understands the services performed sufficiently to oversee them.

Question: Interpretation 101-3 requires that the member establish and document in writing his or her understanding with the client regarding the a) objectives of the engagement; b) services to be performed; c) client’s acceptance of its responsibilities; d) member’s responsibilities; and e) any limitations of the engagement. Would a member be in compliance with this requirement if such was documented in an engagement letter, the audit planning memo, or in a memo of understanding maintained in the client’s billing files?
Answer: Yes. However, since the general requirements of Interpretation 101-3 only require a member to document his or her understanding with the client and does not indicate any specific method of documentation the methods indicated are not all inclusive and other methods may be appropriate as well.

Question: A member provides only nonattest services to a client for the year ending December 31, 2004. In 2005, the member is asked to perform an audit of the client’s year-end 2004 financial statements. Would independence be impaired because the firm did not comply with the documentation requirement under Interpretation 101-3 with respect to the nonattest services performed in 2004?

Answer: No. The documentation requirement does not apply to nonattest services performed prior to the client becoming an attest client. However, upon the acceptance of an attest engagement, the member should prepare written documentation demonstrating his or her compliance with the other general requirements of Interpretation 101-3 during the period covered by the financial statements, including the requirement to establish an understanding with the client.

Question: A member performing bookkeeping services records adjusting and reclassification journal entries and compiles preliminary financial statements. The member delivers the financial statements and compilation report to the client and provides the client copies of the general ledger, journals and journal entries, which contain a description of the nature of each entry. The member asks the client to review the journal entries and then asks whether the client has any questions about any of the entries. Would the requirements of Interpretation 101-3 be met?

Answer: Yes. Provided the member is satisfied that client understands the nature and impact of the journal entries, the requirements of Interpretation 101-3 would be met.

Question: Must the member review the proposed journal entries with the client and explain their impact on the financial statements with the client in person or can this review take place by phone, fax, mail or e-mail?

Answer: The review process can take place in person, by phone, fax, mail, e-mail or a combination thereof. Regardless of the method used, the member must be satisfied that the client understands the nature and impact of the journal entries.

Question: Must the member document the client’s review of the journal entries?

Answer: Interpretation 101-3 does not require that the member document the client’s review of the journal entries. However, the member may wish to document the name of the client representative who reviewed the journal entries and the date of his or her review to provide evidence that such review took place.

Question: Interpretation 101-3 requires that the client designate a competent employee, preferably within senior management, to oversee the nonattest services. Which individual at the client is expected to possess such competency (e.g., the owner(s), controller, bookkeeper)?

Answer: The individuals designated by the client will likely depend on the nature of the client’s organization and the nature of the nonattest engagement. In an owner-managed business, it will often be the owner, but depending on the nature of the nonattest services and the skill, knowledge, or experience of other employees or individuals, it could also be the controller or bookkeeper. In larger organizations or for more complex services, the client is more likely to designate a senior officer to oversee the services. The employee or individual responsible for overseeing the nonattest services needs to understand the services sufficiently to oversee them, but does not need to possess the technical qualifications to perform or reperform the services.

Question: My client has difficulty understanding deferred tax assets and deferred tax liabilities. What must a client know about these concepts in order to meet the competency requirement under Interpretation 101-3?

Answer: The intent of Interpretation 101-3 is not for the client to possess a level of technical expertise commensurate with that of the member. In the case of deferred taxes, the client should understand the basis for the deferred tax assets or liabilities and the impact of the deferred taxes on the financial statements.

Question: Is a member permitted to assist the client in understanding the nature of adjusting entries and their impact on the financial statements?

Answer: Yes. If a client needs assistance in understanding the nature of the entries and their impact on the financial statements, the member may explain the accounting principles giving rise to the adjustments, as well as the impact of the adjustments on the financial statements.

Question: A member’s clients consist of very small businesses with informal control environments and an insufficient number of employees to achieve a proper segregation of duties. How can such clients establish and maintain internal controls as required under Interpretation 101-3?

Answer: The requirement for the client to establish and maintain internal controls, including monitoring ongoing activities, precludes the member from performing internal control activities, including monitoring activities. Accordingly, a member cannot authorize, execute or consummate transactions, maintain custody of the client’s assets, supervise client employees or make management decisions. Regardless of its size, the client...
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must establish and maintain internal control related to the member’s services. These controls are often supervisory controls, for example, if the member prepares the client’s bank reconciliation, the client should review and approve the reconciliation.

Question: A member’s firm does not require its clients to sign engagement letters for tax return preparation services. How does the documentation requirement under Interpretation 101-3 apply with respect to these clients?
Answer: Tax services are nonattest services subject to the requirements of Interpretation 101-3. Therefore, the documentation requirement applies where the member provides tax services to a client for which the member also provides attest services. However, the method of documentation is left to the member’s discretion and, provided it contains all of the required elements, it could be documented in a tax organizer or disclosure statement provided to the client, in a memo in the tax or attest service working papers, or through other means.

Question: Does Interpretation 101-3 apply where the member prepares the personal tax returns of the owners and officers of an audit, review or compilation client?
Answer: If the personal tax returns are prepared without having to rely on representations of the client, then Interpretation 101-3 would not apply. The mere fact that the client pays for the services would also not cause Interpretation 101-3 to apply.

Question: A member provides temporary “controllership services” and various types of other temporary accounting services for clients during client maternity leaves, illness, and sudden departures. Do these activities impair independence under Interpretation 101-3?
Answer: These services would be subject to Interpretation 101-3. If a member performs controller-type activities, independence would be impaired since such activities typically involve the performance of management functions or the supervision of client employees. However, if the member performs temporary accounting and other services in compliance with the requirements of Interpretation 101-3, independence would not be impaired. The member should also consider whether the duration or regularity of the services might appear to impair independence. Having the title of controller would impair independence regardless of the actual services performed.

Question: Why does Interpretation 101-3 indicate that independence would be impaired if a member operated a client’s local area network (LAN) system?
Answer: Operating a client’s LAN is considered to be a management function that would violate the general requirements of Interpretation 101-3.

Question: Would “outsourcing” the client’s entire network operation and independently operating the client’s local area network system impair independence?
Answer: Yes.

Question: Would performing network maintenance (e.g., updating virus protection, applying updates and patches, or configuring user settings consistent with management’s request) impair independence?
Answer: No. Performing network maintenance is not considered to be “operating” the client’s network and therefore, would not impair independence provided a competent client employee is making all decisions and approving all activities.

Question: Would assisting a client with a server project (e.g., install, migrate or update its network operating system, add equipment and users, or copy data to another computer) impair independence?
Answer: No, provided the member does not make other than insignificant modifications to the source code underlying the client’s financial information system.

Question: Would supervising client personnel in the daily operation of the client’s information system impair independence?
Answer: Yes. In this case, the member would be performing management duties (supervising client employees in the performance of their normal recurring activities), which would impair independence.

Question: Would assisting a client with procuring and securing internet access impair independence?
Answer: No, provided a competent client employee makes all decisions as to the internet provider and services to be provided.

Question: What criteria should a member use to determine whether a client’s information system is “unrelated to its financial statements or accounting records?”
Answer: Information systems that produce information that is reflected in the amounts and disclosures in the client’s financial statements, used in determining such amounts and disclosures, or used in effecting internal control over financial reporting are considered to be related to the financial statements and accounting records. However, information systems that are used only in connection with controlling the efficiency and effectiveness of operations are considered to be unrelated to the financial statements and accounting records.

Question: What factors should a member consider in determining whether the modifications made to source code underlying a client’s financial information system are “other than insignificant”?
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Answer: If the modifications have more than an insignificant effect on the functionality of the software, they should be considered to be “other than insignificant.”

Question: Would assisting a client in applying FASB Interpretation (FIN) No. 48, Accounting for Uncertainty in Income Taxes, such as identifying potential uncertain tax positions, advising the client whether these tax positions meet the more-likely-than-not (MLTN) threshold, and calculating the related unrecognized tax benefits impair independence?

Answer: The provision of such services would not impair independence provided the client can make an informed judgment on the results of the member’s services and the other requirements of Interpretation 101-3 are met. In meeting the requirements of Interpretation 101-3, the member may assist the client in understanding why the tax positions do or do not meet the MLTN threshold and the basis for any unrecognized tax benefit so that the client can accept responsibility for the amounts reported and disclosed in the financial statements.

Fees

Question: A client requires an audit for the current year but has not paid the member, a sole proprietor, for fees due for tax-related services performed two years ago. If the client issues the member a note for the unpaid fees, is the member independent with respect to this client?

Answer: No. Independence is impaired because the note is a prohibited loan from the member to the client.

Question: A member’s client has requested a review of its financial statements for the year ended June 30, 2000. The client owes fees to the member’s firm for consulting services performed during the year ended June 30, 1999. Will the prior year’s unpaid consulting fees impair the member’s independence with respect to the current year’s review engagement, even if the client has not yet been billed for consulting services?

Answer: Yes. However, independence will not be impaired if the consulting fees are paid in full before the issuance of the review report.

Question: The trustee of a bankruptcy estate engaged a member to audit a client in bankruptcy. The member is concerned because the client has not paid her for audits she performed in the prior two years. Can the member perform the current year audit without impairing her independence?

Answer: Yes. The prohibition against issuing an audit report when a client has not paid fees for more than one year from the current report date does not apply to a client in bankruptcy.

Business Relationships

Question: A firm decided to build a new facility and wants to engage the services of an audit client in the construction industry. Would the firm’s independence be impaired?

Answer: No. Independence would not be impaired if the construction agreement was arm’s length and comparable with other construction arrangements of a similar nature.

Question: A firm wants to lease office space and equipment from a review client. Would the firm’s independence be impaired?

Answer: No. Independence would not be impaired for a leasing transaction if, at the time the transaction was entered into, it met the criteria of an operating lease as defined in Financial Accounting Standards Board Statement No. 13, “Accounting for Leases,” and was made under the client’s normal leasing procedures, terms, and requirements. The terms and conditions set forth in the lease agreement should be comparable with other leases of a similar nature. If, however, the lease met the criteria of a capital lease as defined in Statement No. 13, independence would be impaired (unless the lease was in compliance with ethics Interpretations 101-1, A4 and 101-5 because such lease would be considered a loan from a client).

Question: A member owns a building and leases office space to his or her client. Would independence of the member or member’s firm be impaired with respect to the client?

Answer: No. Independence would not be impaired provided the lease agreement is at arm’s length, all payments are made in accordance with the terms of the lease and the lease meets the criteria of an operating lease (as defined in FASB Statement No. 13).

Integrity and Objectivity

Question: Must a member in industry disclose material or relevant information to his or her employer’s external accountant even if the accountant did not request such information specifically?

Answer: Yes. Rule 102 of the AICPA Code of Professional Conduct requires an employee to be candid with an employer’s external accountant and to not knowingly fail to disclose material facts to his or her employer’s external accountant.

Question: Should a member in industry sign a management representation letter if he or she knows that full disclosure was not made to his or her employer’s external accountants?

Answer: No. Signing such a letter would be a knowing misrepresentation of fact in violation of Rule 102.
Question: A member in industry disagrees with management over how to record a particular transaction that has a material impact on his or her employer's financial statements. Are there any actions that the member should take in this situation?

Answer: Yes. The member should consider whether the transaction was properly recorded under an acceptable alternative. If after thorough consideration he or she concludes that the transaction was not properly recorded and that the financial statements may be materially misstated, the member should bring these concerns to the attention of one or more levels of senior management and document the matter accordingly. If management subsequently does not take suitable action, the member may wish to reconsider his or her continuing relationship with the employer and any responsibility he or she may have to communicate such information to other parties, such as regulators or the employer's external auditor. The member is specifically cautioned to consider consulting with legal counsel in connection with such communication. (See Interpretation 102-4 of Rule 102.)

Question: A member in industry wants to use the CPA designation on financial statements and his or her employer's correspondence. The member also wants to include the CPA designation with his or her employment title on business cards. Is it permissible for the member to do so?

Answer: Yes. However, if a member in industry uses the CPA designation in a way that suggests he or she is independent of the employer, he or she was committed a knowing misrepresentation of fact in violation of Rule 102.

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

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

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

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

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

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

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

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

1. A member in a one-office firm is asked to audit the books of a corporation in which his partner’s wife is a stockholder. The member has no financial interest in the corporation. Is the firm independent of the corporation?
   (a) No.
   (b) Yes.

2. A member has performed the procedures necessary to audit the financial statements of a privately held enterprise of which the member is part owner. The report was carefully drawn and without bias. In this case the member’s opinion must be
   (a) a compilation report with disclaimer based on lack of independence.
   (b) an unaudited disclaimer with footnote disclosure of the CPA’s stock interest.
   (c) neither of the above.

3. A staff person below the managerial level belongs to an investment club composed of 20 members. She is the only person in the one-office firm belonging to this club. Buy and sell decisions on investments are decided by majority vote, each member of the club having one vote. The members at their last meeting voted to purchase a minor number of shares of the Jones Company, an audit client of the firm in which the staff person is located. Although she does not work on that engagement, the staff person voted against the purchase.
   (a) Since the staff person could not control the actions of the club, independence of the firm with Jones Company is not impaired.
   (b) Since only a minor number of shares were purchased, independence of the firm with Jones Company is not impaired.
   (c) Since the staff person does not work on the Jones Company engagement, independence of the firm with Jones Company is not impaired.
   (d) Independence of the firm with Jones Company is impaired.

4. Assume the same facts as in the question above with the exception that the staff person is at the managerial level in the firm.
   (a) Since the staff person could not control the actions of the club, independence of the firm with Jones Company is not impaired.
   (b) Since only a minor number of shares were purchased, independence of the firm with Jones Company is not impaired.
   (c) Since the staff person does not work on the Jones Company engagement, independence of the firm with Jones Company is not impaired.
   (d) Independence of the firm with Jones Company is impaired.

5. A two-office firm, in Chicago and New York, has a manufacturing audit client in Milwaukee. The Chicago office handles the entire engagement. Which of the following immaterial stockholdings will not impair the firm’s independence?
   (a) Holdings by New York partners.
   (b) Holdings by Chicago partners.
   (c) Holdings by Chicago professional staff working on this job.
   (d) None of the above, i.e., they all impair independence.

6. A retired partner of a one-office public accounting firm owns 1 percent of the outstanding stock of an audit client. The client represents about 2 percent of the firm’s revenues and net earnings. The retired partner is not active in any way in the firm, having been retired for five years. Under the firm’s retirement plan, she will receive for the rest of her life a fixed annual amount. Approximately one-fourth of her retirement pay is funded, and the balance is paid from the general funds of the accounting firm. The total annual payment is not material to the firm. Since
   (a) the partner is completely retired, there is no independence impairment due to her stock-holdings.
   (b) three-fourths of the partner’s retirement pay is not funded and must be paid from current operations, independence is impaired with this client.
   (c) she is receiving payments from the firm and will do so for the rest of her life, independence is impaired with this client.

7. Assume the same facts as in question 6 above except that the retired partner, during the busy season each year, works for about one month helping in the review of tax returns and unaudited financial statements. Traditionally, the firm has given her a $1,000 bonus for this work although they do not bill clients for her review time. Since
   (a) any audit work, there is no impairment of independence.
   (b) this month’s work each winter makes her active in the firm, independence is impaired.
   (c) they do not bill the clients for her review time, independence is not impaired.
   (d) they pay her for this work even though they do not bill the clients, independence is impaired.
8. A calendar-year privately held review client of Andrew & Co. CPAs, has paid only $15,000 of the $25,000 fees billed to them in March 1996. Andrew & Co.’s records show that $18,000 of the time charges and expenses were incurred in 1995 and the balance of $7,000 was time charges and expenses for January and February 1996. The work consisted of review of the 1995 financial statements, 1995 federal and state income tax returns and some management consulting services. The unpaid balance of $10,000 is not significant to Andrews & Co.

In May 1997, Andrews & Co. started and completed their work on the client’s 1996 financial statements. They plan on issuing their report on these financial statements during the early part of June 1997. A staff person questions, in light of the unpaid fees, whether or not they are independent. In answer to her query which of the following statements is true?

(a) To maintain independence with this client, the $10,000 should have been paid within one year of the March 1996 date the statement for $25,000 was sent. Since that date has passed there is nothing that can be done to make the firm independent with respect to the 1996 financial statements.

(b) To maintain independence with this client the $10,000 must be paid before the issuance of the report on 1996.

(c) Since the $10,000 is not significant to the Andrew & Co., it does not pose an independence problem.

(d) If the client agrees to pay the $10,000 in four equal monthly installments starting July 1997, independence will not be impaired.

9. In 1997, Jones, a manager in a one-office firm, is admitted into the partnership. Under the partnership agreement, he is required to contribute $10,000 as his share of partner’s capital which will be returned to him when he retires or in the event he resigns. He has $3,000 saved which he contributes and borrows in November 1997 the additional $7,000 on an unsecured note from a bank audit client. The $7,000 is material to Jones; however, the bank considers him an excellent credit risk because of his firm’s reputation in the community and Jones’ new status as partner. Jones has not and will not work on the audit of the bank. Since

(a) this is a normal lending situation for the bank and Jones is not receiving any favoritism by way of rates; independence with the bank is not impaired.

(b) this type of loan from a bank audit client is prohibited; independence is impaired.

(c) Jones will not work on the audit; independence is not impaired.

10. Jones is a member of a country club that has a total membership of 250. Each member upon admission must buy one share of stock in the club for $5,000. Upon termination of his membership he will be repaid the $5,000. Due to the pressures of his public accounting practice, Jones has refused to accept any officer, board or committee position with the club. Jones is requested by the board of directors to perform the audit of the club for the next year. In this situation, (a) Jones would not be independent since he has an equity interest in the club.

(b) since Jones has only a 0.4 of 1 percent equity interest in the club (he has only one share out of 250 shares outstanding), it is an immaterial direct interest and thus he is independent.

(c) since membership in such a club is essentially a social matter, his equity interest is not considered a direct financial interest and thus he would be independent.

11. Baylor & Associates, CPAs need a $25,000 bank loan for the four months of January through April 1997. The local bank is willing to loan them the money provided a third party guarantees the loan. At lunch one day, one of the partners mentions their need for a guarantor to the president of Bilt-Rite Co. This company has been an audit client of the Baylor firm for the last years. The president offers to have his company guarantee the loan. At a partners’ meeting where the offer is discussed, it is mentioned that borrowing from a client destroys independence with that client. However, in this situation Bilt-Rite would not be loaning the money, merely guaranteeing the bank loan. Further, the loan would be paid on May 1, which would be prior to the completion of work on the annual audit of Bilt-Rite’s financial statements for the year ended December 31, 1996. The offer is accepted, Bilt-Rite guarantees the loan, and the loan is paid in full on May 1, 1997. The audit of Bilt-Rite’s 1996 financial statements is started on April 1, 1997 and the field work is finished on May 15, 1997.

Baylor & Associates_____ independent of Bilt-Rite’s 1996 financial statements.

(a) is

(b) is not

12. A member is told by the president of an audit client that she has named the member as executor of her estate. The president owns about 30 percent of the stock in the client. Being named as executor ________ impair the members’s independence with her company.

(a) does

(b) does not

13. The president (in the question above) dies, and the
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member starts functioning as the executor of the estate. Service as executor _____ her independence with the client.
(a) impairs
(b) does not impair

14. James Stewart, a tax partner who works on the First Bank of Colombia engagement, has a $4,000 loan from First Bank of Colombia. He obtained the loan in September 1996 and it is due in September 1997. The loan is collateralized by stock having a market value of $10,000. This loan _____ Stewart’s firm’s independence for the 1996 calendar year audit of the bank.
(a) impairs
(b) does not impair

15. A member, who is a partner in a one-office firm, loans $5,000 to a friend of hers, the president of Smith Company. Six months later, this president asks the member’s firm to audit Smith Company. The loan has not been paid. In order for the member’s firm to be independent of Smith Company, the loan must be paid before
(a) the audit report is delivered.
(b) the accounting firm’s acceptance of the professional engagement by signing an engagement letter.
(c) the beginning of the period covered by the financial statements to be audited.

16. A partner’s father just purchased stock in an audit client of the partner’s accounting firm. The partner and father are both residing in Los Angeles. The engagement for this audit client is handled entirely by the firm’s Minneapolis office. Which, if any, of the following would cause the accounting firm to lose its independence with this client?
(a) The father is dependent of the partner.
(b) The stock ownership is material to the father
(c) The father is able to exercise significant influence over the audit client.
(d) None of the above.
(e) All of the above.

17. In the situation described in 16 above, what if the engagement was handled by the Los Angeles office and the partner worked on the engagement. Then what is required to prevent an impairment of independence?
(a) The father not be a dependent of the partner.
(b) The stock ownership not be material to the father.
(c) The father cannot exercise significant influence over the audit client.
(d) All of the above required.

18. In a multi-office firm, a manager located in office A is on the board of directors of an audit client C of office B. Office A has nothing to do with the audit of client C. The accounting firm _____ independent of C.
(a) is
(b) is not

19. A professional staff member was asked to join the board of directors of a charitable organization that is an audit client of her firm’s office. If she accepts this position, then for her firm to remain independent, which of the following actions are required?
(a) Her position as a board member is purely honorary.
(b) She does not vote at the board meetings.
(c) Whenever her name and board position are mentioned in the charitable organization’s externally circulated materials, such as letter heads, her board position is described as honorary.
(d) She does not participate in management functions.
(e) All of the above are required.

20. A one-office CPA firm has a partner whose brother is treasurer and owns 26 percent of the stock of a company. The CPA firm is, with respect to this company
(a) independent.
(b) not independent.

21. A member has a joint closely held business investment with a director of one of his audit clients. In order for the member to be independent of this audit client, which of the following statements is correct?
(a) The investment cannot be material to either the member or the director.
(b) The investment cannot be material to the member, but it could be material to the director.
(c) The investment can be material to the member, but it cannot be material to the director.

22. In a one-office accounting firm, a partner’s husband’s brother is a member of the board of directors of a privately held audit client. The accounting firm’s independence with this client is
(a) impaired.
(b) not impaired.

23. One of the partners in a one-office accounting firm has a brother who is a member of the board of directors of an audit client. The accounting firm’s independence with this client is
(a) impaired.
(b) not impaired.
24. A CPA and his firm have been threatened, in writing, with a lawsuit by an audit client who claims that his prior year’s inventory was understated and as a result his firm was not able to obtain the financing it needed to expand operations. His letter states that he believes faulty auditing procedures were responsible for the alleged understatement of inventory. The amount of understated inventory at issue is $50,000. In this situation the CPA would be
   (a) independent with respect to his client since it has not been proven that the auditing procedures were at fault.
   (b) not independent with respect to his client since the allegation, though not proven, has been made that his audit was not adequate.

25. A CPA’s client has threatened suit against the CPA and his firm for $2,000 claiming that due to faulty administrative procedures of the CPA’s firm, their tax return was filed late. The $2,000 represents interest and late penalties imposed by the government plus an amount for legal fees incurred in bringing the action. Total annual audit and tax fees from this client are approximately $45,000 a year. This threatened action by the client will
   (a) impair independence with the client.
   (b) not impair independence with the client.

26. An insurance company, under subrogation rights, has sued a CPA and her firm for $100,000. The insurance company paid $100,000 to a client of the firm because of an embezzlement of that amount by one of the client’s former employees. The former employee has admitted the theft, declared personal bankruptcy, and is serving a three-year term in a federal prison upon being convicted of this theft. The client’s management, its board of directors, and its legal counsel have investigated the matter and decided that since the fraud involved collusion with outside parties by the former employee, the CPA using normal audit procedures would not have been expected to discover the theft. In these circumstances
   (a) the CPA and her firm are independent of the client.
   (b) the CPA and her firm are not independent of the client.

27. A partner in a CPA firm purchases a limited partnership interest in an oil tax shelter. The amount is material to her net worth. She later finds out that the president of one of her audit clients and the treasurer of another audit client have also each purchased limited partnership interests. The general partner who controls the partnership is a nonclient. The interests are material to the net worth of the president and treasurer. Each of the three heard about this tax shelter from their broker. In this situation
   (a) independence is impaired with respect to these two clients.
   (b) independence is not impaired with respect to these two clients.

28. A partner who has been retired for two years continues to serve on the governing board of the accounting firm. This group meets monthly and fulfills the role of a board of directors. The retired partner has no client responsibilities and thus no chargeable time. The retired partner is asked to become a director of an audit client. Acceptance of the director’s position would
   (a) impair independence with this client.
   (b) not impair independence with this client.

29. A member has been asked to cosign checks with an employee of a client during the month of January when the president is on vacation. The president has stated that with the CPA cosigning checks, she will be confident that disbursements are being handled properly. Since
   (a) the member will merely be countersigning, and thus not making the original decision to draw the check, independence with the client will not be impaired.
   (b) the member is only a co-signer and for only one-twelfth of the year, independence is not impaired.
   (c) check signing is a management function, independence is impaired.

30. In a one-office firm a partner’s wife works as a cashier for one of the firm’s audit clients. The partner does not work on the engagement for this client. The wife’s position as cashier ______ impair the firm’s independence with this client.
   (a) does
   (b) does not

31. In question 30, what if the partner worked on the engagement for this client? Would the wife’s position as cashier impair the firm’s independence with this client?
   (a) Yes, it would impair independence.
   (b) No, it would not impair independence.

32. A partner in the Milwaukee office of a CPA firm has a sister who is president of a Chicago-based company that is a client of his firm’s Chicago office. The Milwaukee office does no work for this client. The CPA firm ______ independent of his sister’s Chicago company.
   (a) is
   (b) is not

33. James Penna is a partner in the firm of Swenson & Swern, CPAs. He has a credit card from First Bank of Plainfield. His family charge all of their purchases
using this credit card and his monthly credit card statement will be as high as $12,000. The balance is paid in full each month and thus he does not incur any interest charges. His firm has been asked to be the auditors for First Bank of Plainfield and he will be the partner in charge of the audit.

His credit card account _______ impair the firm’s independence with the bank.

(a) will
(b) will not

34. Merle Garth, CPA is a sole practitioner. A client of his owns 40% of a corporation. The investment is not material to his client. Garth wants to invest in this same corporation. The amount of the investment would not be material to Garth’s net worth. Garth’s investment _______ impair his independence with this client.

(a) will
(b) will not

35. Landry, a Partner in Kimball & Co. (a one-office CPA firm), was formerly treasurer of Charlton & Co. Landry resigned from Charlton & Co. six months ago. Provided there is no independence problem, Charlton & Co. wants Kimball & Co. to perform their next audit. The period covered by the audit would include the six months when Landry had been treasurer of Charlton. Landry had completely disassociated himself from Charlton & Co. prior to accepting employment with Kimball. Landry would not work on the engagement. Kimball & Co. _______ independent of Charlton & Co. for this audit.

(a) would be
(b) would not be

36. A branch manager instructs his controller, a member, to increase the recorded value of the branch’s year-end inventory by $50,000, an amount that is material to the firm’s consolidated financial statements. There is no basis for such an increase; however, it will raise the branch’s profits enough so that the manager will receive an incentive bonus of $5,000. The controller, afraid of being fired if he refuses, follows the manager’s instructions and increases the recorded inventory amount by $50,000. The controller _______ has not violated the ethics code.

(a) has not violated the ethics code.
(b) has violated the ethics code.

37. A retired partner who no longer does any work for the firm and whose retirement pay is fixed is furnished office space, secretarial and telephone service in his former firm’s suite of offices. In which of the following situations would the furnishing of office space and amenities cause an independence problem?

(a) He has an immaterial interest in the stock of a client of his former firm.
(b) He holds a position of significant influence with a client of his former firm.
(c) He holds a position, but not one of significant influence with a client of his former firm.
(d) None of the above causes an independence problem.
(e) They all cause an independence problem.

38. A firm’s client is designing and will supervise the construction of a warehouse for a non-client third party. It is a material contract for this client being some 25% of their expected revenues for this year. The firm has been engaged to prepare the inventory control system that will be used in this new facility. The firm and the client have separate contracts with the third party. Under the two contracts, neither is responsible for the actions of the other nor does either one have the authority to act as an agent or representative of the other. This joint activity _______ impair the firm’s independence with the client.

(a) does
(b) does not

39. A firm performed nonattest services for an attest client during the 2004 calendar year. They did not document in writing their understanding with the client regarding the objectives of the engagement, services to be performed, client’s acceptance of its responsibilities, the member’s responsibilities and the limitations, if any, of the engagement. The lack of such documentation in this case _______ a violation of Rule 202 Compliance with Standards.

(a) is
(b) is not

40. A firm has been asked to perform a nonattest service for an attest client. The client has only one employee capable of overseeing the nonattest services. Due to lack of time, management does not want the employee to accept that responsibility; and therefore, there will be no such oversight by the client. If the firm provides the nonattest service under these conditions, independence with the client _______ impaired.

(a) will be
(b) will not be

41. A public accounting firm uses an outside commercial storage company to store prior years audit and tax files for current and prior clients. The storage company is considered a third-party service provider. The firm _______ required to inform the clients
whose records are so stored that they are using such a third-party service provider.

(a) is
(b) is not

42. Hill, a member, performs some nonattest services for his attest client Smith & Co. In performing these services he complies with the General Requirements for Performing Nonattest Services contained in Interpretation 101-3, Performance of Nonattest Services. The nonattest services performed do not impair Hill’s independence with Smith & Co. under the AICPA Code of Professional Conduct. However, these services do impair Hill’s independence with Smith & Co. under the independence regulations of the authoritative regulatory body where Smith & Co. must file its audited financial statements. In performing these nonattest services for Smith & Co. Hill has

(a) not violated the AICPA Code of Professional Conduct since these services are permitted under that code without impairing independence
(b) violated Interpretation 101-3.

43. Which of the following best describes the difference between a direct financial interest and an indirect financial interest?

(a) Ownership of 100 shares of stock would be a direct financial interest whereas ownership of 5 shares of the same stock would be an indirect financial interest.
(b) a $1,000 investment in a stock would be a direct financial interest where a $50 investment in that stock would be an indirect financial interest.
(c) A direct financial interest is one where the financial interest is owned directly by the individual or by an entity which the individual controls or where he/she can supervise or participate in investment decisions. An indirect financial interest is one where the financial interest is owned beneficially through an intermediary and the beneficiary neither controls the intermediary nor can he/she supervise or participate in the investment decisions.

44. Holmes, the president of Marvin Mfg. Co., was very pleased with the audit and tax work done by Jones & Co., CPAs. He was especially impressed with Jacobs’ work as partner in charge of the engagement. Jacobs made some suggestions that reduced the company’s income taxes by a substantial amount. To show his appreciation he had a large Plasma Television delivered to Jacobs’ house. Holmes knows that Jacobs wanted such a set but that Jacobs felt the $7,000 cost was more than he could afford. If Jacobs accepts this gift of the television, Jones & Co.’s independence with Marvin Mfg. Co. ________ be impaired.

(a) would
(b) would not

45. Bell Co. is being sued by one of its suppliers over non-payment of invoices for materials purchased by Bell. Bell has countersued stating that the materials received were faulty, and therefore Bell lost money due to returned merchandise and lost sales. Fisher, the partner in charge of Bell’s annual audit, has been asked by Bell’s president to furnish both litigation consulting services and to be an expert witness for Bell Co. in the litigation. If Fisher accepts these two roles what effect, if any, will it have on his firm’s independence with Bell Co?

(a) It will have no effect on independence
(b) Independence will be impaired
(c) Litigation consulting services will impair independence while expert witness services will not impair independence.
(d) Litigation consulting services will not impair independence while expert witness services will impair independence.

46. Prior to a member signing and filing a tax return for a client, without impairing the member’s independence with that client, the member needs a signed statement authorizing him to make the filing. Which of the following are required to be enumerated in that statement?

(a) The person signing the statement is authorized to sign and file the return himself or herself.
(b) The person signing the statement has reviewed the tax return and that it is correct and complete.
(c) The person signing the statement authorizes the member to sign and file the return.
(d) All of the above are required.


Chapter Answers

1. (a) is correct, the firm is not independent. Covered members owning stock in a client impair independence with that client (Interpretation 101-1A.1). All partners in the office where the partner in charge of the audit is located are covered members (Chapter 3, Definitions, Covered member) (d). The partner’s wife is classified Immediate family (Chapter 3, Definitions, Immediate family). A covered member’s immediate family is subject to Rule 101 (Interpretation 101-1, Application of the independence rules to a covered member’s immediate family). Her ownership of stock impairs independence.

2. (a) is correct, the member’s report must be a compilation with a disclaimer based on lack of independence. Covered members having a direct financial interest in a client impair independence with that client (Interpretation 101-1A.1). The member is classified as a covered member since he is on the attest engagement team (Chapter 3, Definitions, Covered member a). The type of report he may issue is a compilation report with a disclaimer based on lack of independence (Ruling 74).

3. (c) is correct, independence is not impaired. Her share of the club’s investment in Jones is considered a direct financial interest in Jones (Ruling 36). Covered members having a direct financial interest in a client impair independence with that client (Interpretation 101-1A.1). Since she does not work on the Jones engagement she is not considered a covered person. (Chapter 3, Definitions, Covered member a). Her share of the investment does not impair the firm’s independence, since only covered member’s direct financial interests in clients impairs independence.

4. (c) is correct, independence is not impaired. The explanation given in 3 above also applies here, since her status as a manager does not change the answer. If she was a partner then the correct answer would be (d).

5. (a) is correct, holdings by New York partners will not impair independence. The New York partners are not covered members since they are not located in the office where the partner in charge of the audit is located and they do not work on the engagement since the Chicago office does all the work (Chapter 3, Definitions, Covered member a and d). Their stock holdings will thus not impair independence.

(b) is incorrect since holdings by Chicago partner whether or not they work on the engagement will impair independence (Chapter 3, Definitions, Covered member a and d).

(c) is incorrect since Chicago staff working on the engagement are covered members and their stock holdings will impair independence (Chapter 3, Definitions, Covered member a).

6. (a) is correct, independence is not impaired. The retired partner is not a covered member (Chapter 3, Definitions, Covered member). Her stock holding does not impair the firm’s independence.

(b) is incorrect since she is completely retired, i.e., she has no influence in the firm, does no work for the firm etc. If she did any work for the firm, then she would be considered an active partner in the firm and her stock holdings would impair independence.

(c) is incorrect. The fact that she is receiving fixed retirement payments does not make her an active partner so that her stock holdings would impair independence.

7. (b) is correct, independence is impaired. This work makes her an active partner. Since this is a one-office firm, she is a covered member and independence is impaired. (Chapter 3, Definitions, Covered member d and Interpretation 101-1A.1).

(a) is incorrect because there is no requirement that one work full time to be considered an active partner.

(c) is incorrect because it makes no difference whether they bill clients for her work or not. She is doing work for clients.

(d) is incorrect. The fact that they pay her for the work has no bearing on whether she is an active partner or not. It does reinforce the fact that she’s working for the firm, the firm values her work and compensates her for it.

8. (b) is correct. The past due fee must be paid before the report is issued. Prior year’s work that the client has not paid for was finished in February 1996. Sixteen months later in June 1997 they will issue the report on the current work. A ruling says that independence is impaired if fees for work performed more than one year prior are unpaid when the report for the current year is issued (Ruling 52).

(a) is incorrect. If the $10,000 is paid before the report is issued in June there is no independence impairment.

(c) is incorrect since the significance to Andrew & Co. CPAs of the amount of the unpaid fee does not
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9. (b) is correct, independence is impaired. Since this is a one-office firm, Jones is a covered member with respect to this bank (Chapter 3, Definitions, Covered member d). This type of loan is not one of the permitted loans from client financial institutions where independence is required (Interpretation 101-5 Other Permitted Loans.)

(a) is incorrect since there is no exception in the interpretation because it is a normal bank loan.

(c) is also incorrect because as a partner in the office doing the bank audit he is a covered member. If he was a staff person with a $7,000 loan from this bank and he did not work on the bank’s engagement, independence would not be impaired.

10. (c) is correct, he is independent of the club. This is not considered a direct financial interest (Ruling 17).

(a) is incorrect because the ruling says that as long as membership is essentially a social matter the equity interest does not impair independence.

(b) is also incorrect since it is the fact that he has a share of stock, not the immateriality of his equity membership, that is important.

11. (b) is correct, they are not independent. Independence is impaired if at any time during the professional engagement a covered member has a loan from a client (Interpretation 101-1, 4). The accounting firm is a covered member. (Chapter 3, Definitions, Covered member e). Guarantee of a loan is considered the same as a loan (Chapter 3, Definitions, Loan). Since the guarantee existed during the period of the professional engagement independence is impaired.

12. (b) is correct. Being named as executor does not impair independence (Ruling 11).

13. (a) is correct. Serving as executor when the estate owns stock in the client impairs independence with the client (Interpretation 101-1A.2.(ii) and ruling 11.

14. (a) is correct. The loan impairs independence. James Stewart is a covered member since he works on the engagement for the bank (Chapter 3, Definitions, Covered member, a). Covered member’s loans will impair independence (Interpretation 101-1A.4). It is not one of the permitted loans (101-5, Other Permitted Loans).

15. (b) is correct. The loan must be paid before the professional engagement is accepted. The member will be a covered member for this engagement (Chapter 3, Definitions, Covered member d). Covered members may not have loans to audit client’s officers during the period of the professional engagement without impairing independence (Interpretation 101-1A.4). This is not one of the permitted loans (101-5, Other Permitted Loans). The period of the professional engagement starts the earlier of when an initial engagement letter is signed or work is started on the audit (Chapter 3, Definitions, Period of the professional engagement).

16. (d) is correct. None of these would cause an independence problem. The partner is not a covered member since he is in Los Angeles and the audit is done 100 percent by Minneapolis (Chapter 3, Definitions, Covered member d).

(a) If the partner’s father was a dependent, he would be considered immediate family (Chapter 3, Definitions, Immediate family). If not a dependent, then he would be a close relative of the partner (Chapter 3, Definitions, Close relative). The restrictions on immediate family and close relatives do not apply since the partner is not a covered member (Interpretation 101-1, sections Application of the independence rules to immediate family and Application of the independence rules to close relatives).

17. (d) is correct. All three would be required. Since the partner worked on the engagement he is a covered member (Chapter 3, Definitions, Covered member a) If the partner’s father was a dependent, he would be considered immediate family (Chapter 3, Definitions, Immediate family). A covered member’s immediate family is subject to Rule 101 and its interpretations. (Interpretation 101-1, section Application of the independence rules to immediate family). Since a covered member may not have a direct financial interest in a client without impairing independence, neither can the covered member’s immediate family have a direct investment without impairing independence.

If the father is not immediate family, then he is a close relative (Chapter 3, Definitions, Close family). As a close relative, the father (b) cannot have a stock ownership be material to him nor (c) can he be in a position to exercise any significant influence over the client (Interpretation 101-1, section Application of the Independence Rules to Close Relatives).

18. (b) is correct. Any professional employee serving on a client’s board of directors impairs independence with that client. A few years ago this would not have impaired independence if the member on the board...
was not located in the office doing the audit (Interpretation 101-1C.1).

19. (c) is correct. In order for her firm to remain independent, her position must be purely honorary (a) she cannot vote at board meetings (b) she is classified as honorary on externally circulated materials (c) and she does not participate in management functions (d) (Interpretation 101-4).

20. (b) is correct. The sibling’s position and ownership impair independence. The sibling is a close relative (Chapter 3, Definitions, Close relative). A close relative having that position or that much ownership of a company impairs independence with that company (Interpretation 101-1, Application of the Independence Rules to Close Relatives).

21. (b) is correct. The investment cannot be material to the member (Interpretation 101-1, A.3) The interpretation is silent as to materiality to the client. (a) and (c) are thus incorrect.

22 (b) is correct. Independence is not impaired since the brother-in-law is not a close relative of the partner (Chapter 3, Definitions, Close relative and Interpretation 101-1, Application of the Independence Rules to Close Relatives).

23. (a) is correct. Independence is impaired since the brother is a close relative of the partner (Chapter 3, Definitions, Close relative) The brother, as a director, has a key position with the client (Chapter 3, Definitions, Key position, c) A close relative with a key position with a client impairs independence with that client. (Interpretation 101-1, Application of the Independence Rules to Close Relatives 2a).

24. (b) is correct. Independence is impaired because of the threat of faulty auditing (Interpretation 101-6, Litigation between client and member 3).

25. (b) is correct. Independence not impaired because of the immaterial amount involved and the litigation would not involve an attest engagement (Interpretation 101-6, Litigation between client and member 4)

26. (a) is correct. Independence is not impaired because management is not accusing the auditing firm of faulty procedures (Interpretation 101-6, Other third-party litigation.).

27. (b) is correct. Since the limited partners do not control the partnership, they are not in a joint closely held investment, and therefore independence is not impaired. The general partner controls the partnership and the limited partners are merely investors (Chapter 3, Definitions, Joint closely held investment and Interpretation 101-1A.3).

28. (a) is correct. The partner is still active in the firm and thus independence would be impaired (Interpretation 101-2, 3).

29. (c) is correct. Check signing impairs independence. (Interpretation 101-3, Table, Non tax disbursement).

30. (b) is correct. Her position does not impair independence. The partner is a covered member (Chapter 3, Definitions, Covered member d). His wife is immediate family (Chapter 3, Definitions, Immediate family). Cashier is not a key position, (Chapter 3, Definitions, Key position). Thus independence is not impaired (Interpretation 101-1, Application of the Independence Rules to a Covered Member’s Immediate Family 1).

31. (b) is correct. Her position does not impair independence. The partner is a covered member (Chapter 3, Definitions, Covered member a). His wife is immediate family (Chapter 3, Definitions, Immediate family). Cashier is not a key position, (Chapter 3, Definitions, Key position). Thus independence is not impaired (Interpretation 101-1, Application of the Independence Rules to a Covered Member’s Immediate Family 1).

32. (a) is correct. The firm is independent. The partner’s sister is a close relative (Chapter 3, Definitions, Close relative). Independence impairment due to close relatives relationships with a client apply only to partners who work on the engagement, who can influence the engagement or who is in the office where the partner in charge of the engagement is located (Interpretation 101-1, Application of the Independence Rules to Close Relatives). Since this partner does not meet any of those criteria, independence is not impaired.

33. (b) is correct. His credit card account does not impair independence. As partner in charge of the audit of the bank he is a covered member (Chapter 3, Definitions, Covered member a). Permitted loans that he may have with the bank without impairing independence include credit cards where the balance is reduced to $10,000 or less on a current basis (Interpretation 101-5, Other Permitted Loans). Since he pays the balance in full each month his balance is reduced to zero on a current basis.

34. (b) is correct. His investment will not impair independence with the client. The investment may possibly be a joint closely held investment with his client since the client, owning 40 percent of the corporation may be able to control it (Chapter 3, Definitions, Joint closely held investment). Even if it meets those criteria it still does not impair independence since Garth’s investment is immaterial to him. (Interpretation 101-1, 3.)
35. (a) is correct. They would be independent for this audit. Landry is a covered member since he is a partner in the office doing the audit (Chapter 3, Definitions, Covered member d). Since Landry will not do any work on the audit and he had completely severed his ties with Charlton before joining Kimball & Co., his former employment does not cause an independence problem (Interpretation 101-1, Application of the Independence Rules to Covered Members Formerly Employed by a Client or Otherwise Associated with a Client).

36. (b) is correct. The controller violated the ethics code by making a materially false entry in the financial records (Interpretation 102-1 (a)).

37. (b) is correct. If he holds a position of significant influence with a client independence would be impaired since furnishing him these amenities would seem to mean he was still associated with the firm (Interpretation 101-2, 3).

(a) is incorrect because direct financial interests in a client cause independence problems only if they are held by a covered member, the covered member’s immediate family or in some cases by the covered member’s close relatives. The retired partner does not meet any of the requirements for being classified as a covered member (Chapter 3, Definitions, Covered member.)

(c) is incorrect. Because the position held with the client is not one of significant influence. He may be assumed to still be associated with the firm but that doesn’t matter. Even a covered member’s immediate family is allowed to be employed in a non-key position by a client without impairing independence (Interpretation 101-1 Application of the Independence Rules to a Covered Member’s Immediate Family).

38. (b) is correct. Since this joint activity does not meet the requirements for cooperative arrangement independence is not impaired. The firm and the client have separate contracts, they are not responsible for each other’s work and neither one have the authority to act for the other (Interpretation 101-12).

39. (b) is correct. Interpretation 101-3, General Requirements for Performing Nonattest Services, 3, says the documentation requirement does not apply to (b) nonattest services provided prior to January 1, 2005.

40. (a) is correct. Interpretation 101-3, General Requirements for Performing Nonattest Services, says that independence will be impaired if a client will not oversee the nonattest services provided.

41. (b) is correct. Ruling 112 says a member is not required to inform a client that a third-party service provider is being used for storing records pertaining to them.

42. (b) is correct. Second paragraph of Interpretation 101-3, Engagements Subject to Independence Rules of Certain Regulatory Bodies, says that failure to follow the more restrictive independence rules of the authoritative regulatory body would constitute a violation of Interpretation 101-3.

43. (c) is correct. Interpretation 101-15, Financial Relationships under Definitions of Direct Financial Interest and Indirect Financial Interest, states this. (a) and (b) are both incorrect. The size of the investment does not control whether it is a direct or indirect interest. Ownership of just one share of stock would be a direct financial interest.

44. (a) is correct. Ethics Ruling 114 Acceptance or Offering of Gifts and Entertainment to or From an Attest Client says that independence would be considered to be impaired if a member of the attest engagement team accepts a gift from an attest client unless the value is clearly insignificant to the member.

45. (d) is correct. Interpretation 101-3, Forensic Accounting Services, states if a member agrees to provide expert witness testimony for a client independence would be considered to be impaired. It also states that the performance of litigation consulting services would not impair independence.

46. (d) is correct. Interpretation 101-3, Tax Compliance Services, lists these requirements.
Chapter 5


PCAOB Ethics Rules

The Sarbanes-Oxley Act of 2002 established the Public Accounting Oversight Board. One of its powers under this law is to establish ethics, independence and other standards for public accounting firms. The Securities and Exchange Commission must approve any such standards.

In July 2005, the PCAOB released their ethics rules (Section 3, Professional Standards, Part 5-Ethics). Three are rather short rules, Responsibility Not to Cause Violations, Auditor Independence and Contingent Fees. Three additional rules, Tax Transactions, Tax Services for Persons in Financial Reporting Oversight Roles, and Audit Committee Pre-Approval of Certain Tax Services, are longer and more detailed. The PCAOB does not need to duplicate the SEC’s independence rules since those rules also apply to the audits of all publicly held companies whose financial statements are filed with the Commission. Where the SEC does not have a rule dealing with a specific situation, such as Tax Services for Persons in Financial Reporting Oversight Roles, the PCAOB may be expected to adopt a rule.

SEC Rules

The passage in 1933 and 1934 of the Securities Act and the Securities Exchange Act resulted in requiring that, in most cases, financial statements included in registration statements filed with the SEC must be certified by an “independent public or certified accountant.” Prior to 1933 the American Institute of Accountants, the forerunner of the AICPA, did not have an independence rule.

The SEC for many years used the firm approach for their independence rules. As an example, if any partner in a firm owned stock in an audit client of the firm, the firm was held to be not independent of that client. This was reasonable when accounting firms were smaller. A few years ago the SEC changed its approach to an engagement basis and changed their rules accordingly. Thus if the New York office of an accounting firm has a publicly held client where all the work is handled by the New York office, only the partners in that office are prohibited from owning stock in this client. The partners in Los Angeles, who own stock in this client may retain this stock without impairing the firm’s independence with this client, provided they are not in a position to influence the attest engagement for that client. There is a percentage limit on the amount of stock they could own.

Sarbanes-Oxley Act of 2002

The act gives the Public Company Accounting Oversight Board (PCAOB), under the oversight of the Securities Exchange Commission, broad powers to:

- register public accounting firms
- establish auditing, quality control, ethics, independence and other standards
- conduct inspections of public accounting firms
- conduct investigations, hold disciplinary hearings and impose sanctions against firms and individuals.

The law prohibits accounting firms from furnishing the following services to their publicly held audit clients:

- almost all bookkeeping or other services related to the accounting records or financial statements of the audit client
- financial information systems design and implementation
- appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- actuarial services
- internal audit outsourcing services
- management functions or human resources
- broker or dealer, investment adviser, or investment banking services
- legal services and expert services unrelated to the audit
any other service that the Public Company Accounting Oversight Board determines, by regulation, is impermissible.

The relationship between the client and its auditing firm was changed quite dramatically. The auditor now deals with the audit committee on many matters that used to be in the client management’s domain. Under this law:

- Audit committee selects and employs the auditing firm
- Audit committee must pre-approve all audit and non-audit services

The auditor must report to the client’s audit committee:

- all critical accounting policies and practices used by the client;
- all alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials, the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor.
- other material written communications between the auditor and management such as any management letter or schedule of unadjusted differences.

The law provides for partner rotation on the audit team. It also provides a cooling off period of a year before audit engagement partners may be hired by the client in a financial oversight role.

Members employed in key financial roles in publicly held companies are given added duties and responsibilities under this new law. Some of the requirements are:

- the principal executive officers and the principal financial officers, must certify that the financial statements fairly present in all material respects the financial condition and results of operations of the client
- the officers of the company have evaluated the effectiveness of their internal controls.
- the officers have disclosed to their auditors and the audit committee of the board of directors:
  - all significant deficiencies in the design or operation of internal controls which could adversely affect the company’s ability to record, process, summarize, and report financial data
  - identified any material weaknesses in internal controls
  - inform them of any fraud, whether or not material, that involves management or other employees who have a significant role in the company’s internal controls
- whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

The auditors are required to attest to, and report on, the internal control assessment made by the management of the company.

The Sarbanes-Oxley Act, PCAOB rules, and the SEC rules do not apply to the auditors of privately held clients.

They apply only to the auditors of publicly held clients. Thus they are applicable to the larger public accounting firms and not to the majority of the smaller public accounting firms.

Some states may adopt all or a portion of this law and these rules for privately held companies and their accountants. Thus, smaller public accounting firms may find themselves subject to these more restrictive requirements. Also, plaintiff’s lawyers in lawsuits against auditors of privately held companies may question why, if an action is deemed to impair independence of an auditor of a publicly held company, that same action should not impair the independence of an auditor of a privately held company. To answer such a question by saying that is what the rules state may not be enough to satisfy a judge or a jury.

**GAO Independence Standards**


Nonaudit services fall under the following three categories:

- those that do not impair independence
- those that do not impair independence if supplemental safeguards are implemented
- those that impair independence

Examples are given of each type and of the supplemental safeguards that should be used.

**Conclusion**

Many small and medium-sized firms do not have any publicly held clients. Why then should they be concerned with these rules on independence? One of their clients may decide to go public, or may be acquired by
a company filing with the SEC and audited financial statements for prior years may be required. At that point, it is a little late for the client to find out that the former auditors were not independent under these rules. The lack of independence cannot be retroactively cured, and the client will have to have the prior years’ statements reaudited by another accounting firm—at a substantial cost both in dollars and in time. Other regulatory agencies and some state boards of accountancy may adopt some of the requirements for all public accounting firms. In litigation against accounting firms, plaintiffs may try to say that these rules should also apply to the audits of privately held companies.
Public Company Accounting Oversight Board, Rules
Section 3, Professional Standards, Part 5 Ethics

Rule 3501. Definitions of Terms Employed in Section 3, Part 5 of the Rules

When used in Section 3, Part 5 of the Rules, unless the context otherwise requires:

(a)(i) Affiliate of the Accounting Firm

The term “affiliate of the accounting firm” (or “affiliate of the registered public accounting firm” or “affiliate of the firm”) includes the accounting firm’s parents; subsidiaries; pension, retirement, investment or similar plans; and any associated entities of the firm, as that term is used in Rule 2-01 of the Commission’s Regulation S-X, 17 C.F.R. § 210.2-01(f)(2).

(a)(ii) Affiliate of the Audit Client

The term “affiliate of the audit client” means—

(1) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client’s parents and subsidiaries;

(2) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(3) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(4) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(a)(iii) Audit and Professional Engagement Period

The term “audit and professional engagement period” includes both—

(1) The period covered by any financial statements being audited or reviewed (the “audit period”); and

(2) The period of the engagement to audit or review the audit client’s financial statements or to prepare a report filed with the Commission (the “professional engagement period”)—

(A) The professional engagement period begins when the registered public accounting firm either signs an initial engagement letter (or other agreement to review or audit a client’s financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the registered public accounting firm notifies the Commission that the client is no longer that firm’s audit client.

(3) For audits of the financial statements of foreign private issuers, the “audit and professional engagement period” does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(a)(iv) Audit Client

The term “audit client” means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client.

(c)(i) Confidential Transaction

The term “confidential transaction” means—

(1) In general. A confidential transaction is a transaction that is offered to a taxpayer under conditions of confidentiality and for which the taxpayer has paid an advisor a fee.

(2) Conditions of confidentiality. A transaction is considered to be offered to a taxpayer under conditions of confidentiality if the advisor who is paid the fee places a limitation on disclosure by the taxpayer of the tax treatment or tax structure of the transaction and the limitation on disclosure protects the confidentiality of that advisor’s tax strategies. A transaction is treated as confidential even if the conditions of confidentiality are not legally binding on the taxpayer. A claim that a transaction is proprietary or exclusive is not treated as a limitation on disclosure if the advisor confirms to the taxpayer that there is no limitation on disclosure of the tax treatment or tax structure of the transaction.

(3) Determination of fee. For purposes of this definition, a fee includes all fees for a tax strategy or for services for advice (whether or not tax advice) or for the implementation of a transaction. These fees include consideration in whatever form paid, whether in cash or in kind, for services to analyze the transaction (whether or not related to the tax consequences of the transaction), for services to implement the transaction, for services to document the transaction, and for services to prepare tax returns to the extent that the fees exceed the fees customary for return preparation. For purposes of this
definition, a taxpayer also is treated as paying fees to an advisor if the taxpayer knows or should know that the amount it pays will be paid indirectly to the advisor, such as through a referral fee or fee-sharing arrangement. A fee does not include amounts paid to a person, including an advisor, in that person’s capacity as a party to the transaction. For example, a fee does not include reasonable charges for the use of capital or the sale or use of property.

(4) Related parties. For purposes of this definition, persons who bear a relationship to each other as described in section 267(b) or 707(b) of the Internal Revenue Code will be treated as the same person.

(c)(ii) Contingent Fee

The term “contingent fee” means—

(1) Except as stated in paragraph (2) below, any fee established for the sale of a product or 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 product or service.

(2) Solely for the purposes of this definition, a fee is not a “contingent fee” if the amount is fixed by courts or other public authorities and not dependent on a finding or result.

(f)(i) Financial Reporting Oversight Role

The term “financial reporting oversight role” means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, 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 any equivalent position.

(i)(i) Immediate Family Member

The term “immediate family member” means a person’s spouse, spousal equivalent, and dependents.

(i)(ii) Investment Company Complex

(1) The term “investment company complex” includes—

(i) An investment company and its investment adviser or sponsor;

(ii) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (i) of this definition, or any entity under common control with an investment adviser or sponsor in paragraph (i) of this definition if the entity—

(A) Is an investment adviser or sponsor; or

(B) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and

(iii) Any investment company or entity that would be an investment company but for the exclusions provided by section 3(c) of the Investment Company Act of 1940 (15 U.S.C. Sec. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (i) or (ii) of this definition.

(2) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser.

(3) A sponsor, for purposes of this definition, is an entity that establishes a unit investment trust.

### Rule 3502. Responsibility Not to Knowingly or Recklessly Contribute to Violations

A person associated with a registered public accounting firm shall not take or omit to take an action knowing, or recklessly not knowing, that the act or omission would directly and substantially contribute to a violation by that registered public accounting firm of the Act, the Rules of the Board, the provisions of the securities laws relating to the preparation and issuance of audit reports and the obligations and liabilities of accountants with respect thereto, including the rules of the Commission issued under the Act, or professional standards.

### Subpart 1–Independence

#### Rule 3520. Auditor Independence

A registered public accounting firm and its associated persons must be independent of the firm’s audit client throughout the audit and professional engagement period.

Note 1: Under Rule 3520, a registered public accounting firm or associated person’s independence obligation with respect to an audit client that is an issuer encompasses not only an obligation to satisfy the independence criteria set out in the rules and standards of the PCAOB, but also an obligation to satisfy all other independence criteria applicable to the engagement, including the independence criteria set out in the rules and regulations of the Commission under the federal securities laws.

Note 2: Rule 3520 applies only to those associated persons of a registered public accounting firm required to be independent of the firm’s audit client by standards, rules or regulations of the Commission or other applicable independence criteria.
Rule 3521. Contingent Fees
A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any service or product to the audit client for a contingent fee or a commission, or receives from the audit client, directly or indirectly, a contingent fee or commission.

Rule 3522. Tax Transactions
A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the audit and professional engagement period, provides any non-audit service to the audit client related to marketing, planning, or opining in favor of the tax treatment of, a transaction—

(a) Confidential Transactions—that is a confidential transaction; or

(b) Aggressive Tax Position Transactions—that was initially recommended, directly or indirectly, by the registered public accounting firm and a significant purpose of which is tax avoidance, unless the proposed tax treatment is at least more likely than not to be allowable under applicable tax laws.

Note 1: With respect to transactions subject to the United States tax laws, paragraph (b) of this rule includes, but is not limited to, any transaction that is a listed transaction within the meaning of 26 C.F.R. Sec. 1.6011(b)(2).

Note 2: A registered public accounting firm indirectly recommends a transaction when an affiliate of the firm or another tax advisor, with which the firm has a formal agreement or other arrangement related to the promotion of such transactions, recommends engaging in the transaction.

Rule 3523. Tax Services for Persons in Financial Reporting Oversight Roles
A registered public accounting firm is not independent of its audit client if the firm, or any affiliate of the firm, during the professional engagement period provides any tax service to a person in a financial reporting oversight role at the audit client, or an immediate family member of such person, unless—

(a) the person is in a financial reporting oversight role at the audit client only because he or she serves as a member of the board of directors or similar management or governing body of the audit client;

(b) the person is in a financial reporting oversight role at the audit client only because of the person’s relationship to an affiliate of the entity being audited—

(1) whose financial statements are not material to the consolidated financial statements of the entity being audited; or

(2) whose financial statements are audited by an auditor other than the firm or an associated person of the firm; or

(c) the person was not in a financial reporting oversight role at the audit client before a hiring, promotion, or other change in employment event and the tax services are—

(1) provided pursuant to an engagement in process before the hiring, promotion, or other change in employment event; and

(2) completed on or before 180 days after the hiring or promotion event.

Note: In an engagement for an audit client whose financial statements for the first time will be required to be audited pursuant to the standards of the PCAOB, the provision of tax services to a person covered by Rule 3523 before the earlier of the date that the firm: (1) signed an initial engagement letter or other agreement to perform an audit pursuant to the standards of the PCAOB, or (2) began procedures to do so, does not impair a registered public accounting firm’s independence under Rule 3523.

Rule 3524. Audit Committee Pre-Approval of Certain Tax Services
In connection with seeking audit committee pre-approval to perform for an audit client any permissible tax service, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer—

(1) the scope of the service, the fee structure for the engagement, and any side letter or other amendment to the engagement letter, or any other agreement (whether oral, written, or otherwise) between the firm and the audit client, relating to the service; and

(2) any compensation arrangement or other agreement, such as a referral agreement, a referral fee or fee-sharing arrangement, between the registered public accounting firm (or an affiliate of the firm) and any person (other than the audit client) with respect to the promoting, marketing, or recommending of a transaction covered by the service; and

(b) discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm; and
Rule 3525. Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting

In connection with seeking audit committee pre-approval to perform for an audit client any permissible non-audit service related to internal control over financial reporting, a registered public accounting firm shall—

(a) describe, in writing, to the audit committee of the issuer the scope of the service;

(b) discuss with the audit committee of the issuer the potential effects of the services on the independence of the firm; and

(c) document the substance of its discussion with the audit committee of the issuer.

Rule 3526. Communication with Audit Committees Concerning Independence

A registered public accounting firm must—

(a) prior to accepting an initial engagement pursuant to the standards of the PCAOB—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the potential audit client or persons in financial reporting oversight roles at the potential audit client that, as of the date of the communication, may reasonably be thought to bear on independence:

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (a)(1) on the independence of the registered public accounting firm, should it be appointed the issuer’s auditor;

(3) document the substance of its discussion with the audit committee of the issuer.

(b) at least annually with respect to each of its issuer audit clients—

(1) describe, in writing, to the audit committee of the issuer, all relationships between the registered public accounting firm or any affiliates of the firm and the audit client or persons in financial reporting oversight roles at the audit client that, as of the date of the communication, may reasonably be thought to bear on independence;

(2) discuss with the audit committee of the issuer the potential effects of the relationships described in subsection (b)(1) on the independence of the registered public accounting firm;

(3) affirm to the audit committee of the issuer, in writing, that, as of the date of the communication, the registered public accounting firm is independent in compliance with Rule 3520; and

(4) document the substance of its discussion with the audit committee of the issuer.
Security and Exchange Commission Rules

Rule 2-01
Qualifications of Accountants

Preliminary Note to § 210.2-01

Rule 2-01 is designed to ensure that auditors are qualified and independent of their audit clients both in fact and in appearance. Accordingly, the rule sets forth restrictions on financial, employment, and business relationships between an accountant and an audit client and restrictions on an accountant providing certain non-audit services to an audit client.

Rule 2-01(b) sets forth the general standard of auditor independence. Paragraphs (c)(1) to (c)(5) reflect the application of the general standard to particular circumstances. The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in Paragraph 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: (a) creates a mutual or conflicting interest between the accountant and the audit client; (b) places the accountant in the position of auditing his or her own work; (c) results in the accountant acting as management or an employee of the audit client; or (d) places the accountant in a position of being an advocate for the audit client.

These factors are general guidance only and their application may depend on particular facts and circumstances. For that reason, Rule 2-01 provides that, in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission’s Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services, that are not explicitly described in the Rule.

(a) The Commission will not recognize any person as a certified public accountant who is not duly registered and in good standing as such under the laws of the place of his residence or principal office. The Commission will not recognize any person as a public accountant who is not in good standing and entitled to practice as such under the laws of the place of his residence or principal office.

(b) The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant’s engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission.

(c) This paragraph sets forth a non-exclusive specification of circumstances inconsistent with paragraph (b) of this section.

(1) Financial relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has a direct financial interest or a material indirect financial interest in the accountant’s audit client, such as:

(i) Investments in audit clients. An accountant is not independent when:

(A) The accounting firm, any covered person in the firm, or any of his or her immediate family members, has any direct investment in an audit client, such as stocks, bonds, notes, options, or other securities. The term direct investment includes an investment in an audit client through an intermediary if:

(1) The accounting firm, covered person, or immediate family member, alone or together with other persons, supervises or participates in the intermediary’s investment decisions or has control over the intermediary; or

(2) The intermediary is not a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), and has an investment in the audit client that amounts to 20% or more of the value of the intermediary’s total investments.

(B) Any partner, principal, shareholder, or professional employee of the accounting firm, any of his or her immediate family members, any close family member of a covered person in the firm, or any group of the above persons has filed a Schedule 13D or 13G (17 CFR 240.13d-101 or 240.13d-102) with the Commission indicating beneficial ownership of more than five percent of an audit client’s equity securities ownership of more than five percent of an audit client’s equity securities or controls an audit client, or a close family member of a partner, principal, or shareholder of the accounting firm controls an audit client.

(C) The accounting firm, any covered person in the firm, or any of his or her immediate family members, serves as voting trustee of a trust, or executor of an
estate, containing the securities of an audit client, unless the accounting firm, covered person in the firm, or immediate family member has no authority to make investment decisions for the trust or estate.

(D) The accounting firm, any covered person in the firm, any of his or her immediate family members, or any group of the above persons has any material indirect investment in an audit client. For purposes of this paragraph, the term material indirect investment does not include ownership by any covered person in the firm, any of his or her immediate family members, or any group of the above persons of 5% or less of the outstanding shares of a diversified management investment company, as defined by Section 5(b)(1) of the Investment Company Act of 1940, 15 U.S.C. 80a-5(b)(1), that invests in an audit client.

(E) The accounting firm, any covered person in the firm, or any of his or her immediate family members:

(1) Has any direct or material indirect investment in an entity where:

(i) An audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity; or

(ii) The entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;

(2) Has any material investment in an entity over which an audit client has the ability to exercise significant influence; or

(3) Has the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.

(ii) Other financial interests in audit client. An accountant is not independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has:

(A) Loan/debtor-creditor relationship. Any loan (including any margin loan) to or from an audit client, or an audit client’s officers, directors, or record or beneficial owners of more than ten percent of the audit client’s equity securities, except for the following loans obtained from a financial institution under its normal lending procedures, terms, and requirements:

(1) Automobile loans and leases collateralized by the automobile;

(2) Loans fully collateralized by the cash surrender value of an insurance policy;

(3) Loans fully collateralized by cash deposits at the same financial institution; and

(4) A mortgage loan collateralized by the borrower’s primary residence provided the loan was not obtained while the covered person in the firm was a covered person.

(B) Savings and checking accounts. Any savings, checking, or similar account at a bank, savings and loan, or similar institution that is an audit client, if the account has a balance that exceeds the amount insured by the Federal Deposit Insurance Corporation or any similar insurer, except that an accounting firm account may have an uninsured balance provided that the likelihood of the bank, savings and loan, or similar institution experiencing financial difficulties is remote.

(C) Broker-dealer accounts. Brokerage or similar accounts maintained with a broker-dealer that is an audit client, if:

(1) Any such account includes any asset other than cash or securities (within the meaning of “security” provided in the Securities Investor Protection Act of 1970 (“SIPA”) (15 U.S.C. 78aaa et seq.));

(2) The value of assets in the accounts exceeds the amount that is subject to a Securities Investor Protection Corporation advance, for those accounts, under Section 9 of SIPA (15 U.S.C. 78fff-3); or

(3) With respect to non-U.S. accounts not subject to SIPA protection, the value of assets in the accounts exceeds the amount insured or protected by a program similar to SIPA.

(D) Futures commission merchant accounts. Any futures, commodity, or similar account maintained with a futures commission merchant that is an audit client.

(E) Credit cards. Any aggregate outstanding credit card balance owed to a lender that is an audit client that is not reduced to $10,000 or less on a current basis taking into consideration the payment due date and any available grace period.

(F) Insurance products. Any individual policy issued by an insurer that is an audit client unless:

(1) The policy was obtained at a time when the covered person in the firm was not a covered person in the firm; and

(2) The likelihood of the insurer becoming insolvent is remote.

(G) Investment companies. Any financial interest in an entity that is part of an investment company complex that includes an audit client.

(iii) Exceptions. Notwithstanding paragraphs (c)(1)(i) and (c)(1)(ii) of this section, an accountant will not be deemed not independent if:
(A) Inheritance and gift. Any person acquires an unsolicited financial interest, such as through an unsolicited gift or inheritance, that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the financial interest is disposed of as soon as practicable, but no later than 30 days after the person has knowledge of and the right to dispose of the financial interest.

(B) New audit engagement. Any person has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and:

1. The accountant did not audit the client’s financial statements for the immediately preceding fiscal year; and

2. The accountant is independent under paragraph (c)(1)(i) and (c)(1)(ii) of this section before the earlier of:

   i. Signing an initial engagement letter or other agreement to provide audit, review, or attest services to the audit client; or

   ii. Commencing any audit, review, or attest procedures (including planning the audit of the client’s financial statements).

(C) Employee compensation and benefit plans. An immediate family member of a person who is a covered person in the firm only by virtue of paragraphs (f)(11)(iii) or (f)(11)(iv) of this section has a financial interest that would cause an accountant to be not independent under paragraph (c)(1)(i) or (c)(1)(ii) of this section, and the acquisition of the financial interest was an unavoidable consequence of participation in his or her employer’s employee compensation or benefits program, provided that the financial interest, other than unexercised employee stock options, is disposed of as soon as practicable, but no later than 30 days after the person has the right to dispose of the financial interest.

(iv) Audit clients’ financial relationships. An accountant is not independent when:

(A) Investments by the audit client in the accounting firm. An audit client has, or has agreed to acquire, any direct investment in the accounting firm, such as stocks, bonds, notes, options, or other securities, or the audit client’s officers or directors are record or beneficial owners of more than 5% of the equity securities of the accounting firm.

(B) Underwriting. An accounting firm engages an audit client to act as an underwriter, broker-dealer, market-maker, promoter, or analyst with respect to securities issued by the accounting firm.

(2) Employment relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accountant has an employment relationship with an audit client, such as:

(i) Employment at audit client of accountant. A current partner, principal, shareholder, or professional employee of the accounting firm is employed by the audit client.

(ii) Employment at audit client of certain relatives of accountant. A close family member of a covered person in the firm is in an accounting role or financial reporting oversight role at an audit client, or was in such a role during any period covered by an audit for which the covered person in the firm is a covered person.

(iii) Employment at audit client of former employee of accounting firm.

(A) A former partner, principal, shareholder, or professional employee of an accounting firm is in an accounting role or financial reporting oversight role at an audit client, unless the individual:

1. Does not influence the accounting firm’s operations or financial policies;

2. Has no capital balances in the accounting firm; and

3. Has no financial arrangement with the accounting firm other than one providing for regular payment of a fixed dollar amount (which is not dependent on the revenues, profits, or earnings of the accounting firm):

   i. Pursuant to a fully funded retirement plan, rabbi trust, or, in jurisdictions in which a rabbi trust does not exist, a similar vehicle; or

   ii. In the case of a former professional employee who was not a partner, principal, or shareholder of the accounting firm and who has been disassociated from the accounting firm for more than five years, that is immaterial to the former professional employee.

(B) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role at an issuer (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)), except an issuer that is an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), unless the individual:

1. Employed by the issuer was not a member of the audit engagement team of the issuer during the one year period preceding the date that audit procedures
commenced for the fiscal period that included the date of initial employment of the audit engagement team member by the issuer;

(2) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and the concurring partner, who provided ten or fewer hours of audit, review, or attest services during the period covered by paragraph (c)(2)(iii)(B)(1) of this section;

(ii) Individuals employed by the issuer as a result of a business combination between an issuer that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the successor issuer is aware of the prior employment relationship; and

(iii) Individuals that are employed by the issuer due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors;

(3) For purposes of paragraph (c)(2)(iii)(B)(1) of this section, audit procedures are deemed to have commenced for a fiscal period the day following the date of initial employment of the audit engagement team member by the issuer; and

(C) A former partner, principal, shareholder, or professional employee of an accounting firm is in a financial reporting oversight role with respect to an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), if:

(1) The former partner, principal, shareholder, or professional employee of an accounting firm is employed in a financial reporting oversight role related to the operations and financial reporting of the registered investment company at an entity in the investment company complex, as defined in (f)(14) of this section, that includes the registered investment company; and

(2) The former partner, principal, shareholder, or professional employee of an accounting firm employed by the registered investment company or any entity in the investment company complex was a member of the audit engagement team of the registered investment company or any other registered investment company in the investment company complex during the one year period preceding the date that audit procedures commenced that included the date of initial employment of the audit engagement team member by the registered investment company or any entity in the investment company complex.

(3) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, the following individuals are not considered to be members of the audit engagement team:

(i) Persons, other than the lead partner and concurring partner, who provided ten or fewer hours of audit, review or attest services during the period covered by paragraph (c)(2)(iii)(C)(2) of this section;

(ii) Individuals employed by the registered investment company or any entity in the investment company complex as a result of a business combination between a registered investment company or any entity in the investment company complex that is an audit client and the employing entity, provided employment was not in contemplation of the business combination and the audit committee of the registered investment company is aware of the prior employment relationship; and

(iii) Individuals that are employed by the registered investment company or any entity in the investment company complex due to an emergency or other unusual situation provided that the audit committee determines that the relationship is in the interest of investors.

(4) For purposes of paragraph (c)(2)(iii)(C)(2) of this section, audit procedures are deemed to have commenced the day following the filing of the registered investment company’s periodic annual report with the Commission.

(iv) Employment at accounting firm of former employee of audit client. A former officer, director, or employee of an audit client becomes a partner, principal, shareholder, or professional employee of the accounting firm, unless the individual does not participate in, and is not in a position to influence, the audit of the financial statements of the audit client covering any period during which he or she was employed by or associated with that audit client.

(3) Business relationships. An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the audit client in a decision-making capacity, such as an audit client’s officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the accounting firm or covered person in the firm provides professional services to an audit client or is a consumer in the ordinary course of business.

(4) Non-audit services. An accountant is not independent if, at any point during the audit and profes-
sional engagement period, the accountant provides the following non-audit services to an audit client:

(i) Bookkeeping or other services related to the accounting records or financial statements of the audit client. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements, including:

(A) Maintaining or preparing the audit client’s accounting records;

(B) Preparing the audit client’s financial statements that are filed with the Commission or that form the basis of financial statements filed with the Commission; or

(C) Preparing or originating source data underlying the audit client’s financial statements.

(ii) Financial information systems design and implementation. Any service, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements, including:

(A) Directly or indirectly operating, or supervising the operation of, the audit client’s information system or managing the audit client’s local area network; or

(B) Designing or implementing a hardware or software system that aggregates source data underlying the financial statements or generates information that is significant to the audit client’s financial statements or other financial information systems taken as a whole.

(iii) Appraisal or valuation services. Fairness opinions, or contribution-in-kind reports. Any appraisal service, valuation service, or any service involving a fairness opinion or contribution-in-kind report for an audit client, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.

(iv) Actuarial services. Any actuarially oriented advisory service involving the determination of amounts recorded in the financial statements and related accounts for the audit client other than assisting a client in understanding the methods, models, assumptions, and inputs used in computing an amount, unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.

(v) Internal audit outsourcing services. Any internal audit service that has been outsourced by the audit client that relates to the audit client’s internal accounting controls, financial systems, or financial statements, for an audit client unless it is reasonable to conclude that the results of these services will not be subject to audit procedures during an audit of the audit client’s financial statements.

(vi) Management functions. Acting, temporarily or permanently, as a director, officer, or employee of an audit client, or performing any decision-making, supervisory, or ongoing monitoring function for the audit client.

(vii) Human resources.

(A) Searching for or seeking out prospective candidates for managerial, executive, or director positions;

(B) Engaging in psychological testing, or other formal testing or evaluation programs;

(C) Undertaking reference checks of prospective candidates for an executive or director position;

(D) Acting as a negotiator on the audit client’s behalf, such as determining position, status or title, compensation, fringe benefits, or other conditions of employment; or

(E) Recommending, or advising the audit client to hire, a specific candidate for a specific job (except that an accounting firm may, upon request by the audit client, interview candidates and advise the audit client on the candidate’s competence for financial accounting, administrative, or control positions).

(viii) Broker-dealer, investment adviser, or investment banking services. Acting as a broker-dealer (registered or unregistered), promoter, or underwriter, on behalf of an audit client, making investment decisions on behalf of the audit client or otherwise having discretionary authority over an audit client’s investments, executing a transaction to buy or sell an audit client’s investment, or having custody of assets of the audit client, such as taking temporary possession of securities purchased by the audit client.

(ix) Legal services. Providing any service to an audit client that, under circumstances in which the service is provided, could be provided only by someone licensed, admitted, or otherwise qualified to practice law in the jurisdiction in which the service is provided.

(x) Expert services unrelated to the audit. Providing an expert opinion or other expert service for an audit client, or an audit client’s legal representative, for the purpose of advocating an audit client’s interests in litigation or in a regulatory or administrative proceeding or investigation. In any litigation or regulatory or administrative proceeding or investigation, an accountant’s independence shall not be deemed to be impaired if the accountant provides factual ac-
contests, including in testimony, of work performed or explains the positions taken or conclusions reached during the performance of any service provided by the accountant for the audit client.

(5) **Contingent fees.** An accountant is not independent if, at any point during the audit and professional engagement period, the accountant provides any service or product to an audit client for a contingent fee or a commission, or receives a contingent fee or commission from an audit client.

(6) **Partner rotation.**

(i) Except as provided in paragraph (c)(6)(ii) of this section, an accountant is not independent of an audit client when:

(A) Any audit partner as defined in paragraph (f)(7)(ii) of this section performs:

(1) The services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, for more than five consecutive years; or

(2) One or more of the services defined in paragraphs (f)(7)(ii)(C) and (D) of this section for more than seven consecutive years;

(B) Any audit partner:

(1) Within the five consecutive year period following the performance of services for the maximum period permitted under paragraph (c)(6)(ii)(A) of this section, performs for that audit client the services of a lead partner, as defined in paragraph (f)(7)(ii)(A) of this section, or concurring partner, as defined in paragraph (f)(7)(ii)(B) of this section, or a combination of those services, or

(2) Within the two-consecutive-year period following the performance of services for the maximum period permitted under paragraph (c)(6)(ii) of this section, performs one or more of the services defined in paragraph (f)(7)(ii) of this section.

(ii) Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))), other than an issuer that is an Asset-Backed Issuer as defined in §240.13a-14(g) and §240.15d-14(g) of this chapter, or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8), other than a unit investment trust as defined by section 4(2) of the Investment Company Act of 1940 (15 U.S.C. 80a-4(2)), unless:

(i) In accordance with Section 10A(i) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(i)) either:

(A) Before the accountant is engaged by the issuer or its subsidiaries, or the registered investment company or its subsidiaries, to render audit or non-audit services, the engagement is approved by the issuer’s or registered investment company’s audit committee; or

(B) The engagement to render the service is entered into pursuant to pre-approval policies and procedures established by the audit committee of the issuer or registered investment company, provided the policies and procedures are detailed as to the particular service and the audit committee is informed of each service and such policies and procedures do not include delegation of the audit committees responsibilities under the Securities Exchange Act of 1934 to management; or

(C) With respect to the provision of services other than audit, review or attest services the pre-approval requirement is waived if:

(1) The aggregate amount of all such services provided constitutes no more than five percent of the total amount of revenues paid by the audit client to its accountant during the fiscal year in which the services are provided;

(2) Such services were not recognized by the issuer or registered investment company at the time of the engagement to be nonaudit services; and
(3) Such services are promptly brought to the attention of the audit committee of the issuer or registered investment company and approved prior to the completion of the audit by the audit committee or by one or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee.

(ii) A registered investment company’s audit committee also must pre-approve its accountant’s engagements for non-audit services with the registered investment company’s investment adviser (not including a sub-adviser whose role is primarily portfolio management and is sub-contracted or overseen by another investment adviser) and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company in accordance with paragraph (c)(7)(i) of this section, if the engagement relates directly to the operations and financial reporting of the registered investment company, except that with respect to the waiver of the pre-approval requirement under paragraph (c)(7)(i)(C) of this section, the aggregate amount of all services provided constitutes no more than five percent of the total amount of revenues paid to the registered investment company’s accountant by the registered investment company, its investment adviser and any entity controlling, controlled by, or under common control with the investment adviser that provides ongoing services to the registered investment company during the fiscal year in which the services are provided that would have to be pre-approved by the registered investment company’s audit committee pursuant to this section.

(8) Compensation. An accountant is not independent of an audit client if, at any point during the audit and professional engagement period, any audit partner earns or receives compensation based on the audit partner procuring engagements with that audit client to provide any products or services other than audit, review or attest services. Any accounting firm with fewer than ten partners and fewer than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f))) shall be exempt from the requirement stated in the previous sentence.

(d) Quality controls. An accounting firm’s independence will not be impaired solely because a covered person in the firm is not independent of an audit client provided:

(1) The covered person did not know of the circumstances giving rise to the lack of independence;

(2) The covered person’s lack of independence was corrected as promptly as possible under the relevant circumstances after the covered person or accounting firm became aware of it; and

(3) The accounting firm has a quality control system in place that provides reasonable assurance, taking into account the size and nature of the accounting firm’s practice, that the accounting firm and its employees do not lack independence, and that covers at least all employees and associated entities of the accounting firm participating in the engagement, including employees and associated entities located outside of the United States.

(4) For an accounting firm that annually provides audit, review, or attest services to more than 500 companies with a class of securities registered with the Commission under Section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 781), a quality control system will not provide such reasonable assurance unless it has at least the following features:

(i) Written independence policies and procedures;

(ii) With respect to partners and managerial employees, an automated system to identify their investments in securities that might impair the accountant’s independence;

(iii) With respect to all professionals, a system that provides timely information about entities from which the accountant is required to maintain independence;

(iv) An annual or ongoing firm-wide training program about auditor independence;

(v) An annual internal inspection and testing program to monitor adherence to independence requirements;

(vi) Notification to all accounting firm members, officers, directors, and employees of the name and title of the member of senior management responsible for compliance with auditor independence requirements;

(vii) Written policies and procedures requiring all partners and covered persons to report promptly to the accounting firm when they are engaged in employment negotiations with an audit client, and requiring the firm to remove immediately any such professional from that audit client’s engagement and to review promptly all work the professional performed related to that audit client’s engagement; and

(viii) A disciplinary mechanism to ensure compliance with this section.

(e) (1) Transition and grandfathering. Provided the following relationships did not impair the account-
For audit partners other than the “lead” partner:

(i) Employment relationships that commenced at the issuer prior to May 6, 2003 as described in paragraph (c)(2)(iii)(B) of this section.

(ii) Compensation earned or received, as described in paragraph (c)(8) of this section during the fiscal year of the accounting firm that includes the effective date of this section.

(iii) Until May 6, 2004, the provision of services described in paragraph (c)(4) of this section provided those services are pursuant to contracts In existence on May 6, 2003.

(iv) The provision of services by the accountant under contracts in existence on May 6 2003 that have not been pre-approved by the audit committee as described in paragraph (c)(7) of this section.

(v) Until the first day of the issuer’s fiscal year beginning after May 6, 2003 by a “lead” partner and other audit partner (other than the “concurring” partner) providing services in excess of those permitted under paragraph (c)(6) of this section. An accountant’s independence will not be deemed to be impaired until the first day of the Issuer’s fiscal year beginning after May 6, 2004 by a “concurring” partner providing services in excess of those permitted under paragraph (c)(6) of this section. For the purposes of calculating periods of service under paragraph (c)(6) of this section:

(A) For the “lead” and “concurring” partner, the period of service includes time served as the “lead” or “concurring” partner prior to May 6, 2003; and

(B) For audit partners other than the “lead” partner or “concurring” partner, and for audit partners in foreign firms, the period of service does not include time served on the audit engagement team prior to the first day of issuer’s fiscal year beginning on or after May 6, 2003.

(2) Settling financial arrangements with former professionals. To the extent not required by preexisting requirements of the Commission, the Independence Standards Board, or the accounting profession in the United States, the requirement in paragraph (c)(2)(iii) of this section to settle financial arrangements with former professionals applies to situations that arise after the effective date of this section.

(f) Definitions of terms. For purposes of this section:

(1) Accountant, as used in paragraphs (b) through (e) of this section, means a registered public accounting firm, certified public accountant or public accountant performing services in connection with an engagement for which independence is required. References to the accountant include any accounting firm with which the certified public accountant or public accountant is affiliated.

(2) Accounting firm means an organization (whether it is a sole proprietorship, incorporated association, partnership, corporation, limited liability company, limited liability that is engaged in the practice of public accounting and furnishes reports or other documents filed with the Commission or otherwise prepared under the securities laws, and all of the organization’s departments, divisions, parents, subsidiaries, and associated entities, including those located outside of the United States. Accounting firm also includes the organization’s pension, retirement, investment, or similar plans.

(3) (i) Accounting role means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them.

(ii) Financial reporting oversight role means a role in which a person is in a position to or does exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of the board of directors or similar management or governing body, 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 any equivalent position.

(4) Affiliate of the audit client means:

(i) An entity that has control over the audit client, or over which the audit client has control, or which is under common control with the audit client, including the audit client’s parents and subsidiaries;

(ii) An entity over which the audit client has significant influence, unless the entity is not material to the audit client;

(iii) An entity that has significant influence over the audit client, unless the audit client is not material to the entity; and

(iv) Each entity in the investment company complex when the audit client is an entity that is part of an investment company complex.

(5) Audit and professional engagement period includes both:

(i) The period covered by any financial statements being audited or reviewed (the “audit period”); and
(ii) The period of the engagement to audit or review the audit client’s financial statements or to prepare a report filed with the Commission (the “professional engagement period”):

(A) The professional engagement period begins when the accountant either signs an initial engagement letter (or other agreement to review or audit a client’s financial statements) or begins audit, review, or attest procedures, whichever is earlier; and

(B) The professional engagement period ends when the audit client or the accountant notifies the Commission that the client is no longer that accountant’s audit client.

(iii) For audits of the financial statements of foreign private issuers, the “audit and professional engagement period” does not include periods ended prior to the first day of the last fiscal year before the foreign private issuer first filed, or was required to file, a registration statement or report with the Commission, provided there has been full compliance with home country independence standards in all prior periods covered by any registration statement or report filed with the Commission.

(6) Audit client means the entity whose financial statements or other information is being audited, reviewed, or attested and any affiliates of the audit client, other than, for purposes of paragraph (c)(1)(i) of this section, entities that are affiliates of the audit client only by virtue of paragraph (f)(4)(ii) or (f)(4)(iii) of this section.

(7) (i) Audit engagement team means all partners, principals, shareholders and professional employees participating in an audit, review, or attestation engagement of an audit client, including audit partners and all persons who consult with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events.

(ii) Audit partner means a partner or persons in an equivalent position, other than a partner who consults with others on the audit engagement team during the audit, review, or attestation engagement regarding technical or industry-specific issues, transactions, or events, who is a member of the audit engagement team who has responsibility for decision-making on significant auditing, accounting, and reporting matters that affect the financial statements, or who maintains regular contact with management and the audit committee and includes the following:

(A) The lead or coordinating audit partner having primary responsibility for the audit or review (the “lead partner”);

(B) The partner performing a second level of review to provide additional assurance that the financial statements subject to the audit or review are in conformity with generally accepted accounting principles and the audit or review and any associated report are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board (the “concurring or reviewing partner”);

(C) Other audit engagement team partners who provide more than ten hours of audit, review, or attest services in connection with the annual or interim consolidated financial statements of the issuer or an investment company registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a-8); and

(D) Other audit engagement team partners who serve as the “lead partner” in connection with any audit or review related to the annual or interim financial statements of a subsidiary of the issuer whose assets or revenues constitute 20% or more of the assets or revenues of the issuer’s respective consolidated assets or revenues.

(8) Chain of command means all persons who:

(i) Supervise or have direct management responsibility for the audit, including at all successively senior levels through the accounting firm’s chief executive;

(ii) Evaluate the performance or recommend the compensation of the audit engagement partner; or

(iii) Provide quality control or other oversight of the audit.

(9) Close family members means a person’s spouse, spousal equivalent, parent, dependent, nondependent child, and sibling.

(10) Contingent fee means, except as stated in the next sentence, any fee established for the sale of a product or 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 product or service. Solely for the purposes of this section, a fee is not a “contingent fee” if it is 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. Fees may vary depending, for example, on the complexity of services rendered.

(11) Covered persons in the firm means the following partners, principals, shareholders, and employees of an accounting firm:
The “audit engagement team”;  

The “chain of command”;  

Any other partner, principal, shareholder, or managerial employee of the accounting firm who has provided ten or more hours of non-audit services to the audit client for the period beginning on the date such services are provided and ending on the date the accounting firm signs the report on the financial statements for the fiscal year during which those services are provided, or who expects to provide ten or more hours of non-audit services to the audit client on a recurring basis; and  

Any other partner, principal, or shareholder from an “office” of the accounting firm in which the lead audit engagement partner primarily practices in connection with the audit. 

(12) Group means two or more persons who act together for the purposes of acquiring, holding, voting, or disposing of securities of a registrant. 

(13) Immediate family members means a person’s spouse, spousal equivalent, and dependents. 

(14) Investment company complex. 

(i) “Investment company complex” includes: 

(A) An investment company and its investment adviser or sponsor; 

(B) Any entity controlled by or controlling an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section, or any entity under common control with an investment adviser or sponsor in paragraph (f)(14)(i)(A) of this section if the entity: 

(1) Is an investment adviser or sponsor; or 

(2) Is engaged in the business of providing administrative, custodian, underwriting, or transfer agent services to any investment company, investment adviser, or sponsor; and 

(C) Any investment company or entity that would be an investment company but for the exclusions provided by Section 3(c) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)) that has an investment adviser or sponsor included in this definition by either paragraph (f)(14)(i)(A) or (f)(14)(i)(B) of this section. 

(ii) An investment adviser, for purposes of this definition, does not include a sub-adviser whose role is primarily portfolio management and is subcontracted with or overseen by another investment adviser. 

(iii) Sponsor, for purposes of this definition, is an entity that establishes a unit investment trust. 

(15) Office means a distinct sub-group within an account-
Government Accountability
Office

Ethical Principles in Government Auditing

Ethical Principles

1.10 The ethical principles presented in this section provide the foundation, discipline, and structure, as well as the climate that influence the application of GAGAS. This section sets forth fundamental principles rather than establishing specific standards or requirements.

1.11 Because auditing is essential to government accountability to the public, the public expects audit organizations and auditors who conduct their work in accordance with GAGAS to follow ethical principles. Management of the audit organization sets the tone for ethical behavior throughout the organization by maintaining an ethical culture, clearly communicating acceptable behavior and expectations to each employee, and creating an environment that reinforces and encourages ethical behavior throughout all levels of the organization. The ethical tone maintained and demonstrated by management and staff is an essential element of a positive ethical environment for the audit organization.

1.12 Conducting audit work in accordance with ethical principles is a matter of personal and organizational responsibility. Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditors’ report. Integrity and objectivity are maintained when auditors perform their work and make decisions that are consistent with the broader interest of those relying on the auditors’ report, including the public.

1.13 Other ethical requirements or codes of professional conduct may also be applicable to auditors who conduct audits in accordance with GAGAS. For example, individual auditors who are members of professional organizations or are licensed or certified professionals may also be subject to ethical requirements of those professional organizations or licensing bodies. Auditors employed by government entities may also be subject to government ethics laws and regulations.

1.14 The ethical principles that guide the work of auditors who conduct audits in accordance with GAGAS are:

a. the public interest;
b. integrity;
c. objectivity;
d. proper use of government information, resources, and positions; and
e. professional behavior.

The Public Interest

1.15 The public interest is defined as the collective well-being of the community of people and entities the auditors serve. Observing integrity, objectivity, and independence in discharging their professional responsibilities assists auditors in meeting the principle of serving the public interest and honoring the public trust. The principle of the public interest is fundamental to the responsibilities of auditors and critical in the government environment.

1.16 A distinguishing mark of an auditor is acceptance of responsibility to serve the public interest. This responsibility is critical when auditing in the government environment. GAGAS embodies the concept of accountability for public resources, which is fundamental to serving the public interest.

Integrity

1.17 Public confidence in government is maintained and strengthened by auditors performing their professional responsibilities with integrity. Integrity includes auditors conducting their work with an attitude that is objective, fact-based, nonpartisan, and nonideological with regard to audited entities and users of the auditors’ reports. Within the constraints of applicable confidentiality laws, rules, or policies, communications with the audited entity, those charged with governance, and the individuals contracting for or requesting the audit are expected to be honest, candid, and constructive.

1.18 Making decisions consistent with the public interest of the program or activity under audit is an important part of the principle of integrity. In discharging their professional responsibilities, auditors may encounter conflicting pressures from management of the audited entity, various levels of government, and other likely users. Auditors may also encounter pressures to inappropriately achieve personal or organizational gain. In resolving those conflicts and pressures, acting with integrity means that auditors place priority on their responsibilities to the public interest.
Objectivity
1.19 The credibility of auditing in the government sector is based on auditors’ objectivity in discharging their professional responsibilities. Objectivity includes independence of mind and appearance when providing audits, maintaining an attitude of impartiality, having intellectual honesty, and being free of conflicts of interest. Maintaining objectivity includes a continuing assessment of relationships with audited entities and other stakeholders in the context of the auditors’ responsibility to the public. The concepts of objectivity and independence are closely related. Independence impairments impact objectivity.3

Proper Use of Government Information, Resources, and Positions
1.20 Government information, resources, and positions are to be used for official purposes and not inappropriately for the auditor’s personal gain or in a manner contrary to law or detrimental to the legitimate interests of the audited entity or the audit organization. This concept includes the proper handling of sensitive or classified information or resources.

1.21 In the government environment, the public’s right to the transparency of government information has to be balanced with the proper use of that information. In addition, many government programs are subject to laws and regulations dealing with the disclosure of information. To accomplish this balance, exercising discretion in the use of information acquired in the course of auditors’ duties is an important part in achieving this goal. Improperly disclosing any such information to third parties is not an acceptable practice.

1.22 Accountability to the public for the proper use and prudent management of government resources is an essential part of auditors’ responsibilities. Protecting and conserving government resources and using them appropriately for authorized activities is an important element in the public’s expectations for auditors.

1.23 Misusing the position of an auditor for financial gain or other benefits violates an auditor’s fundamental responsibilities. An auditor’s credibility can be damaged by actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an auditor’s personal financial interests or those of an immediate or close family member; a general partner; an organization for which the auditor serves as an officer, director, trustee, or employee; or an organization with which the auditor is negotiating concerning future employment.

Professional Behavior
1.24 High expectations for the auditing profession include compliance with all relevant legal, regulatory, and professional obligations and avoidance of any conduct that might bring discredit to auditors’ work, including actions that would cause an objective third party with knowledge of the relevant information to conclude that the auditors’ work was professionally deficient. Professional behavior includes auditors putting forth an honest effort in performance of their duties and professional services in accordance with the relevant technical and professional standards.

General Standards

Introduction
3.01 This chapter establishes general standards and provides guidance for performing financial audits, attestation engagements, and performance audits under generally accepted government auditing standards (GAGAS). These general standards, along with the overarching ethical principles presented in chapter 1, establish a foundation for the credibility of auditors’ work. These general standards emphasize the importance of the independence of the audit organization and its individual auditors; the exercise of professional judgment in the performance of work and the preparation of related reports; the competence of staff; and quality control and assurance.

Independence
3.02 In all matters relating to the audit work, the audit organization and the individual auditor, whether government or public, must be independent.

3.03 Independence comprises:

a. Independence of Mind
The state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

b. Independence in Appearance
The absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

3.04 Auditors and audit organizations maintain independence so that their opinions, findings, conclusions, judgments, and recommendations will be impartial and
viewed as impartial by reasonable and informed third parties. Auditors should avoid situations that could lead reasonable and informed third parties to conclude that the auditors are not independent and thus are not capable of exercising objective and impartial judgment on all issues associated with conducting the audit and reporting on the work.

3.05 Except under the limited circumstances discussed in paragraphs 3.47 and 3.48, auditors should be independent from an audited entity during:

a. any period of time that falls within the period covered by the financial statements or subject matter of the audit, and

b. the period of the professional engagement, which begins when the auditors either sign an initial engagement letter or other agreement to perform an audit or begin to perform an audit, whichever is earlier. The period lasts for the entire duration of the professional relationship (which, for recurring audits, could cover many periods) and ends with the formal or informal notification, either by the auditors or the audited entity, of the termination of the professional relationship or by the issuance of a report, whichever is later. Accordingly, the period of professional engagement does not necessarily end with the issuance of a report and recommence with the beginning of the following year’s audit or a subsequent audit with a similar objective.

3.06 GAGAS’s practical consideration of independence consists of four interrelated sections, providing:

a. a conceptual framework for making independence determinations based on facts and circumstances that are often unique to specific environments;

b. requirements for and guidance on independence for audit organizations that are structurally located within the entities they audit;

c. requirements for and guidance on independence for auditors performing nonaudit services, including indication of specific nonaudit services that always impair independence and others that would not normally impair independence; and

d. requirements for and guidance on documentation necessary to support adequate consideration of auditor independence.

GAGAS Conceptual Framework Approach to Independence

3.07 Many different circumstances, or combinations of circumstances, are relevant in evaluating threats to independence. Therefore, GAGAS establishes a conceptual framework that auditors use to identify, evaluate, and apply safeguards to address threats to independence. The conceptual framework assists auditors in maintaining both independence of mind and independence in appearance. It can be applied to many variations in circumstances that create threats to independence and allows auditors to address threats to independence that result from activities that are not specifically prohibited by GAGAS.

3.08 Auditors should apply the conceptual framework at the audit organization, audit, and individual auditor levels to:

a. identify threats to independence;

b. evaluate the significance of the threats identified, both individually and in the aggregate; and

c. apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level.

3.09 If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

3.10 The use of the term “audit organization” in GAGAS is described in paragraph 1.07. For consideration of auditor independence, offices or units of an audit organization, or related or affiliated entities under common control, are not differentiated from one another. Consequently, for the purposes of independence evaluation using the conceptual framework, an audit organization that includes multiple offices or units, or includes multiple entities related or affiliated through common control, is considered to be one audit organization. Common ownership may also affect independence in appearance regardless of the level of control.

3.11 The GAGAS section on nonaudit services in paragraphs 3.33 through 3.58 provides requirements and guidance on evaluating threats to independence related to nonaudit services provided by auditors to audited entities. That section also enumerates specific nonaudit services that always impair auditor independence with respect to audited entities and that auditors are prohibited from providing to audited entities.

3.12 The following sections discuss threats to independence, safeguards or controls to eliminate or reduce threats, and application of the conceptual framework for independence.

Threats

3.13 Threats to independence are circumstances that could impair independence. Whether independence is impaired depends on the nature of the threat, whether

4. See Appendix II for a flowchart to assist in the application of the conceptual framework for independence.
the threat is of such significance that it would compromise an auditor’s professional judgment or create the appearance that the auditor’s professional judgment may be compromised, and on the specific safeguards applied to eliminate the threat or reduce it to an acceptable level. Threats are conditions to be evaluated using the conceptual framework. Threats do not necessarily impair independence.

3.14 Threats to independence may be created by a wide range of relationships and circumstances. Auditors should evaluate the following broad categories of threats to independence when threats are being identified and evaluated:

a. Self-interest threat—the threat that a financial or other interest will inappropriately influence an auditor’s judgment or behavior;
b. Self-review threat—the threat that an auditor or audit organization that has provided nonaudit services will not appropriately evaluate the results of previous judgments made or services performed as part of the nonaudit services when forming a judgment significant to an audit;
c. Bias threat—the threat that an auditor will, as a result of political, ideological, social, or other convictions, take a position that is not objective;
d. Familiarity threat—the threat that aspects of a relationship with management or personnel of an audited entity, such as a close or long relationship, or that of an immediate or close family member, will lead an auditor to take a position that is not objective;
e. Undue influence threat—the threat that external influences or pressures will impact an auditor’s ability to make independent and objective judgments;
f. Management participation threat—the threat that results from an auditor’s taking on the role of management or otherwise performing management functions on behalf of the entity undergoing an audit; and
g. Structural threat—the threat that an audit organization’s placement within a government entity, in combination with the structure of the government entity being audited, will impact the audit organization’s ability to perform work and report results objectively.

3.15 Circumstances that result in a threat to independence in one of the above categories may result in other threats as well. For example, a circumstance resulting in a structural threat to independence may also expose auditors to undue influence and management participation threats.

Safeguards

3.16 Safeguards are controls designed to eliminate or reduce to an acceptable level threats to independence. Under the conceptual framework, the auditor applies safeguards that address the specific facts and circumstances under which threats to independence exist. In some cases, multiple safeguards may be necessary to address a threat. The list of safeguards in this section provides examples that may be effective under certain circumstances. The list cannot provide safeguards for all circumstances. It may, however, provide a starting point for auditors who have identified threats to independence and are considering what safeguards could eliminate those threats or reduce them to an acceptable level.

3.17 Examples of safeguards include:

a. consulting an independent third party, such as a professional organization, a professional regulatory body, or another auditor;
b. involving another audit organization to perform or reperform part of the audit;
c. having a professional staff member who was not a member of the audit team review the work performed; and
d. removing an individual from an audit team when that individual’s financial or other interests or relationships pose a threat to independence.

3.18 Depending on the nature of the audit, an auditor may also be able to place limited reliance on safeguards that the entity has implemented. It is not possible to rely solely on such safeguards to eliminate threats or reduce them to an acceptable level.

3.19 Examples of safeguards within the entity’s systems and procedures include:

a. an entity requirement that persons other than management ratify or approve the appointment of an audit organization to perform an audit;
b. internal procedures at the entity that ensure objective choices in commissioning nonaudit services; and
c. a governance structure at the entity that provides appropriate oversight and communications regarding the audit organization’s services.

Application of the Conceptual Framework

3.20 Auditors should evaluate threats to independence using the conceptual framework when the facts and circumstances under which the auditors perform their work may create or augment threats to independence. Auditors should evaluate threats both individually and in the ag-
3.21 Facts and circumstances that create threats to independence can result from events such as the start of a new audit; assignment of new staff to an ongoing audit; and acceptance of a nonaudit service at an audited entity. Many other events can result in threats to independence. Auditors use professional judgment to determine whether the facts and circumstances created by an event warrant use of the conceptual framework. Whenever relevant new information about a threat to independence comes to the attention of the auditor during the audit, the auditor should evaluate the significance of the threat in accordance with the conceptual framework.

3.22 Auditors should determine whether identified threats to independence are at an acceptable level or have been eliminated or reduced to an acceptable level. A threat to independence is not acceptable if it either (a) could impact the auditor’s ability to perform an audit without being affected by influences that compromise professional judgment or (b) could expose the auditor or audit organization to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization, or a member of the audit team, had been compromised.

3.23 When an auditor identifies threats to independence and, based on an evaluation of those threats, determines that they are not at an acceptable level, the auditor should determine whether appropriate safeguards are available and can be applied to eliminate the threats or reduce them to an acceptable level. The auditor should exercise professional judgment in making that determination, and should take into account whether both independence of mind and independence in appearance are maintained. The auditor should evaluate both qualitative and quantitative factors when determining the significance of a threat.

3.24 In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the auditors should document the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

3.25 Certain conditions may lead to threats that are so significant that they cannot be eliminated or reduced to an acceptable level through the application of safeguards, resulting in impaired independence. Under such conditions, auditors should decline to perform a prospective audit or terminate an audit in progress.6

3.26 If a threat to independence is initially identified after the auditors’ report is issued, the auditor should evaluate the threat’s impact on the audit and on GAGAS compliance. If the auditors determine that the newly identified threat had an impact on the audit that would have resulted in the auditors’ report being different from the report issued had the auditors been aware of it, they should communicate in the same manner as that used to originally distribute the report to those charged with governance, the appropriate officials of the audited entity, the appropriate officials of the organizations requiring or arranging for the audits, and other known users, so that they do not continue to rely on findings or conclusions that were impacted by the threat to independence. If the report was previously posted to the auditors’ publicly accessible website, the auditors should remove the report and post a public notification that the report was removed. The auditors should then determine whether to conduct additional audit work necessary to reissue the report, including any revised findings or conclusions or repost the original report if the additional audit work does not result in a change in findings or conclusions.

Government Auditors and Audit Organization Structure

3.27 The ability of audit organizations in government entities to perform work and report the results objectively can be affected by placement within government and the structure of the government entity being audited. The independence standard applies to auditors in government entities whether they report to third parties externally (external auditors), to senior management within the audited entity (internal auditors), or to both.

External Auditor Independence

3.28 Audit organizations that are structurally located within government entities are often subject to constitutional or statutory safeguards that mitigate the effects of structural threats to independence. For external audit organizations, such safeguards may include governmental structures under which a government audit organization is:

a. at a level of government other than the one of which the audited entity is part (federal, state, or local); for example, federal auditors auditing a state government program; or
b. placed within a different branch of government from that of the audited entity; for example, legislative auditors auditing an executive branch program.

3.29 Safeguards other than those described above may mitigate threats resulting from governmental structures. For external auditors or auditors who report both externally and internally, structural threats may be mitigated if

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6. See paragraph 3.44 for a discussion of conditions under which an auditor may be required by law or regulation to perform both an audit and a nonaudit service and cannot decline to perform or terminate the service. See the discussion of nonaudit services beginning in paragraph 3.45 for consideration of threats related to nonaudit services that cannot be eliminated or reduced to an appropriate level.
the head of an audit organization meets any of the following criteria in accordance with constitutional or statutory requirements:

a. directly elected by voters of the jurisdiction being audited;
b. elected or appointed by a legislative body, subject to removal by a legislative body, and reports the results of audits to and is accountable to a legislative body;
c. appointed by someone other than a legislative body, so long as the appointment is confirmed by a legislative body and removal from the position is subject to oversight or approval by a legislative body, and reports the results of audits to and is accountable to a legislative body; or
d. appointed by, accountable to, reports to, and can only be removed by a statutorily created governing body, the majority of whose members are independently elected or appointed and are outside the organization being audited.

3.30 In addition to the criteria in paragraphs 3.28 and 3.29, GAGAS recognizes that there may be other organizational structures under which external audit organizations in government entities could be considered to be independent. If appropriately designed and implemented, these structures provide safeguards that prevent the audited entity from interfering with the audit organization’s ability to perform the work and report the results impartially. For an external audit organization or one that reports both externally and internally to be considered independent under a structure different from the ones listed in paragraphs 3.28 and 3.29, the audit organization should have all of the following safeguards. In such situations, the audit organization should document how each of the following safeguards was satisfied and provide the documentation to those performing quality control monitoring and to the external peer reviewers to determine whether all the necessary safeguards are in place. The following safeguards may also be used to augment those listed in paragraphs 3.28 and 3.29:

a. statutory protections that prevent the audited entity from abolishing the audit organization;
b. statutory protections that require that if the head of the audit organization is removed from office, the head of the agency reports this fact and the reasons for the removal to the legislative body;
c. statutory protections that prevent the audited entity from interfering with the initiation, scope, timing, and completion of any audit;
d. statutory protections that prevent the audited entity from interfering with audit reporting, including the findings and conclusions or the manner, means, or timing of the audit organization’s reports;
e. statutory protections that require the audit organization to report to a legislative body or other independent governing body on a recurring basis;
f. statutory protections that give the audit organization sole authority over the selection, retention, advancement, and dismissal of its staff; and
g. statutory access to records and documents related to the agency, program, or function being audited and access to government officials or other individuals as needed to conduct the audit.

Internal Auditor Independence

3.31 Certain entities employ auditors to work for entity management. These auditors may be subject to administrative direction from persons involved in the entity management process. Such audit organizations are internal audit functions and are encouraged to use the Institute of Internal Auditors (IIA) International Standards for the Professional Practice of Internal Auditing in conjunction with GAGAS. In accordance with GAGAS, internal auditors who work under the direction of the audited entity’s management are considered independent for the purposes of reporting internally if the head of the audit organization meets all of the following criteria:

a. is accountable to the head or deputy head of the government entity or to those charged with governance;
b. reports the audit results both to the head or deputy head of the government entity and to those charged with governance;
c. is located organizationally outside the staff or line-management function of the unit under audit;
d. has access to those charged with governance; and
e. is sufficiently removed from political pressures to conduct audits and report findings, opinions, and conclusions objectively without fear of political reprisal.

3.32 When internal audit organizations perform audits of external parties such as auditing contractors or outside party agreements, and no impairments to independence exist, the audit organization can be considered independent as an external audit organization of those external parties.

Provision of Nonaudit Services to Audited Entities

3.33 Auditors have traditionally provided a range of nonaudit services that are consistent with their skills and expertise to entities at which they perform audits. Providing such nonaudit services may create threats to an auditor’s independence.
Requirements for Performing Nonaudit Services

3.34 Before an auditor agrees to provide a nonaudit service to an audited entity, the auditor should determine whether providing such a service would create a threat to independence, either by itself or in aggregate with other nonaudit services provided, with respect to any GAGAS audit it performs. A critical component of this determination is consideration of management’s ability to effectively oversee the nonaudit service to be performed.

The auditor should determine that the audited entity has designated an individual who possesses suitable skill, knowledge, or experience, and that the individual understands the services to be performed sufficiently to oversee them. The individual is not required to possess the expertise to perform or reperform the services. The auditor should document consideration of management’s ability to effectively oversee nonaudit services to be performed.

3.35 If an auditor were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could reduce them to an acceptable level. Management responsibilities involve leading and directing an entity, including making decisions regarding the acquisition, deployment and control of human, financial, physical, and intangible resources.

3.36 Whether an activity is a management responsibility depends on the facts and circumstances and auditors exercise professional judgment in identifying these activities. Examples of activities that are considered management responsibilities and would therefore impair independence if performed for an audited entity include:

a. setting policies and strategic direction for the audited entity;

b. directing and accepting responsibility for the actions of the audited entity’s employees in the performance of their routine, recurring activities;

c. having custody of an audited entity’s assets;

d. reporting to those charged with governance on behalf of management;

e. deciding which of the auditor’s or outside third party’s recommendations to implement;

f. accepting responsibility for the management of an audited entity’s project;

g. accepting responsibility for designing, implementing, or maintaining internal control;

h. providing services that are intended to be used as management’s primary basis for making decisions that are significant to the subject matter of the audit;

i. developing an audited entity’s performance measurement system when that system is material or significant to the subject matter of the audit; and

j. serving as a voting member of an audited entity’s management committee or board of directors.

3.37 Auditors performing nonaudit services for entities for which they perform audits should obtain assurance that audited entity management performs the following functions in connection with the nonaudit services:

a. assumes all management responsibilities;

b. oversees the services, by designating an individual, preferably within senior management, who possess suitable skill, knowledge, or experience;

c. evaluates the adequacy and results of the services performed; and

d. accepts responsibility for the results of the services.

3.38 In cases where the audited entity is unable or unwilling to assume these responsibilities (for example, the audited entity does not have an individual with suitable skill, knowledge, or experience to oversee the nonaudit services provided, or is unwilling to perform such functions due to lack of time or desire), the auditor’s provision of these services would impair independence.

3.39 In connection with nonaudit services, auditors should establish and document their understanding with the audited entity’s management or those charged with governance, as appropriate, regarding the following:

a. objectives of the nonaudit service;

b. services to be performed;

c. audited entity’s acceptance of its responsibilities;

d. the auditor’s responsibilities; and

e. any limitations of the nonaudit service.

3.40 Routine activities performed by auditors that relate directly to the performance of an audit, such as providing advice and responding to questions as part of an audit, are not considered nonaudit services under GAGAS. Such routine activities generally involve providing advice or assistance to the entity on an informal basis as part of an audit. Routine activities typically are insignificant in terms of time incurred or resources expended and generally do not result in a specific project or engagement or in the auditors producing a formal report or other formal work product. However, activities such as financial statement preparation, cash to accrual conversions, and reconciliations are considered nonaudit services under GAGAS, not routine activities related to

7. See paragraph 3.34 for additional discussion of management’s ability to effectively oversee the nonaudit service.
the performance of an audit, and are evaluated using the conceptual framework as discussed in paragraph 3.46.

3.41 Routine activities directly related to an audit include the following:

a. providing advice to the audited entity on an accounting matter as an ancillary part of the overall financial audit;
b. researching and responding to the audited entity’s technical questions on relevant tax laws as an ancillary part of providing tax services;
c. providing advice to the audited entity on routine business matters;
d. educating the audited entity on matters within the technical expertise of the auditors; and
e. providing information to the audited entity that is readily available to the auditors, such as best practices and benchmarking studies.

3.42 An auditor who previously performed nonaudit services for an entity that is a prospective subject of an audit should evaluate the impact of those nonaudit services on independence before accepting an audit. If the nonaudit services were performed in the period to be covered by the audit, the auditor should (1) determine if the nonaudit service is expressly prohibited by GAGAS and, if not, (2) determine whether a threat to independence exists and address any threats noted in accordance with the conceptual framework.

3.43 Nonaudit services provided by auditors can impact independence of mind and in appearance in periods subsequent to the period in which the nonaudit service was provided. For example, if auditors have designed and implemented an accounting and financial reporting system that is expected to be in place for many years, a threat to independence in appearance for future financial audits or attestation engagements performed by those auditors may exist in subsequent periods. For recurring audits, having another independent audit organization perform an audit of the areas affected by the nonaudit service may provide a safeguard that allows the audit organization that provided the nonaudit service to mitigate the threat to its independence. Auditors use professional judgment to determine whether the safeguards adequately mitigate the threats.

3.44 An auditor in a government entity may be required to perform a nonaudit service that could impair the auditor’s independence with respect to a required audit. If the auditor cannot, as a consequence of constitutional or statutory requirements over which the auditor has no control, implement safeguards to reduce the resulting threat to an acceptable level, or decline to perform or terminate a nonaudit service that is incompatible with audit responsibilities, the auditor should disclose the nature of the threat that could not be eliminated or reduced to an acceptable level and modify the GAGAS compliance statement accordingly.8

Consideration of Specific Nonaudit Services

3.45 By their nature, certain nonaudit services directly support the entity’s operations and impair auditors’ ability to maintain independence in mind and appearance. The nonaudit services discussed below are among those frequently requested of auditors working in a government environment. Some aspects of these services will impair an auditor’s ability to perform audits for the entities for which the services are provided. The specific services indicated are not the only nonaudit services that would impair an auditor’s independence.

3.46 Auditors may be able to provide nonaudit services in the broad areas indicated in paragraphs 3.49 through 3.58 without impairing independence if (1) the nonaudit services are not expressly prohibited, (2) the auditor has determined that the requirements for performing nonaudit services in paragraphs 3.34 through 3.44 have been met, and (3) any significant threats to independence have been eliminated or reduced to an acceptable level through the application of safeguards. Auditors should use the conceptual framework to evaluate independence given the facts and circumstances of individual services not specifically prohibited in this section.

3.47 For performance audits and agreed-upon procedures engagements, nonaudit services that are otherwise prohibited by GAGAS may be provided when such services do not relate to the specific subject matter of the engagement.

3.48 For financial statement audits and examination or review engagements, a nonaudit service performed during the period covered by the financial statements may not impair an auditor’s independence with respect to those financial statements provided that the following conditions exist:

a. the nonaudit service was provided prior to the period of professional engagement;
b. the nonaudit service related only to periods prior to the period covered by the financial statements; and
c. the financial statements for the period to which the nonaudit service did relate were audited by another auditor (or in the case of an examination or review engagement, examined, reviewed, or audited by another auditor as appropriate).

8. See paragraphs 2.24 and 2.25 for the discussion of modifications to the GAGAS compliance statement.
**Management Responsibilities**

3.49 If performed on behalf of an audited entity by the entity’s auditor, management responsibilities such as those listed in paragraph 3.36 would create management participation threats so significant that no safeguards could reduce them to an acceptable level. Consequently the auditor’s independence would be impaired with respect to that entity.

**Preparing Accounting Records and Financial Statements**

3.50 Some services involving preparation of accounting records always impair an auditor’s independence with respect to an audited entity. These services include:

a. determining or changing journal entries, account codes or classifications for transactions, or other accounting records for the entity without obtaining management’s approval;

b. authorizing or approving the entity’s transactions; and

c. preparing or making changes to source documents without management approval. Source documents include those providing evidence that transactions have occurred (for example, purchase orders, payroll time records, customer orders, and contracts). Such records also include an audited entity’s general ledger and subsidiary records or equivalent.

3.51 Management is responsible for the preparation and fair presentation of the financial statements in accordance with the applicable financial reporting framework, even if the auditor assisted in drafting those financial statements. Consequently, an auditor’s acceptance of responsibility for the preparation and fair presentation of financial statements that the auditor will subsequently audit would impair the auditor’s independence.

3.52 Services related to preparing accounting records and financial statements that an auditor may be able to provide to an audited entity if the conditions in paragraph 3.46 are met include:

a. recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an audited entity’s general ledger;

b. preparing financial statements based on information in the trial balance;

c. posting entries that have been approved by an audited entity’s management to the entity’s trial balance;

d. preparing account reconciliations that identify reconciling items for the audited entity management’s evaluation; and

e. proposing standard, adjusting, or correcting journal entries or other changes affecting the financial statements to an audited entity’s management provided management reviews and accepts the entries and the auditor is satisfied that management understands the nature of the proposed entries and the impact the entries have on the financial statements.

**Internal Audit Assistance Services Provided by External Auditors**

3.53 Internal audit assistance services involve assisting an entity in the performance of its internal audit activities. Certain internal audit assistance activities always impair an external auditor’s independence with respect to an audited entity. These activities include:

a. setting internal audit policies or the strategic direction of internal audit activities;

b. performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges; and

c. determining the scope of the internal audit function and resulting work.

**Internal Control Monitoring as a Nonaudit Service**

3.54 Accepting responsibility for designing, implementing or maintaining internal control includes accepting responsibility for designing, implementing, or maintaining monitoring procedures. Monitoring involves the use of either ongoing monitoring procedures or separate evaluations to gather and analyze persuasive information supporting conclusions about the effectiveness of the internal control system. Ongoing monitoring procedures performed on behalf of management are built into the routine, recurring operating activities of an organization. Therefore, the management participation threat created if an auditor performs or supervises ongoing monitoring procedures is so significant that no safeguards could reduce the threat to an acceptable level.

3.55 Separate evaluations are sometimes performed as nonaudit services by individuals who are not directly involved in the operation of the controls being monitored. As such, it is possible for an auditor to provide an objective analysis of control effectiveness by performing separate evaluations without creating a management participation threat that would impair independence. However, in all such cases, the significance of the threat created by performing separate evaluations should be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level.

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9. See A.03 and A.04 for a discussion of internal control.
Auditors should assess the frequency of the separate evaluations as well as the scope or extent of the controls (in relation to the scope of the audit performed) being tested when evaluating the significance of the threat. An evaluation prepared as a nonaudit service is not a substitute for audit procedures in a GAGAS audit.

**Information Technology Systems Services**

3.56 Services related to information technology (IT) systems include the design or implementation of hardware or software systems. The systems may aggregate source data, form part of the internal control over the subject matter of the audit, or generate information that affects the subject matter of the audit. IT services that would impair independence if provided by an audit organization to an audited entity include:

a. designing or developing a financial or other IT system that will play a significant role in the management of an area of operations that is or will be the subject matter of an audit;
b. providing services that entail making other than insignificant modifications to the source code underlying such a system; and
c. operating or supervising the operation of such a system.

**Valuation Services**

3.57 A valuation comprises the making of assumptions with regard to future developments, the application of appropriate methodologies and techniques, and the combination of both to compute a certain value, or range of values, for an asset, a liability, or an entity as a whole. If an audit organization provides valuation services to an audited entity and the valuations would have a material effect, separately or in the aggregate, on the financial statements or other information on which it is reporting, and the valuation involves a significant degree of subjectivity, the audit organization’s independence would be impaired.

**Other Nonaudit Services**

3.58 Provision of certain other nonaudit services always impairs an external auditor’s independence with respect to an audited entity. These activities include:

a. Non tax disbursement—prohibited nonaudit services
   (1) Accepting responsibility to authorize payment of audited entity funds, electronically or otherwise.
   (2) Accepting responsibility for signing or co-signing audited entity checks, even if only in emergency situations.
   (3) Maintaining an audited entity’s bank account or otherwise having custody of an audited entity’s funds or making credit or banking decisions for the audited entity.
   (4) Approving vendor invoices for payment.

b. Benefit plan administration—prohibited nonaudit services
   (1) Making policy decisions on behalf of audited entity management.
   (2) When dealing with plan participants, interpreting the plan document on behalf of management without first obtaining management’s concurrence.
   (3) Making disbursements on behalf of the plan.
   (4) Having custody of a plan’s assets.
   (5) Serving a plan as a fiduciary as defined by the Employee Retirement Income Security Act (ERISA).

c. Investment—advisory or management—prohibited nonaudit services
   (1) Making investment decisions on behalf of audited entity management or otherwise having discretionary authority over an audited entity’s investments.
   (2) Executing a transaction to buy or sell an audited entity’s investment.
   (3) Having custody of an audited entity’s assets, such as taking temporary possession of securities purchased by an audited entity.

d. Corporate finance—consulting or advisory—prohibited nonaudit services
   (1) Committing the audited entity to the terms of a transaction or consummating a transaction on behalf of the audited entity.
   (2) Acting as a promoter, underwriter, broker-dealer, or guarantor of audited entity securities, or distributor of private placement memoranda or offering documents.
   (3) Maintaining custody of an audited entity’s securities.

e. Executive or employee personnel matters—prohibited nonaudit services
   (1) Committing the audited entity to employee compensation or benefit arrangements.
   (2) Hiring or terminating audited entity employees.
f. Business risk consulting—prohibited nonaudit services
   (1) Making or approving business risk decisions.
   (2) Presenting business risk considerations to those charged with governance or others on behalf of management.

Documentation

3.59 Documentation of independence considerations provides evidence of the auditor’s judgments in forming conclusions regarding compliance with independence requirements. GAGAS contains specific requirements for documentation related to independence which may be in addition to the documentation that auditors have previously maintained. While insufficient documentation of an auditor’s compliance with the independence standard does not impair independence, appropriate documentation is required under the GAGAS quality control and assurance requirements. The independence standard includes the following documentation requirements:

a. document threats to independence that require the application of safeguards, along with safeguards applied, in accordance with the conceptual framework for independence as required by paragraph 3.24;

b. document the safeguards required by paragraph 3.30 if an audit organization is structurally located within a government entity and is considered independent based on those safeguards;

c. document consideration of audited entity management’s ability to effectively oversee a nonaudit service to be provided by the auditor as indicated in paragraph 3.34; and

d. document the auditor’s understanding with an audited entity for which the auditor will perform a nonaudit service as indicated in paragraph 3.39.

10. See paragraph 3.84 for additional discussion of documenting compliance with quality control policies and procedures and paragraph 3.88 for additional discussion of policies and procedures on and ethical requirements independence, legal,
Chapter Questions

1. SEC independence rules apply to the ___________.
   (a) audits of all privately held companies.
   (b) audits of all publicly held companies.
   (c) audits of all publicly held and privately held companies.

2. May a public accounting firm ever receive from a publicly held audit client a contingent fee or commission (as those terms are defined in the SEC rules) without impairing the accounting firm’s independence with that client?
   (a) Yes
   (b) No

3. When the client is required to file its financial statements with the SEC
   (a) the outside auditor cannot prepare any of the accounting records.
   (b) the outside auditor may prepare the accounting record for up to 10 percent of the U.S. operations.
   (c) the outside auditor may prepare the accounting records for foreign operations under certain conditions.

4. Which of the following groups in the public accounting firm would not be called covered persons, as that word is defined by the SEC?
   (a) Tax and consulting partners in the office handling the audit engagement.
   (b) Professional staff below the managerial level who do not work on the audit engagement but have furnished 10 or more hours of non-audit services to the client during the year under audit.
   (c) Professional staff below the managerial level who work on the audit engagement.
   (d) All of the above are considered covered persons.

5. Company A and Company B, both SEC reporting companies, each own 50% of Company C. The investment in Company C is not material to Company A but is material to Company B. Jones & Brown audit Company A while Smith and Co. audit Company C. A partner in Smith and Co. (a one-office CPA firm) has an immaterial direct investment in nonclient Company B. Under SEC rules this investment _______ impair Smith and Co.’s independence with Company C.
   (a) will
   (b) will not

6. CPAs audit an entity that must file its audit reports with the Government Accountability Office. In addition to the audit they provide some nonaudit work that is neither significant nor material to the audited financial statements. Barnes, a semi-senior at Smith & Smith CPAs, did most of this nonaudit work for 2002. He along with others is assigned to work on the 2002 annual audit for this entity. If Barnes works on the 2002 audit
   (a) The independence of Smith & Smith, CPAs would be impaired
   (b) It would have no effect on the independence of Smith & Smith CPAs.

7. Jones & Co. audits an entity that files its audit reports with the Government Accountability Office. Management of the entity has asked Jones & Co. to provide payroll services for the calendar year 2004. They would be computing pay based on approved time cards, generating unsigned pay checks and other clerical functions. The payroll is a material amount of the expenses of this entity. Doing this payroll work for 2004
   (a) will have no effect on independence of Jones & Co. with this entity.
   (b) will impair independence of Jones & Co. with this entity.

8. A registered public accounting firm audits a publicly held company that is required to file its financial statements with the SEC. During the audit and professional engagement period, the public accounting firm may furnish tax services to the following persons connected with this company without impairing their independence with the company.
   (a) The president of the company
   (b) The chief financial officer of the company
   (c) A member of the board of directors. She is also the dean of a large university
   (d) All of the above
   (e) None of the above

9. Ethics rules promulgated by the PCAOB must be approved by:
   (a) The GAO
   (b) The SEC
   (c) The IRS
   (d) They do not need the approval of any other governmental agency.
Chapter Answers

1. (b) is correct. SEC rules apply only to the auditors of companies whose reports must be filed with the SEC. This would normally be publicly held companies (SEC Rules).

(a) and (c) are incorrect because privately held companies normally do not have their reports filed with the SEC.

2. (b) is correct. An accountant is not independent if he receives a commission or a contingent fee during the professional engagement period (Rule 2-01(c) (5)). The professional engagement period begins when the first signs an engagement letter or starts the audit and ends when the SEC is notified that the client is no longer that accountant’s audit client (Rule 2-01(f) (5) (ii) (A&B)).

3. (a) is correct. The auditor, basically, cannot do any bookkeeping and remain independent. Rule 2-01 (c) (4) (i).

(b) is incorrect because there never was an exception like this.

(c) is now incorrect. Until the latest change in SEC rules to comply with the Sarbanes–Oxley law, an accountant could provide bookkeeping services for a foreign subsidiary if the subsidiary was not material, services were routine, and the subsidiary did not have an employee capable of doing the bookkeeping, etc.

4. (b) is correct. Staff below manager who provides 10 or more hours of non-audit services are not covered persons. If they were managers or above, they would be covered persons (Rule 2-01(f) (11) (iii)).

(a) is incorrect since all partners in the office doing the work are covered persons (Rule 2-01 (f) (11) (iv)).

(c) is incorrect since all who work on the audit are covered persons (Rule 2-01 (f) (11) (i)).

5. (a) is correct. An immaterial direct investment in a company that has a material investment in audit client impairs independence with audit client (Rule 2-01(c)(1)(i)(E)(1)(ii) and 2-01(c)(1)(i)(E)(3)).

6. (a) is correct. Smith & Smith, CPAs independence is impaired since Barnes would be helping to audit his own work (GAO’s Standard 3.50).

7. (b) is correct. Independence will be impaired if they do this payroll work, even with management approved time records, because payroll is computed and records prepared by the audit firm (GAO’s Standard 3.50).

8. (c) is correct. Under the PCAOB Rule 3523 (a), they may furnish tax services to her because she is in a financial reporting oversight role solely because of her membership on the board of directors. Being the dean of a large university, she would not have any other position with this company. This rule states that furnishing tax services for other persons in a financial oversight reporting role would impair independence with the client. The definition of financial reporting oversight role mentions president and chief financial officer as having such a role.

9. (b) is correct. The SEC must approve PCAOB ethics rules.
Chapter 6

General and Technical Standards

General Standards
The following four general standards apply to professional services:

• Professional competence
• Due professional care
• Planning and supervision
• Sufficient relevant data

They are applicable, as appropriate, to all members—whether or not they are in the practice of public accounting.

Competence as an Ethical Obligation
For years, American physicians have been paying ever increasing rates for malpractice insurance. More recently CPAs have joined this class with their professional liability insurance having higher premiums, higher deductibles and lower limits of coverage. One of the primary factors for both the doctors and CPAs has been the increased number of claims and the tendency for higher settlements and larger jury awards. Courts are enforcing the concept that those who offer service to the public, especially professionals such as CPAs and doctors, must be competent to do so. More than ever, the CPA must practice within the prevailing standards of the profession.

CPAs have an ethical duty to maintain high standards of technical competence.

Just as we expect a doctor to be skilled in medicine, we expect certain technical standards of a CPA. However, a CPA may be asked to render a service for which he or she is not competent and in many such cases the CPA should refer the client to a practitioner who is. For a CPA to do otherwise might be unethical—possibly illegal.

The law holds that a person commits a type of fraud on everyone who employs him or her if that person does not have the degree of skill “commonly possessed by others practicing the same profession.”

Yet ethical principles may transcend the law. Certainly, most CPAs have the degree of skill commonly possessed by others. Similar academic training and the Uniform CPA Examination go far in establishing a common body of knowledge for the profession. But with today’s changing economy, accounting practice is rapidly increasing in scope, thereby increasing the CPA’s need for special as well as general competence.

The Need for Competence
A CPA should maintain and seek to improve competence in all areas of the accounting services performed. The competence requirement is stated explicitly in Rule 201 which says a member should undertake only those professional services that the member or the member’s firm can reasonably expect to be completed with professional competence.

The maintenance of competence requires a commitment to learning and professional improvement that must continue throughout a member’s professional life.

Gaining Competence
In the past, 120 hours or four years of college training was enough to permit a person to take the CPA examination. Recently almost all of the jurisdictions have passed 150-semester-hour requirements for future CPAs. Implementation dates for this requirement extend for many years. Since 2000, applicants for AICPA membership had to have at least 150 college-level semester hours including a bachelor’s degree or its equivalent.

Satisfying the requirements for the CPA certificate is evidence of basic competence at the time the certificate is granted. This, however, is only the beginning of a lifelong study. Continuing effort is necessary to maintain and improve competence and keep up with technical standards. Almost all states now require evidence of continuing professional education as a condition for license renewal. Certified public accountants should review the State Board of Accountancy requirements for their state.

Specialized Training
An ethical CPA must not try to perform services that he or she cannot handle competently. It may be necessary for
the CPA to take special training before beginning the task. Any CPA with adequate skill and a sound background in auditing, accounting, and taxation can learn to perform many services for management. But the three fields of audit, tax and consulting services encompass so much today that a CPA who attempts to practice in all of them may well become a jack-of-all-trades and master of none.

**Competence Lacking**

A CPA may not be able to gain timely competence through research or study. In such a situation, the practitioner may find it necessary to refer a client to a practitioner having recognized expertise to solve a particular problem. Although not ethically required, many firms who receive an engagement by referral from another CPA will not accept a client’s request to extend services beyond the specific referred engagement, without first notifying the referred accountant. As a result, many firms find such referral arrangements quite satisfactory.

Within a firm, partners often devote their efforts to different kinds of services. In a small firm, for example, one partner might spend almost all his or her time in auditing, another in taxes, and still another in consulting services. Thus, a firm may raise its standard of technical performance and offer a wider range of services to the public.

Under the Code, a firm may accept an engagement if any of its partners is competent in the service called for. An alternative is to engage an outside consultant in that area.

**Infallibility of Knowledge or Judgment**

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

Cooley on Torts, a treatise that has stood the test of time, describes a professional’s obligation for competence and due care as follows:

Every man who offers his services to another and is employed, assumes the duty to exercise in the employment such skill as he possesses with reasonable care and diligence. In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession. But no man, whether skilled or unskilled, undertakes that the task he assumes shall be performed successfully, and without fault or error; he undertakes for good faith and integrity, but not for infallibility, and he is liable to his employer for negligence, bad faith, or dishonesty, but not for losses consequent upon mere errors of judgment.

**Committees and Boards Promulgating Standards**

Council has designated the following groups as authorized to promulgate standards which are enforceable under the Code of Professional Conduct:

- Accounting and Review Services Committee—Rules 201 and 202
- Auditing Standards Board—Rules 201 and 202
- Financial Accounting Standards Board—Rules 202 and 203
- International Accounting Standards Board—Rules 202 and 203
- Governmental Accounting Standards Board—Rules 202 and 203
- Federal Accounting Standards Advisory Board—Rule 203
- Consulting Services Executive Committee—Rules 201 and 202
- Tax Executive Committee—Rules 201 and 202
- Forensic and Valuation Services Executive Committee—Rules 201 and 202
- Personal Financial Planning Executive Committee—Rules 201 and 202
- Other AICPA committees may ask Council for similar authority. If granted, then violations of any standards promulgated by these bodies would be a violation of the Code of Professional Conduct.

**Lack of Independence by the Auditor**

What can a CPA who lacks independence do? Is an auditor barred from providing any services of an accounting nature to a client when the auditor is not considered independent of that client? Suppose a CPA is both a stockholder and a director in a small corporation. It is not expedient to sell the financial interest at this time. Yet the associates of the company ask for assistance with their accounting procedures and preparation of the company’s financial statements. Is there anything the CPA can do?

Yes. The CPA may properly perform general accounting services for the company; however, the CPA must remember that his or her name may be associated with the statements. The CPA must be careful not to mislead
a reader of the statements into giving them more reliance than is justified.

Use of CPA’s Name by Another
Rules 202 and 203 cover the CPA’s technical standards for reporting. Suppose an accountant who was not a CPA offered a CPA part of the fee if the CPA would sign the non-CPA’s report. The CPA would not sign such a report, of course, for it would be unethical and illegal.

PCAOB, SEC, GAO and Other Rules on Financial Statements
The rules of the American Institute and the state CPA societies are only part of the rules covering an auditor’s professional responsibility. State accountancy boards and other government agencies such as the Public Company Accounting Oversight Board, Securities and Exchange Commission and the Government Accountability Office also have rules. These agencies’ regulations cover the responsibility of auditors who express opinions on financial statements of enterprises under their jurisdiction. CPAs are obliged to familiarize themselves with these rules and to practice accordingly.

Conclusion
A CPA should not undertake any engagement that he or she cannot reasonably expect to complete with professional competence (Rule 201). If the CPA uses the work of others, he or she must be competent to supervise and judge that work. Moreover, CPAs must be convinced of their competence. The current age of specialization demands increasing skills. As CPAs branch out into other consulting services, they must work with commensurate skill. If a CPA is not able to develop timely competence through research or study, he or she should suggest engaging someone competent to perform the needed service, either independently or as an associate.

A CPA should observe the profession’s technical standards. Rule 202 requires adherence to these standards. Departures from these statements must be justified by those who do not follow them. Statements issued by the Financial Accounting Standards Board or the Governmental Accounting Standards Board must be followed (Rule 203) or (except in unusual circumstances) a CPA cannot attest that the financial statements are presented in conformity with generally accepted accounting principles. If the CPA feels the statements would be misleading if the principles were followed, he or she is obligated to describe the departures, the approximate effects thereof, and the reasons why compliance would not result in fair statements.

Rules 201–203 require competent performance. Adherence to technical standards is a requisite to that performance.
Rules, Interpretations, Rulings, AICPA Council Resolutions

Rule 201, General Standards
A member shall comply with the following standards and with any interpretations thereof by bodies designated by Council.

A. Professional Competence. Undertake only those professional services that the member or 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.

Interpretation Under Rule 201—General Standards

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

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

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

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

Rule 202, Compliance with Standards
A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council.

Rule 203, Accounting Principles
A member shall not (1) express an opinion or state affirmatively that the financial statements or other financial data of any entity are presented in conformity with generally accepted accounting principles or (2) state that he or she is not aware of any material modifications that should be made to such statements or data in order for them to be in conformity with generally accepted accounting principles, if such statements or data contain any departure from an accounting principle promulgated by bodies designated by Council to establish such principles that 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.

Interpretations Under Rule 203—Accounting Principles

203-1—Departures From Generally Accepted Accounting Principles.
Reference to generally accepted accounting principles (GAAP) in Rule 203, Accounting Principles [sec. 203 par. .01], means those accounting principles promulgated by bodies designated by Council, which are listed in appendix A, Council Resolution Designating Bodies to Promulgate Technical Standards. In the establishment of such principles, it is difficult to anticipate all circumstances to which such principles might be applied. There is a strong presumption that adherence to GAAP would,
in nearly all instances, result in financial statements that are not misleading. Rule 203 [sec. 203 par. .01] recognizes that, upon occasion, there may be unusual circumstances when the literal application of GAAP would have the effect of rendering financial statements misleading. In such cases, the proper accounting treatment is that which will render the financial statements not misleading.

The question of what constitutes unusual circumstances, as referred to in Rule 203 [sec. 203 par. .01] is a matter of professional judgment involving the ability to support the position that adherence to a promulgated principle within GAAP would be regarded generally by reasonable persons as producing misleading financial statements.

Examples of circumstances that may justify a departure from GAAP are new legislation or the evolution of a new form of business transaction. An unusual degree of materiality or the existence of conflicting industry practices are examples of circumstances that would not ordinarily be regarded as unusual in the context of Rule 203 [sec. 203 par. .01].

### 203-2—Status of FASB, GASB and FASAB interpretations.

Council is authorized under Rule 203 [sec. 203 par. .01] to designate bodies to establish accounting principles. Council has designated the Financial Accounting Standards Board (FASB) as such a body and has resolved that FASB Accounting Standards Codification™ (ASC) constitutes accounting principles as contemplated in Rule 203 [sec. 203 par. .01]. Council has also designated the Governmental Accounting Standards Board (GASB), with respect to Statements of Governmental Accounting Standards issued in July 1984 and thereafter, as the body to establish financial accounting principles for state and local governmental entities pursuant to Rule 203 [sec. 203 par. .01]. Council has also designated the Federal Accounting Standards Advisory Board (FASAB), with respect to Statements of Federal Accounting Standards adopted and issued in March 1993 and subsequently, as the body to establish accounting principles for federal government entities pursuant to Rule 203 [sec. 203 par. .01].

In determining the existence of a departure from an accounting principle established in FASB ASC and encompassed by Rule 203 [sec. 203 par. .01], or the existence of a departure from an accounting principle established by a Statement of Governmental Accounting Standards or a Statement of Federal Accounting Standards encompassed by Rule 203 [sec. 203 par. .01], the division of professional ethics will construe such codification or statements, in the light of any interpretations thereof issued by FASB, GASB, or FASAB.

### 203-4—Responsibility of employees for the preparation of financial statements in conformity with GAAP.

Rule 203 [sec. 203 par. .01] provides, in part, that a member shall not state affirmatively that financial statements or other financial data of an entity are presented in conformity with generally accepted accounting principles (GAAP) if such statements or data contain any departure from an accounting principle promulgated by a body designated by Council to establish such principles that has a material effect on the statements or data taken as a whole.

Rule 203 [sec. 203 par. .01] applies to all members with respect to any affirmation that financial statements or other financial data are presented in conformity with GAAP. Representation regarding GAAP conformity included in a letter or other communication from a client entity to its auditor or others related to that entity’s financial statements is subject to Rule 203 [sec. 203 par. .01] and may be considered an affirmative statement within the meaning of the rule with respect to members who signed the letter or other communication; for example, signing reports to regulatory authorities, creditors and auditors.

### 203-5—Financial Statements Prepared Pursuant to Financial Reporting Frameworks Other Than GAAP

Reference to GAAP in Rule 203 [sec. 203 par. .01] means those accounting principles promulgated by bodies designated by council, which are listed in appendix A. Financial statements prepared pursuant to other accounting principles would be considered financial reporting frameworks other than GAAP within the context of Rule 203 [sec. 203 par. .01].

However, Rule 203 [sec. 203 par. .01] does not preclude a member from preparing or reporting on financial statements that have been prepared pursuant to financial reporting frameworks other than GAAP, such as (a) financial reporting frameworks generally accepted in another country, including jurisdictional variations of International Financial Reporting Standards (IFRSs) such that the entity’s financial statements do not meet the requirements for full compliance with IFRSs as promulgated by the International Accounting Standards Board; (b) financial reporting frameworks prescribed by an agreement or a contract; or (c) an other comprehensive basis of accounting, including statutory financial reporting provisions required by law or a U.S. or foreign governmental regulatory body to whose jurisdiction the entity is subject.
In such circumstances, however, the financial statements or reports should not purport that the financial statements are in accordance with GAAP, and the financial statements or reports on those financial statements, or both, should make clear the financial reporting framework(s) used.

Ethics Rulings on General and Technical Standards

8. Subcontractor Selection for Management Consulting Service Engagements

Question: A member has been engaged to design and program a computer system. The engagement is well within the member’s competence. The member plans to retain a contract programming organization as a subcontractor to provide additional qualified manpower. What procedures should the member consider in making the selection of a subcontractor?

Answer: When selecting subcontractors the member has a responsibility to ensure that the subcontractors have the professional qualifications, technical skills and other resources required. Factors that can be helpful in evaluating a prospective subcontractor include business, financial and personal references from banks, from other CPAs, and from other customers of the subcontractor; the subcontractor’s professional reputation and recognition; published materials (articles and books authored); and the member’s personal evaluation of the subcontractor.

9. Supervision of Technical Specialist on Management Consulting Service Engagements

Question: A member would like to add to the member’s staff a systems analyst who specializes in developing computer systems. Must the member be able to perform all of the services that the specialist can perform in order to be able to supervise specialist?

Answer: The member must be qualified to supervise and evaluate the work of specialists in the member’s employ. Although supervision does not require that the member be qualified to perform each of the specialist’s tasks, the member should be able to define the tasks and evaluate the end product.

10. Submission of Financial Statements by a Member in Public Practice

Question: A member in public practice is also a stockholder, partner, director, officer, or employee of an entity and in this capacity submits the entity’s financial statements to third parties. What are the ethical considerations?

Answer: If the member submits the financial statements in his or her capacity as a stockholder, partner, director, officer, or employee to a third party, the member should clearly communicate, preferably in writing, the relationship of the member to the entity and should not imply that the member is independent of the entity [ET section 191.130-.131]. In addition, if the communication states affirmatively that the financial statements are presented in conformity with generally accepted accounting principles, the member is subject to rule 203 [ET section 203.01] of the Code of Professional Conduct.

If the member prepares financial statements as a member in public practice and/or submits them using the member’s public practitioner’s letterhead or other identification, the member should comply with applicable standards, including any requirement to disclose a lack of independence.

12. Applicability of General and Technical Standards When Using a Third-Party Service Provider

Question: What responsibility does a member in public practice have for complying with the general and technical standards under Rule 201, General Standards [ET section 201.01], and Rule 202, Compliance With Standards [ET section 202.01], when using an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined by in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) or an individual not employed by the member (a third-party service provider) to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients?

Answer: Using a third-party service provider to assist the member in providing professional services to clients does not in any way relieve the member from his or her responsibilities to comply with the requirements of Rules 201 [ET section 201.01] and 202 [ET section 202.01]. Accordingly, the member remains responsible for the adequate oversight of all services performed by the third-party service provider and for ensuring that all professional services are performed with professional competence and due professional care. In addition, the member must adequately plan and supervise the professional services provided by the third-party service provider, obtain sufficient relevant data to support his or her work product and comply with all technical standards applicable to the professional services.

This ruling does not extend the member’s responsibility for planning and supervising the work of a third-party service provider beyond the requirements of applicable professional standards, which may vary depending upon the nature of the member’s engagement.

See ethics ruling No. 112 [ET section 191.224-225] under Rule 102 [ET section 102.01], Integrity and Objectivity, and ethics ruling No. 1 [ET section 391.001-.002] under Rule 301, Confidential Client Information [ET section 301.01], for additional responsibilities of the member when using a third-party service provider.
Council Resolutions
Designating Bodies to Promulgate Technical Standards

Financial Accounting Standards Board
WHEREAS: In 1959 the Council designated the Accounting Principles Board to establish accounting principles, and
WHEREAS: The Council is advised that the Financial Accounting Standards Board (FASB) has become operational, it is
RESOLVED: That as of the date hereof the FASB, in respect of statements of financial accounting standards finally adopted by such board in accordance with its rules of procedure and the bylaws of the Financial Accounting Foundation, be, and hereby is, designated by this Council as the body to establish accounting principles pursuant to rule 203 [ET section 203.01] and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202 [ET section 202.01] of the Rules of the Code of Professional Conduct of the American Institute of Certified Public Accountants provided, however, any accounting research bulletins, or opinions of the accounting principles board issued or approved for exposure by the accounting principles board prior to April 1, 1973, and finally adopted by such board on or before June 30, 1973, shall constitute statements of accounting principles promulgated by a body designated by Council as contemplated in rule 203 [ET section 203.01] of the Rules of the Code of Professional Conduct unless and until such time as they are expressly superseded by action of the FASB.

Governmental Accounting Standards Board
WHEREAS: The Governmental Accounting Standards Board (GASB) has been established by the board of trustees of the Financial Accounting Foundation (FAF) to issue standards of financial accounting and reporting with respect to activities and transactions of state and local governmental entities, and
WHEREAS: The American Institute of Certified Public Accountants is a signatory to the agreement creating the GASB as an arm of the FAF and has supported the GASB professionally and financially, it is
RESOLVED: That as of the date hereof, the GASB, with respect to statements of governmental accounting standards adopted and issued in July 1984 and subsequently in accordance with its rules of procedure and the bylaws of the FAF, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for state and local governmental entities pursuant to rule 203 [ET section 203.01], and standards on disclosure of financial information for such entities outside financial statements in published financial reports containing financial statements under rule 202 [ET section 202.01].

Federal Accounting Standards Advisory Board
RESOLVED: That the Federal Accounting Standards Advisory Board, with respect to its statements of federal accounting standards and concepts adopted and issued in March of 1993 and subsequently, in accordance with its rules of procedure, the memorandum of understanding and public notice designating the FASAB’s standards and concepts as having substantial authoritative support, be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish financial accounting principles for federal governmental entities pursuant to rule 203 [ET section 203.01].

Public Company Accounting Oversight Board
WHEREAS: The Public Company Accounting Oversight Board (PCAOB) has been established pursuant to the Sarbanes-Oxley Act of 2002 (the Act), and
WHEREAS: The PCAOB has authority under the Act to establish or adopt, or both, by PCAOB rule, auditing and related attestation standards, quality control, ethics, independence and other standards relating to the preparation and issuance of audit reports for issuers as defined in the Act.
RESOLVED: That the PCAOB be, and hereby is, designated by the Council of the American Institute of Certified Public Accountants as the body to establish standards relating to the preparation and issuance of audit reports for entities within its jurisdiction as defined by the Act pursuant to rules 201 [ET section 201.01] and 202 [ET section 202.01].

International Accounting Standards Board
RESOLVED: That the International Accounting Standards Board (IASB) is hereby designated as the body to establish professional standards with respect to international financial accounting and reporting principles pursuant to Rule 202 and Rule 203 and
BE IT FURTHER RESOLVED: That the Council shall reassess, no sooner than three years but no later than five years after the effective date of this resolution, whether continued recognition of the IASB as the body designated to establish professional standards with respect to international financial accounting and reporting principles under Rule 202 and Rule 203 is appropriate.

AICPA Committees and Boards
WHEREAS: The membership of the Institute has adopted rules 201 and 202 of the Rules of the Code of Professional Conduct, which authorizes the Council to designate bodies to promulgate technical standards with which members must comply, and therefore it is

Accounting and Review Services Committee
RESOLVED: That the AICPA accounting and review services committee is hereby designated to promulgate technical standards under rules 201 and 202 with respect to unaudited financial statements or other unaudited financial information of an entity that is not required to file financial statements with a regulatory agency in connection with the sale or trading of its securities in a public market.

Auditing Standards Board
RESOLVED: That with respect to standards relating to the preparation and issuance of audit reports not included within the resolution on the Public Company Accounting Oversight Board, the AICPA auditing standards board is hereby designated as the body authorized under rules 201 and 202 to promulgate auditing, attestation, and quality control standards and procedures.

RESOLVED: That the auditing standards board shall establish under statements on auditing standards the responsibilities of members with respect to standards for disclosure of financial information outside of the financial statements in published financial reports containing financial statements.

Consulting Services Executive Committee
RESOLVED: That the AICPA consulting services executive committee is hereby designated to promulgate standards under rules 201 and 202 with respect to the offering of consulting services, provided, however, that such standards do not deal with the broad question of what, if any, services should be proscribed.

AND FURTHER RESOLVED: That any institute committee or board now or in the future authorized by the Council to issue enforceable standards under Rules 201 and 202 must observe an exposure process seeking comment from other affected committees and boards, as well as the general membership.

Attestation Standards
RESOLVED: That the AICPA accounting and review services committee, auditing standards board, and management consulting services executive committee are hereby designated as bodies authorized under rules 201 and 202 to promulgate attestation standards in their respective areas of responsibility.

Tax Executive Committee
RESOLVED: That the Tax Executive Committee is hereby designated as the body authorized under AICPA rules 201 and 202 to promulgate professional practice standards with respect to tax services.

Forensic and Valuation Services Executive Committee
RESOLVED: That the Forensic and Valuation Services Executive Committee is hereby designated as the body to promulgate professional standards with respect to forensic and valuation services under Rules 201 and 202.

Personal Financial Planning Executive Committee
RESOLVED: That the Personal Financial Planning Executive Committee is hereby designated as the body to promulgate professional standards with respect to personal financial planning services under Rules 201 and 202.
AICPA Staff Responses to Inquiries

Standards

Question: A member in industry represented to external auditors that financial statements remitted were prepared in conformity with generally accepted accounting principles. Is this representation appropriate if the financial statements contain a material departure from an established accounting principle?

Answer: No. If a member makes an affirmative representation that financial statements are in conformity with GAAP and the statements contain any departure from an established accounting principle that has a material effect on them, the member is in violation of Rule 203, Interpretation 203-4.

Question: A member’s firm (firm A) is not independent with respect to a corporation. To what extent can firm A’s staff participate in the audit of the corporation’s financial statements to be performed by firm B?

Answer: Firm A staff may participate in the audit engagement without impairing firm B’s independence with respect to the corporation as long as firm B uses firm A’s work in a manner similar to that of internal auditors and complies with AICPA statements on auditing standards.

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

Answer: No. Rule 203, Interpretation 203-4, provides that a member shall not state affirmatively that the financial statements are in conformity with GAAP if such financial statements contain any departure from an established accounting principle that has a material effect on them. In addition, Rule 102 requires that in the performance of any professional service a member shall not knowingly misrepresent facts.
Chapter Questions

1. In the member’s practice, he or she is bound by
   (a) only the rules of the AICPA.
   (b) the rules of more than one group.
   (c) only the rules of the Securities and Exchange Commission.

2. Stemper & Associates, LLP are the auditors of Cotter & Co. The financial statements of Cotter & Co. do not conform in one area with generally accepted accounting principles. The partners in Stemper agree that to use generally accepted accounting principles in this area would make the financial statements misleading. In this situation, the auditors
   (a) may in their report describe the departure from generally accepted accounting principles, its approximate effects and reasons why compliance with the principle would result in misleading statements.
   (b) cannot express an opinion on the financial statements.

3. Mass, a member, is the treasurer of Brown’s Auto. In connection with Brown’s bank loan, she sends a copy of Brown’s quarterly financial statements to the bank. Her transmittal letter to the bank says that the statements are not audited, her staff has prepared them and that they are in conformity with GAAP. The statements are, however, not in conformity with GAAP. Mass ______ violated the Code of Professional Conduct.
   (a) has
   (b) has not

4. Which of the following is not one of the general standards?
   (a) Planning and supervision
   (b) Professional competence
   (c) Independence
   (d) Due professional care
   (e) Significant relevant data

5. Karlson, a member, bids on a consulting job and has his bid accepted. He attempts to do the work and finds he lacks and cannot gain sufficient competence to complete the job. In such a situation he should:
   (a) engage an associate who has the necessary skills to work with him on finishing the job
   (b) withdraw from the engagement
   (c) both (a) and (b) are acceptable solutions
Chapter Answers

1. (b) is correct. A member must follow the rules of more than one group such as PCAOB, SEC and GAO.

2. (a) is correct. A member may depart from generally accepted accounting principles (GAAP) if the member believes that complying with GAAP would make the financial statements misleading. The member must disclose the departure, its approximate effect and why compliance would make the statements misleading (Rule 203).

3. (a) is correct. A member stating that financial statements are in conformity with generally accepted accounting principles (GAAP) when they do not comply, has violated the Code of Professional Conduct (Interpretation 203-4).

4. (c) is correct. Independence is not one of the General Standards (Rule 204).

   (a) Planning and Supervision, (b) Professional Competence, (d) Due Professional Care and (e) Significant Relative Data are General Standards (Rule 204).

5. (c) is correct. If a CPA does not have the skills necessary for the engagement should get someone to work with who has such skill or else withdraw from the job (Interpretation 201-1).
Confidential Client Information
A client who engages a CPA places trust in a professional. The client looks to the CPA to perform services he or she is unable to perform. Often the client may not be able to judge the competence of the performed services. Therefore, a prospective client must have faith in the CPA’s competence and integrity. When the client takes the CPA into confidence, the client has the right to expect that the CPA will not violate that confidence.

A CPA has a dual responsibility: the CPA has a responsibility to the public and to the client. The CPA has to have professional concern for the client’s best interests consistent with his or her responsibilities to the public. The CPA must not let regard for the client’s interests override his or her obligation to the public to maintain independence, integrity and objectivity.

It is important that the CPA be clear with each client as to his or her position on issues of significance, whether such issues involve tax matters, consulting services or any other professional services. A CPA is a professional and, as such, must not subordinate his or her judgment, or conceal or modify it, merely to please the client.

What does a CPA do if a conflict arises on an important question of principle? In cases of irreconcilable difference, the matter may be of sufficient importance that the CPA should consider resigning from the engagement.

It is fundamental that the CPA hold in strict confidence all information concerning a client’s affairs. This is expressed in part of Rule 301:

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

However, the following four cases are cited where the rule cannot be used—

1. “to relieve a member of the member’s professional obligations under rules 202 and 203.”

Clearly the confidentiality rule cannot be allowed to interfere with a CPA’s obligation to adhere to generally accepted auditing standards or to interfere with the expression of the member’s opinion in conformity with generally accepted accounting principles. Thus, it cannot negate the member’s responsibility to make disclosures in financial reports that are necessary for a fair presentation.

2. “to affect in any way the member’s obligation to comply with a validly issued and enforceable subpoena or summons.”

Obviously an ethics rule cannot prevent a member from complying with the law or government regulations.

3. “to prohibit review of a member’s professional practice under PCAOB, AICPA or state CPA society or Board of Accountancy authorization.”

With practice monitoring requirements of the PCAOB, AICPA, state CPA societies and Boards of Accountancy, the CPA in public practice must be able to allow the practice review team access to his or her working papers and other files.

4. “to preclude a member from initiating a complaint with, or responding to any inquiry made by, the 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.”

Obligation of Investigative Bodies
The investigative bodies, in turn, have an obligation of confidentiality. Members of any of the disciplinary bodies or of practice review teams mentioned in the rule shall not use to their own advantage or disclose any member’s confidential client information that comes to their attention in carrying out these activities. That does not however prohibit the exchange of information between such bodies in connection with investigative or disciplinary proceedings or practice reviews mentioned in the rule.

Confidentiality in Tax Matters
What if a CPA finds that a client’s prior years’ tax returns grossly understated net income and the amount of income tax? In fact, the client has not complied with the
Privileged Communications

The common law says that certain communications with physicians, clergymen, and lawyers are “privileged.” A judge, however, may compel a CPA to divulge information about a client’s affairs in court. A few states allow privileged communications between CPAs and clients, although the privilege is more limited in some states than others.

The federal courts hold that state statutes do not apply to any federal administrative proceeding. Therefore, state provisions allowing privileged communications do not necessarily apply in federal courts.

But what are the ethical considerations? What does a CPA do if a client is in litigation? What does the CPA do if he or she knows a client has done something wrong?

These are hard questions, but there are some answers. If the CPA knows a client has done something wrong, the CPA may withdraw from the engagement—and tell the client why. If a CPA is subpoenaed to testify, he or she must follow court orders. The CPA should not voluntarily disclose the client’s affairs. Rule 301 expressly states that “this rule shall not be construed to affect in any way the member’s obligation to comply with a validly issued and enforceable subpoena or summons.” In any such situation, a CPA should consult with his or her legal counsel.

Ownership of Working Papers

In addition to a client’s knowledge of a client’s affairs, the CPA also keeps his or her own working papers and other documents. These must be kept confidential. Generally speaking, the law holds that working papers are a CPA’s property, and a client cannot force the CPA to give them up. If necessary, however, the CPA might furnish copies of certain working papers to the client for the latter’s use. Perhaps the CPA is doing “write-up work” for the client that may include information and details that are not in the client’s books. Such details should go into the client’s records. Also, a court may subpoena the papers.

Often when companies change auditors, the new auditor will request permission to review the prior auditor’s working papers. The Code of Professional Conduct does not require that such permission be granted. Most accounting firms will permit reviews of all or part of their working papers.
Responsibilities to Clients and Colleagues

Working papers by a successor auditor provided there is no actual or threatened litigation or other problems with the former client.

Obviously such a review may reduce the time required by the new auditor and help the new auditor become familiar with the client’s operations. In all such cases, the client’s permission for such a review must be obtained.

Perhaps some government agency, such as the Internal Revenue Service, informally asks to review the CPA’s working papers. Should the request be granted? The CPA should not comply without first obtaining the client’s permission. If the CPA’s working papers are subpoenaed by anyone such as the Internal Revenue Service, any other governmental agency or a private party, the CPA should inform the client and also consult with his or her own counsel. The client may wish to take legal action to quash the subpoena and might not have knowledge of the subpoena unless informed of it by the accountant.

If anyone does review the working papers, the CPA or a representative should always be present. The CPA must make sure that nothing is taken from the papers nor should anyone be allowed to add to them or to alter them.

Contingent Fees

The AICPA rule and interpretation prohibit members from preparing an original tax return or claim for refund of tax for a contingent fee for any client.

Members are also prohibited from performing any professional services for a client for a contingent fee if the member or his or her firm performs for that client:

- An audit or review.
- An examination of prospective financial information.
- A compilation when the member expects or reasonably could expect that a third party will use the statement. If the compilation report discloses a lack of independence then this prohibition is removed.

This prohibition of contingent fees from clients where one performs these attest services applies during the period the member is engaged to perform the attest service and the period covered by any historical financial statements involved in these services.

Fees are not considered as contingent fees if they are fixed by courts or public authorities. In tax matters, they are not considered contingent fees if they are determined based on judicial proceedings or findings of governmental agencies.

Establishing Fees

A CPA should be motivated more by a desire for excellence in performance than for material reward. Striving for excellence does not mean being indifferent about compensation. In determining fees, a CPA may assess the degree of responsibility assumed by undertaking an engagement, as well as the time, manpower, and skills required to perform the service in conformity with professional standards. Other factors involved in establishing fees are the value of the service to the client and the customary charges of professional colleagues.

When professional judgments are involved, it is usually not possible to set a fair charge until an engagement has been completed. On the other hand, clients have a right to know in advance what rates will be charged and approximately how much an engagement will cost.

Respect for Colleagues

A certain respect for one’s colleagues in the profession appeared as early as Roman days. In the 16th century, Francis Bacon said that every man was a debtor to his profession and had a duty to be a help and an ornament to it. And that view was restated a few decades ago when Theodore Roosevelt remarked that every man owes some time and effort to the profession which sustains him.

Accountants, too, have long known that courtesy within the profession is essential. There may be competition between individuals—in fact, some hostility—but good sense and professional decorum dictate an attitude of respect toward and confidence in each other.

The cumulative accomplishments of all CPAs, past and present, largely determine the public confidence and respect enjoyed by CPAs.

Need for Cooperation

Among CPAs, as among lawyers, physicians and other professionals, there are two kinds of cooperation. One is the informal, friendly help that strengthens bonds and that members extend toward each other. There are dozens of small but often important courtesies the professionals exchange; these may include technical information or the loan of uncommon books.

Then there is the more formal cooperation—group action that can accomplish things an individual cannot. An organization, usually a society or association, provides benefits for all its members. CPAs in every jurisdiction enjoy the benefits of formal cooperation.

Lawmakers may introduce bills that may not be in the best interest of CPAs. Also there are times when CPAs need helpful laws passed. It is desirable for the profession to have a voice in these lawmakers. While a large CPA firm might engage its own legislative advocate, it is generally far more effective for a group of firms to pool resources through their association and
engage the necessary counsel. Further, the expertise of the profession as a whole should be used to benefit the public with certain rule-making bodies, such as the Securities and Exchange Commission, the Internal Revenue Service, and various State Boards.

Universities often call upon outstanding practitioners to advise them in developing educational programs. They also call upon the societies and associations for assistance in the technical aspects of accountancy.

**Continuing Education**

Continuing education is a field in which the AICPA and state societies have greater resources than are available to individual firms, although, many firms do operate successful in-house programs. Through the group’s formal structure and seminars, meetings and publications, members can exchange knowledge and information not generally available otherwise. Group action makes possible the publication of journals, magazines, books and other educational materials.

The group can help maintain professional standards. In this profession, as well as in others, one finds almost continuous pressure to lower standards for political or economic reasons. Together, the nation’s CPAs work diligently to keep standards high to assure the public of quality professional services.

**Disciplinary Authorities**

A CPA should help other CPAs implement the Code of Professional Conduct. It is each CPA’s duty to assist appropriate disciplinary authorities in enforcing the Code. A CPA should not commit an infraction, nor should the CPA ignore serious faults in his or her colleagues. Many errors result from ignorance of the rules, and they may be repeated if not brought to the attention of the CPA committing the error. The welfare of the public is the prime consideration in such situations.

**Professional Rivalry**

The competitive spirit is generally encouraged by our current mores. In sports, the laurels go to the fastest runner, the highest jumper, or the most accurate marksman. Accolades of our society go to the successful in sports, adventure, school and college. No wonder that rivalry carries forward into business and the professions, where the rewards are glory as well as financial.

CPAs, too, carry some of this competitive spirit into their work. Properly channeled, this is a desirable trait. It is a spirit that may well motivate the practitioner to excel, to work diligently and accurately, to seek more advantageous engagements and to see his or her own firm grow more proficient and profitable than others. In the United States we believe such aims generally benefit the public.

While professional rivalry does have its limits, which are set primarily by good sense, good taste and respect for one’s professional competitors, there is little in law or in ethics to prescribe these bounds. Despite one’s spirit of rivalry, an individual should temper relations with competitors by a sense of fair play, courtesy, mutual respect and a spirit of fraternity.

**Uncomplimentary Allusions to Fellow Practitioners**

The professional should beware of making thoughtless comments concerning others. People do indeed consider the source. A CPA may have valid reasons for bitterly resenting a fellow practitioner, but caution must be exercised in expressing these sentiments publicly.

The undesirability of such comments needs little elaboration. Mention an unfavorable opinion, even in confidence, and it will speedily find its way to the object of the remark—who may reply in kind. Soon, mutual bad feelings grow out of control. Worse, both of the hostile speakers lose the esteem of their peers by such remarks. Members of the public have come to expect a high level of professionalism from CPAs and are disappointed when they see or hear CPAs engage in unworthy conduct. Moreover, civil and even criminal penalties exist for unguarded remarks. Actions for libel and slander may be instituted by fellow practitioners who feel that such remarks have damaged their professional standing or reputation.

**Conclusion**

A CPA has a professional responsibility to the client, for the CPA-client relationship is one of trust and confidence. The rules of professional conduct specifically forbid violating the confidential relationship.

CPAs, like other professionals, engage in two kinds of cooperation to help strengthen the profession and aid the individual members. One type is the informal, friendly help that individual practitioners often give to each other.

The other type is the formal, structured group action by CPA associations and societies. Through this latter type, CPAs are able to carry on professional development and stimulate appropriate legislation. Through both types of cooperation, mutual respect, professionalism and healthy professional rivalry the profession is strengthened and its standards are maintained or raised.

Professional rivalry should always be “professional,” and a CPA should not make uncomplimentary allusions to fellow practitioners. The reputation of the profession is worth more than satisfying a personal fit of pique.
Rules, Interpretations, Rulings

Rule 301, Confidential Client Information
A member in public practice shall not disclose any confidential client information without the specific consent of the client.

This rule shall not be construed (1) to relieve a member of his or her professional obligations under rules 202 [ET section 202.01] and 203 [ET section 203.01], (2) to affect in any way the member’s obligation to comply with a validly issued and enforceable subpoena or summons, or to prohibit a member’s compliance with 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.

Interpretation under Rule 301—Confidential Client Information

301-3—Confidential information and the purchase, sale, or merger of a practice.
Rule 301 [ET section 301.01] prohibits a member in public practice from disclosing any confidential client information without the specific consent of the client. The rule provides that it shall not be construed to prohibit the review of a member’s professional practice under AICPA or state CPA society authorization.

For purposes of rule 301 [ET section 301.01], a review of a member’s professional practice is hereby authorized to include a review in conjunction with a prospective purchase, sale, or merger of all or part of a member’s practice. The member must take appropriate precautions (for example, through a written confidentiality agreement) so that the prospective purchaser does not disclose any information obtained in the course of the review, since such information is deemed to be confidential client information.

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

Rule 302, Contingent Fees
A member in public practice shall not

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

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

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

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

Interpretation Under Rule 302—Contingent Fees

302-1—Contingent fees in tax matters.
This interpretation defines certain terms in rule 302 [ET section 302.01] and provides examples of the application of the rule. When practicing before the IRS or other taxing authorities, members should ensure compliance with any requirements that are more restrictive.
Definition of Terms

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

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

Examples

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

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

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

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

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

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

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

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

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

Ethics Rulings on Responsibilities to Clients

1. Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member

Question: A member in public practice uses an entity that the member, individually or collectively with his or her firm or with members of his or her firm, does not control (as defined by in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) or an individual not employed by the member (a “third-party service provider”) to assist the member in providing professional services (for example, bookkeeping, tax return preparation, consulting, or attest services, including related clerical and data entry functions) to clients or for providing administrative support services to the member (for example, record storage, software application hosting, or authorized e-file tax transmittal services). Does Rule 301, Confidential Client Information [ET section 301.01], require the member to obtain the client’s consent before disclosing confidential client information to the third-party service provider?

Answer: No. Rule 301 [ET section 301.01] is not intended to prohibit a member in public practice from disclosing confidential client information to a third-party service provider used by the member for purposes of providing professional services to clients or for administrative support purposes. However, before using such a service provider, the member should enter into a contractual agreement with the third-party service provider to maintain the confidentiality of the information and be reasonably assured that the third-party service provider has appropriate procedures in place to prevent the unauthorized release of confidential information to others. The nature and extent of procedures necessary to obtain reasonable assurance depends on the facts and circumstances, including the extent of publicly available information on the third-party service provider’s controls and procedures to safeguard confidential client information.

In the event the member does not enter into a confidentiality agreement with a third-party service provider, specific client consent should be obtained before the member discloses confidential client information to the third-party service provider.

See ethics ruling No. 112 [ET section 191.224–225] under Rule 102, Integrity and Objectivity [ET section 102.01], and ethics ruling No. 12 [ET section 291.023–
Responsibilities to Clients and Colleagues

2. Distribution of Client Information to Trade Associations

Question: A member has received a request from a third party (for example, a trade association, member of academia, or surveying or benchmarking organization) to disclose client information or intends to use such information for the member’s own purposes (for example, publication of benchmarking data or studies) in a manner that may result in the client’s information being disclosed to others without the client being specifically identified. May the member comply with such a request or use client information for such purposes without violating Rule 301 [sec. 301 par.01]?

Answer: A member would be in violation of Rule 301 [sec. 301 par.01] if the information is considered to be confidential client information, unless the member has the clients’ specific consent, preferably in writing, for the disclosure or use of such information. The disclosure or use of the information that is available to the public is not subject to Rule 301 [sec. 301 par.01]. The member should be cautious in the disclosure or use of the information so as not to disclose client information that may go beyond what is available to the public or that the client has agreed may be disclosed.

Accordingly, before disclosing confidential client information to a third party or using such information for the member’s own purposes when the use of such information results in disclosure of confidential client information to others, the member should obtain the client’s specific consent, preferably in writing, about the nature of the information that may be disclosed, the type of third party to whom it may be disclosed, and its intended use.

A member is not prohibited from marketing his or her services or advising a third party, such as a current or prospective client, of information based on his or her expertise or knowledge obtained from prior experiences with clients (for example, the nature of services provided to other clients or common practices within a client’s industry). However, in cases when such information may be identifiable to one or more clients, specific consent, preferably in writing, would be required from such client(s). Prior to disclosing confidential client information to a third party, the member should consider whether a contractual agreement with the third party to maintain the confidentiality, or limit the use, of the information is necessary.

In addition, the member should consider whether federal, state, or local statutes, rules, or regulations concerning confidentiality of client information may be more restrictive than the requirements contained in this ethics ruling.

See Ethics Ruling No. 12 of section 291 [sec. 291 par.023–024] and Ethics Ruling No. 1, “Use of a Third-Party Service Provider to Provide Professional Services to Clients or Administrative Support Services to the Member,” of this section [sec. 391 par.001–002] for guidance when disclosing confidential client information to a third party used to assist the member in providing professional services to clients that will not result in disclosure to others.

3. Information to Successor Accountant About Tax Return Irregularities

Question: A member withdrew from an engagement on discovering irregularities in his or her client’s tax return. May he or she reveal to the successor accountant why the relationship was terminated?

Answer: Rule 301 [ET section 301.01] is not intended to help an unscrupulous client cover up illegal acts or otherwise hide information by changing CPAs. If the member is contacted by the successor he or she should, at a minimum, suggest that the successor ask the client to permit the member to discuss all matters freely with the successor. The successor is then on notice of some conflict. Because of the serious legal implications, the member should seek legal advice as to his or her status and obligations in the matter.

6. Revealing Client Information to Competitors

Question: A municipality in a particular state enforces a personal property tax on business inventories, fixtures and equipment, and machinery by retaining a firm of CPAs to examine the books and records of the businesses to be sure the proper amount has been declared. In the course of its engagement, the CPA firm will examine sales, purchases, gross profit percentages, and inventories as well as fixed asset accounts. A member serving one of the companies involved objects to these procedures on the ground that information gathered from the books and records of his or her client could be inadvertently conveyed to competitors by employees of the CPA firm doing the audit. Is such an engagement ethically proper?

Answer: It would be proper for a member’s firm to perform such services. It should be emphasized to everyone concerned that rule 301 [ET section 301.01] prohibits members from revealing to others any confidential information obtained in their professional capacity.

7. Revealing Names of Clients

Question: May a member in public practice disclose the name of a client for whom the member or the member’s firm performed professional services?

Answer: It is permissible under rule 301 [ET section 301.01] for a member to disclose the name of a client,
whether publicly or privately owned, without the client’s specific consent unless the disclosure of the client’s name constitutes the release of confidential information. For example, if a member’s practice is limited to bankruptcy matters, the disclosure of a client’s name would suggest that the client may be experiencing financial difficulties, which could be confidential client information.

14. Use of Confidential Information on Management Consulting Service Engagements

Question: In the course of performing a feasibility study a nonclient outside source has provided pertinent information to the member’s firm with the understanding that the source and the details of the information will not be disclosed. The information, which the firm believes is pertinent, directly affects its conclusions and recommendations. How may this information be utilized in connection with the feasibility study engagement and related conclusions and recommendations?

Answer: Rule of conduct 301 [ET section 301.01] regarding confidential client information is not directly applicable to the circumstances described; however, Rule of conduct 501, Acts Discreditable [ET section 501.01], is applicable to situations involving confidential relationships with non-clients. For an engagement in which it appears likely that the development of pertinent information will have to come from outside non-client sources, and such information must remain confidential, the terms of the engagement with the client should specify that the confidences of outside non-client sources will not be divulged by the member’s firm even when they might affect the outcome of the engagement. If the use of confidential outside sources is necessary and the terms of the engagement are silent regarding disclosure of source and details, the member should promptly seek the approval of the client to present his or her recommendations without making disclosures that include confidential information. If the client does not agree to this, the member should withdraw rather than breach a confidence or improperly limit the inclusion of information in his or her final recommendation.

15. Earlier Similar Management Consulting Service Study with Negative Outcome

Question: A prospective client has asked a member’s firm to study the desirability of his using a newly developed electronic ticketing system for his or her business. A recent study made for another client leads the member’s firm to believe that the system would not be desirable for him or her. Must the firm state its reservations at the risk of disclosing information acquired while performing an assignment for a client competitor?

Answer: Rule of conduct 301 [ET section 301.01] provides that a member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client. Knowledge and expertise which results in a special competence in a particular field can be provided to a client without violating the confidence of another client. Reservations that the firm may have concerning the electronic ticketing system should be communicated to the prospective client with the details of the other client’s engagement are not disclosed. If, however, circumstances are such that the prospective client would clearly know the origin of the information on which the member’s reservations are based, and such information is sensitive, the engagement should not be accepted without clearance with the first client.

16. Disclosure of Confidential Client Information

Question: A recent study made for another client leads the member to believe that the system would not be desirable for him or her. The system should be communicated to the prospective client with the details of the other client’s engagement are not disclosed. If, however, circumstances are such that the prospective client would clearly know the origin of the information on which the member’s reservations are based, and such information is sensitive, the engagement should not be accepted without clearance with the first client.

Answer: As defined by the Code of Professional Conduct, a contingent fee or a commission is deemed to be received when the performance of the related services is complete and the fee or the commission is determined. For example, if in one year a member sells a life insurance policy to a client and the member’s commission payments are determined to be a fixed percentage of future years’ renewal premiums, the commission is deemed to be received in the year the policy is sold.

17. Definition of the Receipt of a Contingent Fee or a Commission

Question: Rules 302 [ET section 302.01] and 503 [ET section 503.01] prohibit, among other acts, the receipt of contingent fees for the performance of certain services and the receipt of a commission for the referral of products or services under certain circumstances. When is a contingent fee or commission deemed to be received?

Answer: A contingent fee or a commission is deemed to be received when the performance of the related services is complete and the fee or the commission is determined. For example, if in one year a member sells a life insurance policy to a client and the member’s commission payments are determined to be a fixed percentage of future years’ renewal premiums, the commission is deemed to be received in the year the policy is sold.

18. Bank Director

Question: May a member in public practice serve as a director of a bank?

Answer: Yes; however, before accepting a bank directorship, the member should carefully consider the implications of such service if the member has clients that are customers of the bank.
These implications fall into two categories:

(a) Confidential Client Information—Rule 301 [ET section 301.01] provides that a member in public practice shall not disclose any confidential client information without the specific consent of the client. This ethical requirement applies even though failure to disclose information may constitute a breach of the member’s fiduciary responsibility as a director.

(b) Conflicts of Interest—Interpretation 102-2 [ET section 102.03] provides that a conflict of interest may occur if a member performs a professional service (including service as a director) and the member or his or her firm has a relationship with another entity that could, in the member’s professional judgment, be viewed by appropriate parties as impairing the member’s objectivity. If the member believes that the professional service can be performed with objectivity and the relationship is disclosed to and consent is obtained from all appropriate parties, performance of the service shall not be prohibited.

In view of the above factors, it is generally not desirable for a member in public practice to accept a position as bank director where the member’s clients are likely to engage in significant transactions with the bank. If a member is engaged in public practice, the member should avoid the high probability of a conflict of interest and the appearance that the member’s fiduciary obligations and responsibilities to the bank may conflict with or interfere with the member’s ability to serve the client’s interest objectively and in complete confidence.

The general knowledge and experience of CPAs in public practice may be very helpful to a bank in formulating policy matters and making business decisions; however, in most instances, it would be more appropriate for the member as part of the member’s public practice to serve as a consultant to the bank’s board. Under such an arrangement, the member could limit activities to those which did not involve conflicts of interest or confidentiality problems.

19. Receipt of Contingent Fees or Commissions by Member’s Spouse

Question: May a member’s spouse provide services to the member’s attest client for a contingent fee or refer products or services for a commission to or from the member’s attest client without causing the member to be in violation of rule 302 [ET section 302.01] or rule 503 [ET section 503.01]?

Answer: Yes, if the activities of the member’s spouse are separate from the member’s practice and the member is not significantly involved in those activities. The member, however, should consider whether a conflict of interest may exist as described in rule 102 [ET section 102.01] and interpretation 102-2 [ET section 102.03].

20. Disclosure of Confidential Client Information to Professional Liability Insurance Carrier

Question: A member has learned of a potential claim that may be filed against the member. The member’s professional liability insurance policy requires that the carrier be promptly notified of actual or potential claims. If the member notifies the carrier and complies with its request for documents that would constitute confidential client information without the client’s permission, would the member be in violation of rule 301 [ET section 301.01]?

Answer: No. Rule 301 [ET section 301.01] is not intended to prohibit a member from releasing confidential client information to the member’s liability insurance carrier solely to assist the defense against an actual or potential claim against the member.

21. Member Providing Services for Company Executives

Question: A member has been approached by a company, for which he or she may or may not perform other professional services, to provide personal financial planning or tax services for its executives. The executives are aware of the company’s relationship with the member, if any, and have also consented to the arrangement. The performance of the services could result in the member recommending to the executives actions that may be adverse to the company. What rules of conduct should the member consider before accepting and during the performance of the engagement?

Answer: Before accepting and during the performance of the engagement, the member should consider the applicability of Rule 102, Integrity and Objectivity [ET section 102.01]. If the member believes that he or she can perform the personal financial planning or tax services with objectivity, the member would not be prohibited from accepting the engagement. The member should also consider informing the company and the executives of possible results of the engagement. During the performance of the services, the member should consider his or her professional responsibility to the clients (that is, the company and the executives) under Rule 301, Confidential Client Information [ET section 301.01].

23. Disclosure of Confidential Client Information in Legal or Alternative Dispute Resolution Proceedings

Question: A member discloses confidential client information to the member’s attorney or a court or in documents or proceedings in connection with an actual or threatened lawsuit or alternative dispute resolution proceedings relating to that client. Would the member be in violation of the rule 301 [ET section 301.01] of the Code of Professional Conduct?
Chapter 7

Answer: No. Rule 301 [ET section 301.01] is not included to prohibit a member from disclosing the information necessary to initiate, pursue or defend himself or herself in such proceedings.

This ruling is not intended to prohibit a member’s compliance with applicable federal or state laws or regulations.

24. Investment Advisory Services

Question: A member or member’s firm (“member”) provides investment advisory services for an attest client for a fee based on a percentage of the client’s investment portfolio. Would the member be considered to be in violation of rule 302, Contingent Fees [ET section 302.01]?

Answer: Yes. However, the fee would not be contingent upon portfolio performance and, therefore, would not be in violation of rule 302 [ET section 302.01] if all of the following conditions are met:

1. The fee is determined as a specified percentage of the client’s investment portfolio.
2. The dollar amount of the portfolio on which the fee is based is determined at the beginning of each quarterly period (or longer period of time as may be agreed upon) and is adjusted only for additions or withdrawals made by the client during the period.
3. The fee arrangement is not renewed with the client more frequently than on a quarterly basis.

When performing such services, the member should also consider Rule 101, Independence [ET section 101.01], especially interpretation 101-3 [ET section 101.05].

25. Commission and Contingent Fee Arrangements with Nonattest Client

Question: A member or member’s firm (member) provides for a contingent fee investment advisory services, or refers for a commission products or services of a nonclient or a nonattest client, to the owners, officers, or employees of an attest client or to a nonattest client employee benefit plan sponsored by an attest client. Would the member be considered to be in violation of either rule 302 [ET section 302.01] or rule 503 [ET section 503.01]?

Answer: No. The member would not be in violation of either rule 302 [ET section 302.01] or rule 503 [ET section 503.01] provided that, with respect to rule 503 [ET section 503.01], the member discloses the commission to the owners, officers, or employees or to the employee benefit plan. The member should also consider the applicability of interpretation 102-2, Conflicts of Interest [ET section 102.03], and his or her professional responsibility to clients under Rule 301, Confidential Client Information [ET section 301.01].
AICPA Staff Responses to Inquiries

Confidential Client Information

Question: A regulatory agency has asked a member to supply confidential client information in connection with an investigation of the client. May the member comply with the agency’s request if the client refuses to give the member permission to do so?

Answer: No. As provided in Rule 301, a member may disclose confidential client information only with the client’s specific consent. However, the rule is not intended to interfere with a member’s compliance with a validly issued and enforceable summons or subpoena.

Question: During an engagement to prepare a tax return for a client, a member discovers that the client has defrauded the government in previous years by significantly under reporting income. After advising the client on the appropriate actions to take and determining that the client will not act on such advice, the member withdraws from the engagement. Is the member under any obligation to bring the matter to the attention of the Internal Revenue Service?

Answer: Not necessarily. Rule 301–Confidential Client Information, prohibits a member from making disclosures to third parties without client permission. Therefore, unless required by a validly issued and enforceable subpoena or summons or by law, a member is precluded from disclosing any information to the IRS, regardless of his or her knowledge.

Question: A member has as audit clients two companies, A and B, the owners of which are Mr. A and Mr. B, respectively. Company A is a significant supplier of materials to Company B. Mr. A and Mr. B are also individual tax clients of hers. In preparing Mr. B’s individual tax return, she comes across information that raises going-concern issues with respect to Company B. Since both companies are clients, the member believes it would be appropriate under the circumstances to discuss this issue with Mr. A. Is this a correct assumption?

Answer: No. The information that the member has obtained from preparing Mr. B’s individual tax return is confidential client information and may not be discussed with Mr. A or any other party without Mr. B’s permission.

Question: A member has prepared tax returns for a married couple for several years. The couple is now divorcing and both parties have requested copies of previous tax returns and supporting schedules. Over the years, the member worked primarily with husband, who has requested that the workpapers not be provided to his spouse. Is the member obligated to provide copies to both spouses?

Answer: Yes. In a joint tax return engagement, both spouses are considered to be the client; therefore, the member may provide information to either party. However, a member may wish to obtain legal advice in connection with making the disclosure.

Question: A member has been served with a subpoena to turn over certain client records that contain confidential client information. May the member comply with the subpoena without violating any rule of conduct?

Answer: Yes, if the subpoena is validly issued and enforceable. The member should consider discussing the matter with his or her legal counsel before complying.

Contingent Fees

Question: A member firm audited the financial statements of a client for the year ended December 31, 1999. In October 1999, a firm partner assisted the client in obtaining financing under an arrangement in which the fee for such service would not be paid unless the financing was obtained. Has a violation of Rule 302 occurred?

Answer: Yes. Rule 302 prohibits a member from performing a professional service for a contingent fee for an audit client during the period in which the member or the member’s firm is engaged to perform the audit services and during the period of the historical financial statements involved in the audit engagement.

Question: Rule 302 provides that in tax matters, fees are not considered to be contingent if based on the findings of government agencies. Is the processing of an original tax return and the payment of a refund by the Internal Revenue Service considered to be a finding of a government agency under Rule 302?

Answer: No. Rule 302 prohibits filing an original return for a contingent fee. As stated in Interpretation 302-1, under Rule 302, in tax matters, a fee is considered based on the findings of government agencies if the member can demonstrate a reasonable expectation, at the time of the fee arrangement, of substantive consideration by an agency with respect to the member’s client. Such an expectation is deemed unreasonable in connection with the preparation of original tax returns. Therefore, preparation of an original tax return on a contingent fee basis violates Rule 302.

Question: A compilation client has engaged the member to find a buyer for some of its plant and equipment. The member will be paid only if the sale is realized. Would the member violate Rule 302 by performing this service and the compilation at the same time?
**Answer:** Yes, if the member expects or reasonably might expect that a third party will use the compiled financial statements and the compilation report does not disclose a lack of independence.

**Question:** Company A has asked a firm to audit company B in connection with a possible initial public offering (IPO). Company A established a holding company, C, to which the firm would issue an engagement letter. C would pay the firm only if the IPO was successful. Would this arrangement be a contingent fee in violation of Rule 302?

**Answer:** Yes. As defined in the Code of Professional Conduct companies A, B, and C would be considered firm clients. Rule 302 prohibits a member from performing for a contingent fee any professional services or receiving such a fee from a client for whom the member performs an audit of a financial statement. The member would be performing the audit of client B for C, the holding company, at the direction of A, and the fee for such services would be contingent.

**Question:** A member is preparing a client’s amended income tax return because a deduction was omitted from the original return. Would it be a violation of Rule 302 to perform this service on a contingent fee basis?

**Answer:** Yes, as the amended return is being filed to correct an omission, and there is no reasonable expectation of substantive consideration by the taxing authority.

**Question:** A member’s audit client sponsors an employee benefit plan. The member provides no attest services to the plan. May the member provide investment advisory services to the plan under a contingent fee arrangement?

**Answer:** Yes. The member may provide investment advisory services to the plan for a contingent fee and not be in violation of Rule 302, Contingent Fees. The member should consider Interpretation 102-2, Conflicts of Interest, of Rule 102 and his or her professional responsibility under Rule 301, Confidential Client Information.
Chapter Questions

1. May a judge compel a member to divulge information about a client’s affairs?
   (a) Yes.
   (b) No.

2. Do some states allow privileged communications between members and their clients?
   (a) No.
   (b) Yes.

3. If a member knows a client has acted outside the tax laws, the member
   (a) must immediately inform the authorities.
   (b) might decide to withdraw from the engagement.

4. Morton, a member, obtains a new tax client ABC Window Company. In reviewing the prior year’s tax return, which the company’s treasurer had prepared, she found that a fairly large expense item had been inadvertently omitted. She proposed to file an amended return for that year. Her fee for that would be 20% of the tax refund received. Charging this contingent fee is
   (a) permissible since this is not an attest client.
   (b) a violation of the Code of Professional Conduct.
   (c) permissible since she did not prepare the original return that failed to take the deduction.

5. Cornell, a member, wants to include in a sales brochure a list of some of his larger nonpublic audit clients. He believes this will increase his stature with potential clients. Does Cornell have to get the various clients permission to list their names in his brochure?
   (a) Yes, he must get permission since the fact that these companies have annual audits is confidential information.
   (b) No, he need not get their permission though it may be good public relations with these clients to do so.

6. Generally, the law holds that the member’s working papers
   (a) belong to the member.
   (b) belong to the client.
   (c) are in the public domain.

7. Jane Kalley, CPA, a sole practitioner, has decided to retire and wishes to sell her practice. Her business consists of 50% tax and compilation reports, 30% tax and review reports and the balance tax and audit reports. Laughlin & Co., CPAs, are interested in purchasing the practice but wish to review her working papers and other client files before making a final decision. Which of the following statements is correct?
   (a) It would be a violation of the Code of Professional Conduct to let Laughlin & Co. review the files since such files contain confidential client information.
   (b) Laughlin & Co. may review the files without violating the Code of Professional Conduct. Permission for such a review from the clients is not required.
   (c) If permission from the clients is obtained, Laughlin & Co. may review the files without violating the Code of Professional Conduct.

8. Meier, a member, issues a review report in April for the prior calendar year on the financial statements for Erie Company. Two months before the review report is issued, his firm starts working on another engagement for Erie. The fee for this engagement will be a percentage of funds recovered from a review of purchase orders as compared to billings received. Has Meier’s firm violated the Code of Professional Conduct with this second engagement?
   (a) Yes, since they were working on the contingent fee engagement and the review engagement at the same time.
   (b) No, since the work on the contingent fee engagement started in the year following the period covered by the review report.
Chapter Answers

1. (a) is correct. A judge can compel a member to disclose information about a client’s affairs (Rule 301 Confidential Client Information).

2. (b) is correct. A few states allow privileged communications between a member and his client (Privileged Communications).

3. (b) is correct. Member may not inform authorities that client has violated the law, unless legally obligated to do so. (Confidentiality in Tax Matters).

4. (b) is correct. A member cannot prepare a claim for a tax refund for any client for a contingent fee (Rule 302.2), unless the member has a reasonable expectation that the amended return will receive a substantive review (Interpretation 302-1).

5. (b) is correct. Members do not have to get their client’s permission to reveal that they have performed professional services for them unless the disclosure would mean the release of confidential information (Ruling 7).

6. (a) is correct. The law generally holds that a member’s working papers are his or her property (Ownership of Working Papers).

7. (b) is correct. Permission is not needed for such a review and there is no requirement to obtain the client’s permission for the review (Interpretation 301-3).

(a) is incorrect because permission for such a review is given by Interpretation 301-3.

(c) is incorrect since client’s permission is not required (Interpretation 301-3).

8. (a) is correct. A member cannot receive a contingent fee from a client for work performed during the period a member was engaged in an attest engagement or the period covered by any financial statements included in the attest engagement (Rule 302). The member would be considered working on the reviews report up until the date it was issued.
Chapter 8

Advertising and Solicitation

History
Until 1922, the organized accounting profession in the United States had no prohibitions against advertising. In that year, the American Institute of [Certified Public] Accountant’s Council, apparently following the examples set by the legal and medical advertising, adopted a rule against advertising. For the next 56 years, 1922 to 1978, advertising by CPAs in public practice was prohibited. Although the text of the rule was modified over the years, the basic rule prohibited all paid advertising.

Pressure began to be brought by various government agencies against other professions and their restrictions on advertising. Engineers, pharmacists, dentists, doctors, and lawyers were all involved in either an investigation or litigation on this matter. The Attorney Generals of many states were advising regulatory boards of the professions, including State Boards of Accountancy, either to remove their bans on advertising or at least not to enforce them.

In 1978 and 1979, the AICPA membership approved by mail ballots changes in the rules to permit both paid advertising and solicitation. It was not a unanimous decision on either issue. About 18,000 members voted against permitting advertising, and 22,000 members voted against permitting solicitation. Although many years have passed since this major change in the rules was made, feelings on the subject continue to run high.

Designation As Expert
Since 1981, a person has been able to call himself or herself an expert or specialist in a given area provided that such self-designation was not false, deceptive or misleading. Prior to 1981, an interpretation had prohibited such an act.

Consider these scenarios. A CPA annually spends about 20 hours preparing an Australian tax return for his client’s Australian subsidiary. This is the only international tax work that this person does. This CPA would probably have a hard time justifying advertising his/her expertise or specialization in international income taxes or even Australian income taxes. Another CPA who has spent the last 30 years dealing solely with international income taxes would have no problem calling himself or herself an expert or specialist in that area. Where, between these two extremes, one will be deemed to qualify as an expert or specialist has not yet been determined and may well never be determined.

The courts have held that a CPA must meet the standards applicable to the average professional, not the “superstars” or those at the bottom of the ladder of expertise. Some CPAs have expressed the belief that if one calls oneself an expert or specialist in any area the courts may hold that CPA to a higher standard of knowledge in that field than they would expect of the average professional. Thus claiming to be a specialist or expert may be a mixed bag—on the positive side it may help to acquire clients, while on the negative side the CPA may be held to higher standards than he or she would want.

Testimonials and Endorsements
Starting in 1986, testimonials and endorsements were permitted in advertising and solicitation. An interpretation had prohibited their use prior to that date. The only guidelines issued on who may give such testimonials and endorsements and what statements they may contain are included in an ethics division staff statement which says that they cannot be false, misleading or deceptive.

Would it be ethical for Sampson & Co., a hypothetical public accounting firm, to use in their advertising and solicitation work testimonial letters from the presidents of some of their clients if such letters contained statements such as:

1. Sampson & Co. is the best accounting firm in this city.
2. Sampson & Co.’s work was far superior and their billing rates lower than our prior accountants, Greeley and Co.
3. During the last 15 years, we have used at various times the other three accounting firms in this city. None of the three measured up to Sampson & Co. in quality of work done, timeliness or fees charged.
4. If you want the best services at the lowest price, I would use Sampson & Co.

5. Sampson & Co. is a better firm than any other public accounting firm in this area.

Although using such material might be repugnant to many CPAs, it would appear that using them would not be a violation of the Code of Professional Conduct.

What if one of the statements had been—“Sampson & Co.’s billing rates are lower than any other public accounting firm in this area?” If Sampson & Co.’s partners know this to be untrue, then it would probably be a violation of the Code of Professional Conduct to use that testimonial in either an advertisement or a solicitation.

What if the testimonials were written by the brother-in-law or some other close relative of the managing partner of Sampson & Co.? Would that have to be disclosed? Would it be misleading or deceptive (and thus a violation of the Code of Professional Conduct) not to disclose it?

**Conclusion**

Advertising and solicitation are still relatively unfamiliar areas for public accountants. For 50 years, it was unethical to advertise or solicit; now CPAs may do both with few restrictions. Some people believe that the removal has led to excessive competition which in the long run may not be good for the public or the profession. Others have said that public accounting is no longer a profession. It is just another business. Unrestricted advertising and solicitation may have helped them reach that conclusion.
Rule, Interpretations, Rulings

Rule 502, Advertising and Other Forms of Solicitation
A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation in a manner that is false, misleading, or deceptive. Solicitation by the use of coercion, over-reaching or harassing conduct is prohibited.

Interpretations Under Rule 502—Advertising and Other Forms of Solicitation

502-2—False, misleading or deceptive acts in advertising or solicitation.
Advertising or other forms of solicitation that are false, misleading, or deceptive are not in the public interest and are prohibited. Such activities include those that—

1. Create false or unjustified expectations of favorable results.
2. Imply the ability to influence any court, tribunal, regulatory agency, or similar body or official.
3. Contain a representation that specific professional services in current or future periods will be performed for a stated fee, estimated fee or fee range when it was likely at the time of the representation that such fees would be substantially increased and the prospective client was not advised of that likelihood.
4. Contain any other representations that would be likely to cause a reasonable person to misunderstand or be deceived.

502-5—Engagements obtained through efforts of third parties.
Members are often asked to render professional services to clients of third parties. Such third parties may have obtained such clients or customers as the result of their advertising and solicitation efforts.

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

Rulings on Advertising and Other Forms of Solicitation

38. CPA Title, Controller of Bank
Question: A member not in public practice is controller of a bank. May the member permit the bank to use his CPA title on bank stationery and in paid advertisements listing the officers and directors of the bank?

Answer: The use of the CPA title on bank stationery by a member not in public practice is proper. It would also be proper for the CPA title of the member to appear in paid advertisements of the bank that list the officers and directors.

78. Letterhead: Lawyer-CPA
Question: May a member who is also admitted to the Bar represent himself on his letterhead as both an attorney and a CPA, or should he use separate letterheads in the conduct of the two practices?

Answer: The Code does not prohibit the simultaneous practice of accounting and law by a member licensed in both professions. Either a single or separate letterheads may be used, provided the information with respect to the CPA designation complies with rule 502 [ET section 502.01]. However, the member should also consult the rules of the applicable Bar Association.

183. Use of the AICPA Personal Financial Specialist Designation
Question: In what circumstances may a firm include the AICPA-awarded designation “Personal Financial Specialists” on the firm’s letterhead and in marketing materials?

Answer: It is permissible under rule 502 [ET section 502.01] for the designation “Personal Financial Specialists” (PFS) to be used on a firm’s letterhead and in marketing materials if all partners or shareholders of the firm currently have the AICPA-awarded designation. An individual member who holds the designation may use it after his or her name.
AICPA Staff Responses to Inquiries

Advertising and Solicitation

Question: May a member employ telemarketing techniques to solicit clients for his or her firm?

Answer: Yes. Rule 502 does not prohibit direct solicitation by telemarketing to obtain clients. However, the member must ensure the statements and the way they are made are not false, misleading or deceptive.

Question: Is it permissible under Rule 502 for a member to advertise in a local newspaper that his or her practice concentrates in tax services?

Answer: It is permissible, as long as the practice does in fact concentrate on tax services. A member may advertise in any manner that is not false, misleading or deceptive.

Question: The partners of a firm wish to list key employees’ names on the firm’s letterhead. Is this permissible under the Code of Professional Conduct?

Answer: Yes. However, a clear distinction must be made between the partners and the employees. It is customary to list partner’s names, draw a line, and then list employees’ names.

Question: May a member who is controller of a bank permit the use of his or her name and CPA status in paid advertisements listing the officers and directors of the bank?

Answer: As provided in Ethics Ruling No. 38, it would be permissible for the CPA title of the member to appear in such advertising.

Question: Before commencing public practice, a member was employed by the Internal Revenue Service. May the member include a statement to this effect in advertisements?

Answer: Members are permitted to include information about their past experience in advertisements or other solicitation material. However, as provided in Interpretation 502-2, the member should avoid any statements that would “imply an ability to influence any court, tribunal, regulatory agency, or similar body or official.”

Question: A member who is also a certified financial planner provides financial planning services through his practice of public accounting. May the member use the CFP designation in firm advertising, on the firm’s letterhead and on his business cards?

Answer: Use of the member’s CFP designation would be permissible under Rule 502—Advertising and Other Forms of Solicitation of the Code.

Question: May a member list other designations, in addition to CPA, on a letterhead or business card?

Answer: Yes, the Code of Professional Conduct does not prohibit simultaneous practices by a member licensed or certified in more than one profession. The member may wish to consult the rules of the appropriate state board of accountancy.

Question: A member in private practice wants to use the CPA designation on his or her business cards. Is this permissible under the Code of Professional Conduct?

Answer: Yes. The use of the CPA designation on business cards and in correspondence on his or her employer’s letterhead would be proper, provided the member does not use the designation to imply that he or she is independent of the employer. The member should also consult his or her state board of accountancy for any regulatory restrictions.

Question: May a member’s firm include its name on a tax newsletter if it was not prepared by the firm?

Answer: Yes, provided reasonable measures are taken to ensure the information contained within the publication is not false, misleading or deceptive.

Question: A CPA firm’s marketing brochure, prepared by an outside agency, includes the following statement: “When it comes to taxes, no other firm has the knowledge and experience of XY&Z, CPAs.” Would this statement be in violation of Rule 502—Advertising and Solicitation?

Answer: Probably. Such a representation would be considered false or misleading if there is no practical way to substantiate the statement.

Question: A member terminates his or her relationship with a firm and establishes a practice as a sole proprietor. May the member solicit clients of the former firm?
Answer: Yes, provided the member does not solicit clients in a false, misleading, deceptive, or harassing manner.

Question: In an ad in the yellow pages, a member refers to himself or herself as a “tax expert.” Is this permissible under the Code of Professional Conduct?

Answer: Possibly. The use of such a designation is permissible provided the member can demonstrate he or she has expertise in the tax area as a result of education, training, experience, etc.
Chapter Questions

1. A CPA firm presents a seminar on the latest changes in the federal income tax laws. Invitations to attend the seminar are sent by letter to both clients and non-clients. A portion of the letter reads: “James Smith of our firm’s Washington, D.C. office will chair the seminar. He has been a partner in our firm for more than 20 years and during that period has specialized in the income tax area. Mr. Smith is a recognized expert in the income tax field and has given talks on the subject to many national groups. Currently he is a member of the AICPA Federal Taxation Executive Committee and Chairman of our State CPA Society’s Committee on Taxation.” The presentation of such a seminar ________ a violation of the Code of Professional Conduct.
   (a) is
   (b) is not

2. With respect to question 1 above, the content of the letters of invitation ________ a violation of the Code of Professional Conduct.
   (a) is
   (b) is not

3. A CPA’s ad in a neighborhood newspaper states:
   Jane Jones, Certified Public Accountant; 1060 Walnut Street Western Springs—Telephone 244-6666
   Practice limited to write-up work and income taxes.
   This ad ________ a violation of the Code of Professional Conduct.
   (a) is
   (b) is not

4. A CPA firm placed the following ad in a newspaper:
   “We are pleased to announce that Frank Jones who spent the last twenty years with the Internal Revenue Service has joined our firm as a partner. The influence of friends Mr. Jones has in the Internal Revenue Service will prove invaluable in handling investigations by that department. Why not see us with respect to your tax problems?”
   This ad ________ a violation of the Code of Professional Conduct.
   (a) is
   (b) is not

5. A CPA is also an attorney who has been admitted to the bar. Under the AICPA Code of Professional Conduct, on her letterhead,
   (a) she may indicate she is both a CPA and an attorney.
   (b) she may state that she is a CPA or an attorney, but not both, on the same letterhead. Thus she will need separate letterheads for her CPA practice and her law practice.

6. A state wherein a CPA practices has just passed a law mandating that all municipalities over 10,000 population have annual audits. The CPA and his partners telephone all the council presidents and city managers of cities of that size soliciting their audit work. His and his partners’ actions ________ a violation of the Code of Professional Conduct.
   (a) are
   (b) are not

7. A CPA is approached by a bank president asking her to enter into a joint venture with the bank in providing services. The bank would advertise and solicit for this business. The CPA would do the personal income tax returns while the bank would handle trusts, estates, etc. There would be no sharing of fees or profits between the CPA and the bank, each billing the clients separately. It ________ be a violation of the Code of Professional Conduct for the CPA to enter into such an agreement.
   (a) would
   (b) would not

8. Two of the three partners in Scriba & Phillips, CPAs have received the AICPA-awarded designation, “Personal Financial Specialist.” In what way, if any, may this designation be used on their letterhead?
   (a) Since a majority of the partners have been awarded this title the designation may be applied to the firm, i.e., Scriba & Phillips, CPAs, Personal Financial Specialists.
   (b) The individual partners who hold this designation may use it after their names.
   (c) The title may not be used by either the firm or the individual partners.
9. Jones and Smith, a CPA firm, arranges with Connors & Hammer, a publisher, to purchase 500 copies of the publisher’s Annual Tax Guide. The tax partner, Smith, has reviewed the guide, and she believes that the information in it is not false, misleading or deceptive. The following will be printed on the cover of the Guide:

“We hope this Annual Tax Guide by Connors & Hammer will be of interest and useful to you.

JONES & SMITH
Certified Public Accountants”

Jones & Smith will distribute the 500 copies to clients and non-clients. This action by the CPA firm ______ be a violation of the Code of Professional Conduct.

(a) would
(b) would not

10. For many years, Mr. Jones, a CPA, has wished he had Smith Manufacturing Company as a client. This company has had for at least the last ten years Barnaby & Co. as its auditors. Mr. Jones makes an uninvited call on the president of Smith Manufacturing Company attempting to convince him to switch his work to Jones Company. Mr. Jones realizes that many CPAs believe his actions to be unprofessional and not in the best interests of either the public or the profession. However, he believes that his solicitation of the Smith Manufacturing Company account was ethical under the Code of Professional Conduct. Mr. Jones’ belief as to the ethical propriety of his actions is

(a) correct.
(b) incorrect.
Chapter Answers

1. (b) is correct. There are no prohibitions against inviting non-clients to seminars presented by a member’s firm (Rule 502). The only prohibitions are against false, misleading or deceptive advertising or solicitation.

2. (b) is correct. One is permitted to give the background of the speaker. Saying that James Smith is an expert in income taxes is also allowed as long as it is a true statement (Staff Responses to Inquiries).

3. (b) is correct. It is AICPA permissible for a member to advertise in a newspaper that his practice is limited to certain areas if in fact that is a true statement (AICPA Staff Responses to Inquiries).

4. (a) is correct. This ad is not allowed since it implies the ability to influence the IRS (Interpretation 502-2,2).

5. (a) is correct. The AICPA Code of Professional Conduct permits this. She should however, check with her Bar Association to see whether the association permits it (Ruling 78).

6. (b) is correct. Telemarketing is permitted (AICPA Staff Responses to Inquiries).

7. (b) is correct. Such joint ventures are permitted (Interpretation 502-5).

8. (b) is correct. Individuals holding that designation may use it after their name (Ruling 183).
   (a) is incorrect. The firm cannot use the designation unless each one of its owners have that AICPA awarded designation. (Ruling 183).
   (c) is wrong since individuals may use the title (Ruling 183).

9. (b) is correct. Distribution of such material is permitted provided the member believes the material contained in it is not false, deceptive or misleading (AICPA Staff Responses to Inquiries).

10. (a) is correct. There are no restrictions as to which entities may be solicited for their business (Rule 502).
Chapter 9

Other Responsibilities and Practices

Professional Attitude
The professional literature of public accounting stresses two important, interrelated concepts: the professional attitude and public acceptance of the profession. John L. Carey puts these concepts into perspective:

Professional men should not only be competent and independent; they should also place public service ahead of financial reward. Why should any group accept such an obligation? Because it is otherwise impossible to achieve recognition as a profession. Acceptance of this obligation is by definition the professional attitude.

Placing service ahead of reward does not imply an unrealistic lack of concern about making money. All professional men desire adequate incomes. But profit cannot be the dominant motive in a profession. If it were, by definition the vocation would be a business.

Without a professional attitude it is impossible for any vocational group, even when it possesses all the other attributes of a profession, to realize its maximum opportunities for service, and to attain the full satisfaction to be derived from public confidence and approval.  

Public confidence and approval, however, do not arise overnight. In time, the public recognizes a profession based on expertise. This is largely true of law and medicine. In the United States, and in most of the world, the law grants lawyers and doctors an almost exclusive right to practice. The younger profession of public accounting has not yet reached that point, although some states grant CPAs and other licensed public accountants sole rights to perform certain services. Only licensed CPAs can express opinions as CPAs. In many states only licensed persons can express an opinion on financial statements. The business community generally recognizes CPAs as professionals who render professional services.

Most CPAs wish their recognition to extend beyond the business and financial community to a larger public.

Public esteem will come in direct proportion to the degree to which the profession’s members, individually and collectively, exhibit the professional attitude.

Recent fraud accusations against some large corporation’s management and in some cases their auditing firm have eroded public confidence in the accounting profession. The bankruptcy of major companies and the collapse of the stock market, rightly or wrongly, aided this decline in confidence. The AICPA and state CPA societies are engaged in numerous campaigns to restore the public’s trust in the profession. It is up to each individual CPA to perform his/her work and conduct themselves in a manner that brings credit to the profession. By doing so the public will once more hold CPAs in high esteem.

In his book on the ethics of lawyers, Henry S. Drinker sums up the professional attitude of the legal profession as

1. A duty of public service, of which the emolument is a by-product, and in which one may attain the highest eminence without making much money...
2. A relation to clients in the highest degree of fiduciary.  

What is true of lawyers is true of CPAs and other professionals.

In a broad sense, every rule of the Code of Professional Conduct encourages the professional attitude. Sections dealing with relations with clients and the public and with technical standards all foster professionalism.

Enhancing the Stature of the Profession
CPAs perform important functions for society, and they and their firms must maintain a keen consciousness of the public interest and of the needs of society. A CPA is a beneficiary of the organization and character of the profession. The CPA is seen as a representative of the profession by those with whom he or she comes in contact. It is important that the CPA behave honorably

in both personal and professional life and that the CPA avoid any conduct that might erode the public’s respect and confidence.

**Acts Discreditable to the Profession**

Because of professional standing, a CPA places limits on his or her conduct which may differ from those observed by people in other areas of work. The non-professional may conduct business as he sees fit, within the framework of the law and general moral guidelines. If the non-professional stumbles past these moral guide lines, he may suffer some inconvenience, embarrassment, or discomfort. The non-professional’s responsibility, however, is primarily to himself, bound as he is by his own behavioral and occupational standards. Not so with CPAs and other professional people. As CPAs practice, they must bear in mind that their every professional act reflects upon their fellow practitioners as well as on themselves. Rule 501 states that: “A member shall not commit an act discreditable to the profession.”

What are “acts discreditable to the profession?” Violating anti-discrimination laws, failure to follow government requirements in performing attest services and negligence in preparing financial statements or records are some of the items enumerated as being an act discreditable. The CPA may be taken to task under Rule 501 if he breaks any of the rules of ethical conduct, or if he does anything of an illegal or immoral nature that discredits the profession. He is not alone in practice; the reputation of every CPA may be affected by what every other practitioner does.

A CPA was charged with “unlawfully, willfully, knowingly and corruptly, directly and indirectly giving money to an employee of the Internal Revenue Service with intent to influence an official act of that employee in violation of the Federal Bribery Statute.”

A federal court tried him and the evidence indicated that he had given money to an IRS agent. The case was dismissed on a legal technicality. The Institute’s Ethics Committee charged him with a breach of ethical conduct. A Trial Board heard the charges against him and found him guilty. They ordered him expelled from membership in the American Institute. Moreover, his name, where he lives and that he had been found guilty and expelled was printed in The CPA Letter. A private citizen might move away and start anew. Not the CPA! Even if he practiced elsewhere, other members of the AICPA might know of his offense. His good reputation, the basis of every CPA’s success, was ruined.

What was this CPA’s ethical offense? One must distinguish between ethics and the law. The Code does not specifically forbid bribery. A briber is expelled because of a character fault. The act demonstrates he cannot be trusted. He also brings dishonor to the profession because its integrity can be measured by the self-discipline of its members, both singly and collectively.

Interpretation 501-1 (Response to Requests by Client and Former Clients for Records) says that client records are any accounting or other records belonging to the client. Conversely, a member’s workpapers are those created by the member plus analyses and schedules prepared by the client at the member’s request.

Sometimes a member’s workpapers contain information that is not in the client’s records and thus the client’s records are incomplete. This could be property, plant and equipment records and related depreciation schedules which the accountant maintains but which have not been duplicated in the client’s records. Another example would be adjusting and closing entries or information that is normally contained in books of original entry and general ledgers or subsidiary ledgers. If the client were to change accountants, the new CPA might be unable to prepare financial statements or tax returns unless furnished copies of these working papers.

Client’s records (those accounting and other records that belong to the client) must be returned to the client if the client requests them. Even though state statutes may give the member a lien on such records in his possession, it would be a violation of Rule 501 to retain them after the client has demanded them. This is one case where ethics rules are tougher than the law. Whether the client has paid the member for his work or not is immaterial. When the client or former client asks for them, they must be given to the client.

With respect to member’s workpapers that are needed to make a client’s records complete, i.e., adjusting entries, depreciation schedules, etc.:

- The member may require that fees due the member with respect to completed engagements be paid before such information is provided.
- In the event an engagement is terminated prior to completion, the member need return only client records—but not copies of any part of the member’s workpapers.

What is the period of an engagement for purposes of this interpretation? There is no definition of a period of an engagement given.

The following scenario was posed to the AICPA Ethics Division staff.
A member has had an engagement for many years with a client to

- prepare cash receipts and cash disbursement journals from duplicate checks and daily sales summaries. The client sends these to the member on a monthly basis.
- prepare a monthly compilation report without footnotes.
- reconcile the client’s bank statement each month.
- at year-end prepare a review report and the federal and state income tax returns.

The client pays a monthly retainer of $800. At the year-end, he is billed an additional amount for the review report and the tax returns. He terminates the services of the member in October and hires another accountant to finish up the work for the calendar year.

The member has been paid the monthly retainer through August. The client refuses to pay the retainer for September. The former client then requests the member to give him

- January through September bank statements and cancelled checks.
- January through September bank reconciliations.
- Duplicate checks and sales summaries from January through September.
- Cash receipts and cash disbursement journals from January through September.
- Depreciation and capital account schedules for prior years and for January through September.

The Ethics Division staff said that the member must furnish his former client with the following even though he has not been paid the September retainer:

- Bank statements and cancelled checks for January through September.
- Bank reconciliations for January through August.
- Duplicate checks and sales summaries for January through September.
- Cash receipts and cash disbursement journals for January through August.
- Depreciation and capital account schedules for prior years and for January through September.

The following situation was also posed to the AICPA Ethics Division staff.

A member has an engagement to perform the annual audit for a client and an engagement to develop a new inventory control system. Both engagements are completed. The client is billed $20,000 for the audit and $15,000 for the new inventory control system. The client pays the audit fee but refuses to pay the $15,000 for the inventory control system claiming that it is no better than their prior system. He also dismisses the member and hires a new firm to handle his work in the future. He then asks for copies of the depreciation schedules and other data that the new firm will need to handle his account.

The Ethics Division staff said that the member must furnish the requested data even though he hasn’t been paid the $15,000. Further, the staff said that it wouldn’t make any difference in their answer whether the two engagements were performed concurrently or consecutively or whether there was one or two engagement letters. The member was paid for the audit engagement and therefore should give his former client the information.

A fairly common violation of the acts discreditable rule is failure to respond to an ethics committee’s inquiries. It is up to the member to let the AICPA and his or her state society know of any changes of address. If the member purposefully does not answer correspondence from the ethics committee or the ethics committee is unable to locate the member, the CPA may find himself or herself tried in absentia and expelled from the AICPA and the applicable state society for failure to cooperate with the ethics committee.

Most CPAs have felt and believed that discrimination was unethical and that it was an act discreditable to the profession. Interpretation 501-2 (Discrimination and Harassment in Employment Practices) clarifies that position.

**Commissions and Referral Fees**

The rule says:

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.

If a member meets the above restrictions and will receive a commission the member must disclose that fact to the person or entity to whom the member has recommended a product or service to which the commission relates.

When is a commission considered to be received? Ruling 184, Definition of the Receipt of a Contingent Fee or a Commission, says that a commission is deemed to be received when the performance of the related services is complete and the commission is determined.

What if a member sells a life insurance policy to a client? The member will receive a commission during the first year the policy is in effect. He or she will also receive a percentage of the annual premiums paid. Is the member then considered to be receiving commission payments each year? Ruling 184 says that the commission is deemed to be received in the year the policy is sold. The member could thus perform an audit or review of this client’s financial statements in all but the first year of the policy even though he will continue to receive a percentage of each year’s renewal premiums.

Also if a member pays a referral fee to obtain a client or receives a referral fee for recommending or referring any service of a CPA to any person or entity the member must disclose the acceptance or payment to the client.

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

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

**Conclusion**

A certified public accountant should exemplify conduct which enhances the stature of the profession and its ability to serve the public. The reputation of every CPA may be affected by the conduct of every other practitioner. The public’s concept of the CPA’s professionalism is linked with what the public thinks of CPA standards of conduct as evidenced by its contact with individual CPAs and what it reads in the press. Favorable public recognition is in direct proportion to the degree to which members exhibit a professional attitude.
Rules, Interpretations, Rulings

Rule 501, Acts Discreditable
A member shall not commit an act discreditable to the profession.

Interpretations Under Rule 501—Acts Discreditable

501-1—Response to Requests by Clients and Former Clients for Records.

Terminology
The following terms are defined subsequently solely for use with this interpretation:

- The term client includes current and former clients.
- Client-provided records are accounting or other records belonging to the client that were provided to the member, by or on behalf of, the client, including hardcopy or electronic reproductions of such records.
- Member-prepared records are accounting or other records that the member was not specifically engaged to prepare and that are not in the client’s books and records or are otherwise not available to the client, with the result that the client’s financial information is incomplete. Examples include adjusting, closing, combining, or consolidating journal entries (including computations supporting such entries) and supporting schedules and documents that are proposed or prepared by the member as part of an engagement (for example, an audit).
- Member’s work products are deliverables as set forth in the terms of the engagement, such as tax returns.
- Member’s working papers are all other items prepared solely for purposes of the engagement and include items prepared by the
  - member, such as audit programs, analytical review schedules, and statistical sampling results and analyses, and
  - client, at the request of the member and reflecting testing or other work done by the member.

Interpretation
Members must comply with the rules and regulations of authoritative regulatory bodies, such as the member’s state board(s) of accountancy, when the member performs services for a client and is subject to the rules and regulations of such regulatory body. For example, a member’s state board(s) of accountancy may not permit a member to withhold certain records notwithstanding fees due to the member for the work performed. Failure to comply with the more restrictive provisions contained in the rules and regulations of the applicable regulatory body concerning the return of certain records would constitute a violation of this interpretation.

Client-provided records in the member’s custody or control should be returned to the client at the client’s request. Unless a member and the client have agreed to the contrary, when a client makes a request for member-prepared records, or a member’s work products that are in the custody or control of the member or the member’s firm (member) that have not previously been provided to the client, the member should respond to the client’s request as follows:1

- Member-prepared records relating to a completed and issued work product should be provided to the client, except that such records may be withheld if there are fees due to the member for the specific work product.
- Member’s work products should be provided to the client, except that such work products may be withheld
  - if there are fees due to the member for the specific work product;
  - if the work product is incomplete;
  - for purposes of complying with professional standards (for example, withholding an audit report due to outstanding audit issues); or
  - if threatened or outstanding litigation exists concerning the engagement or member’s work.

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

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

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1. The member is under no obligation to retain records for periods that exceed applicable professional standards, state and federal statutes and regulations, and contractual agreements relating to the service performed.
In connection with any request for client-provided records, member-prepared records, or a member’s work products, the member may

• charge the client a reasonable fee for the time and expense incurred to retrieve and copy such records and require that such fee be paid prior to the time such records are provided to the client,
• provide the requested records in any format usable by the client, and
• make and retain copies of any records returned or provided to the client.

The member is not required to convert records that are not in electronic format to electronic format or to convert electronic records into a different type of electronic format. However, if the client requests records in a specific format, and the records are available in such format within the member’s custody and control, the client’s request should be honored. In addition, the member is not required to provide the client with formulas, unless the formulas support the client’s underlying accounting or other records, or the member was engaged to provide such formulas as part of a completed work product.

Where a member is required to return or provide records to the client, the member should comply with the client’s request as soon as practicable but, absent extenuating circumstances, no later than 45 days after the request is made. The fact that the statutes of the state in which the member practices grant the member a lien on certain records in his or her custody or control does not relieve the member of his or her obligation to comply with this interpretation.

501-2—Discrimination and harassment in employment practices.

Whenever a member is finally determined by a court of competent jurisdiction to have violated any of the antidiscrimination laws of the United States or any state or municipality thereof, including those related to sexual and other forms of harassment, or has waived or lost his/her right of appeal after a hearing by an administrative agency, the member will be presumed to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01].

501-3—Failure to follow standards and/or procedures or other requirements in governmental audits.

Engagements for audits of government grants, government units or other recipients of government monies typically require that such audits be in compliance with government audit standards, guides, procedures, statutes, rules, and regulations, in addition to generally accepted auditing standards. If a member has accepted such an engagement and undertakes an obligation to follow specified government audit standards, guides, procedures, statutes, rules and regulations, in addition to generally accepted auditing standards, he or she is obligated to follow such requirements. Failure to do so is an act discreditable to the profession in violation of rule 501 [ET section 501.01], unless the member discloses in his or her report the fact that such requirements were not followed and the reasons therefor.

501-4—Negligence in the preparation of financial statements or records.

A member shall be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01] when, by virtue of his or her negligence, such member—

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

501-5—Failure to follow requirements of governmental bodies, commissions, or other regulatory agencies.

Many governmental bodies, commissions or other regulatory agencies have established requirements such as audit standards, guides, rules, and regulations that members are required to follow in the preparation of financial statements or related information, or in performing attest or similar services for entities subject to their jurisdiction. For example, the Securities and Exchange Commission, Federal Communications Commission, state insurance commissions, and other regulatory agencies, such as the Public Company Accounting Oversight Board, have established such requirements.

If a member prepares financial statements or related information (for example, management’s discussion and analysis) for purposes of reporting to such bodies, commissions, or regulatory agencies, the member should follow the requirements of such organizations in addition to generally accepted accounting principles. If a

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4. Footnote deleted by the Professional Ethics Executive Committee, April 2012.
member agrees to perform an attest or similar service for the purpose of reporting to such bodies, commissions, or regulatory agencies, the member should follow such requirements, in addition to generally accepted auditing standards (where applicable). A material departure from such requirements is an act discreditable to the profession, unless the member discloses in the financial statements or his or her report, as applicable, that such requirements were not followed and the reasons therefore.

501-6—Solicitation or disclosure of CPA examination questions and answers.
A member who solicits or knowingly discloses the May 1996 or later Uniform CPA Examination question(s) and/or answer(s) without the written authorization of the AICPA shall be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01].

501-7—Failure to file tax return or pay tax liability.
A member who fails to comply with applicable federal, state, or local laws or regulations regarding the timely filing of his or her personal tax returns or tax returns of the member’s firm, or the timely remittance of all payroll and other taxes collected on behalf of others, may be considered to have committed an act discreditable to the profession in violation of rule 501 [ET section 501.01].

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

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


501-9—Confidential Information Obtained From Employment or Volunteer Activities.
A member should maintain confidentiality of his or her employer’s or firm’s (employer) confidential information and should not use or disclose any confidential employer information obtained as a result of an employment relationship (for example, discussions with the employer’s vendors, customers, or lenders). This includes, but is not limited to, any confidential information pertaining to a current or previous employer, subsidiary, affiliate, or parent thereof, as well as any entities for which the member is working in a volunteer capacity. For purposes of this interpretation, confidential employer information is any proprietary information pertaining to the employer or any organization for whom the member may work in a volunteer capacity that is not known to be available to the public and is obtained as a result of such relationships.

A member should be alert to the possibility of inadvertent disclosure, particularly to a close business associate or a close or immediate family member. The member should also take reasonable steps to ensure that staff under his or her control or others within the employing organization and persons from whom advice and assis-
When a member changes employment, a member should not use confidential employer information acquired as a result of the prior employment relationship to his or her personal advantage or the advantage of a third party, such as a current or prospective employer. The requirement to maintain confidentiality of an employer’s confidential information continues even after the end of the relationship between a member and the employer. However, the member is entitled to use experience and expertise gained through prior employment relationships.

A member would be considered to have committed an act discreditable to the profession 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.

The following are examples when 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 professional interests of a member 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.

Members should also consider Interpretation No. 102-4, “Subordination of Judgment by a Member,” under Rule 102, Integrity and Objectivity [sec. 102 par. .05], for additional guidance.

d. Disclosure is permitted on behalf of the employer to
   i. obtain financing with lenders;
   ii. deal with vendors, clients, and customers; or
   iii. deal with the employer’s external accountant, attorneys, regulators, and other business professionals.

In deciding whether to disclose confidential employer information, relevant factors to consider include, but are not limited to, the following:

a. Whether all the relevant information is known and substantiated to the extent that it is practicable (when the situation involves unsubstantiated facts, incomplete information, or unsubstantiated conclusions, professional judgment should be used in determining the type of disclosure to be made, if any)
b. Whether the parties to whom the communication may be addressed are appropriate recipients

A member may wish to consult with his or her legal counsel prior to disclosing, or determining whether to disclose, confidential employer information.

501-10—False, Misleading, or Deceptive Acts in Promoting or Marketing Professional Services.

A member in business who promotes or markets his or her abilities to provide professional services or makes claims about his or her experience or qualifications in a manner that is false, misleading, or deceptive will be considered to have committed an act discreditable to the profession, in violation of Rule 501 [sec. 501 par. .01]. A false, misleading, or deceptive promotion includes any claim or representation that would be likely to cause a reasonable person to be misled or deceived. This includes any representation about CPA licensure or any other professional certification or accreditation that is not in compliance with the requirements of the relevant licensing authority or designating body.

Rule 503, Commissions and Referral Fees

A. Prohibited commissions

A member in public practice shall not for a commission recommend or refer to a client any product or service, or for a commission recommend or refer any product or service to be supplied by a client, or receive a commission, when the member or the member’s firm also performs for that client:
a. an audit or review of a financial statement; or  
b. a compilation of a financial statement when the member expects, or reasonably might expect, that a third party will use the financial statement and the member’s compilation report does not disclose a lack of independence; or  
c. an examination of prospective financial information.

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

B. Disclosure of permitted commissions

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

C. Referral fees

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

Ethics Rulings on Other Responsibilities and Practices

184. Definition of the Receipt of a Contingent Fee or a Commission

Question: Rules 302 [ET section 302.01] and 503 [ET section 503.01] prohibit, among other acts, the receipt of contingent fees for the performance of certain services and the receipt of a commission for the referral of products or services under certain circumstances. When is a contingent fee or commission deemed to be received?

Answer: A contingent fee or commission is deemed to be received when the performance of the related services is complete and the fee or the commission is determined. For example, if in one year a member sells a life insurance policy to a client and the member’s commission payments are determined to be a fixed percentage of future years’ renewal premiums, the commission is deemed to be received in the year the policy is sold.

185. Sale of Products to Clients

Question: May a member purchase a product from a third-party supplier and resell the product to a client without violating rule 503 [ET section 503.01]?

Answer: Yes. If a member purchases a product and resells it to a client, any profit on the sale would not constitute a commission. Purchasing entails taking title to the product and having all the associated risks of ownership.

186. Billing for Subcontractor’s Services

Question: A member has contracted with a computer-hardware maintenance servicer to provide support for a client’s computer operations. Would it be a violation of rule 503 [ET section 503.01] for that member to bill the client a higher service fee than that charged the member by the service provider?

Answer: No. The increased fee would not constitute a commission.

187. Receipt of Contingent Fees or Commissions by Member’s Spouse

Question: May a member’s spouse provide services to the member’s attest client for a contingent fee or refer products or services for a commission to or from the member’s attest client without causing the member to be in violation of rule 302 [ET section 302.01] or rule 503 [ET section 503.01]?

Answer: Yes, if the activities of the member’s spouse are separate from the member’s practice and the member is not significantly involved in those activities. The member, however, should consider whether a conflict of interest may exist as described in rule 102 [ET section 102.01] and interpretation 102-2 [ET section 102.03].

188. Referral of Products of Others

Question: A member refers computer products of wholesalers to clients of the firm through distributors and agents. A payment is received by the member from the wholesaler if the clients purchase the computer products. Must the member consider rule 503 [ET section 503.01] in connection with this payment?

Answer: Yes. Section 91.02 [ET section 91.02] of the Code of Professional Conduct provides that a member shall not permit others to perform acts on behalf of the member that, if carried out by the member, would place the member in violation of the rules. Therefore, the member would be held responsible for the actions of the distributors and agents.

Rule 503 [ET section 503.01] provides that, if a member or the member’s firm performs for a client a service described in rule 503 [ET section 503.01], the member may not recommend or refer to that client for a commission any product or service, or receive a commission for a recommendation or referral. This prohibition applies during the period in which the member is engaged to perform any of the services described in rule 503 [ET section 503.01] and during the period covered by any historical financial statements in such services.
If the products are referred on a commission basis to clients for which the member is not engaged to perform any of the services described in rule 503 [ET section 503.01], rule 503 [ET section 503.01] would not be violated as long as the commission is disclosed to the client. However, any subsequent performance of services described in rule 503 [ET section 503.01] during a period in which the commission was received would constitute a violation of rule 503 [ET section 503.01].

189. Requests for Records Pursuant to Interpretation 501-1

Question: Individuals associated with a client entity who are currently on opposing sides in an internal dispute have each issued separate requests calling for the member to supply them with records pursuant to interpretation 501-1 [ET section 501.02]. Does the member have to comply with all such requests?

Answer: In providing professional services to individuals, partnerships, or corporations, a member will usually deal with an individual who has been designated or held out as the client’s representative. Such a representative might include, for example, a general partner or a majority shareholder. A member who has provided the records to the individual designated or held out as the client’s representative has no obligation to provide such records to other individuals associated with the client.

191. Member Removing Client Files from an Accounting Firm

Question: If the relationship of a member who is not an owner of a firm is terminated, may he or she take or retain originals or copies from the firm’s client files or proprietary information without the firm’s permission?

Answer: No, except where permitted by contractual arrangement.

192. Commission and Contingent Fee Arrangements with Nonattest Client

Question: A member or member’s firm (member) provides for a contingent fee investment advisory services, or refers for a commission products or services of a nonclient or a nonattest client, to the owners, officers, or employees of an attest client or to a nonattest client employee benefit plan sponsored by an attest client. Would the member be considered to be in violation of either rule 302 [ET section 302.01] or rule 503 [ET section 503.01]?

Answer: No. The member would not be in violation of either rule 302 [ET section 302.01] or rule 503 [ET section 503.01] provided that, with respect to rule 503 [ET section 503.01], the member discloses the commission to the owners, officers, or employees or to the employee benefit plan. The member should also consider the applicability of interpretation 102-2, Conflicts of Interest [ET section 102.03], and his or her professional responsibility to clients under Rule 301, Confidential Client Information [ET section 301.01].
AICPA Staff Responses to Inquiries

Acts Discreditable

Question: A member has been contacted by the successor accountant of a former client. The successor has requested copies of schedules supporting certain adjusting entries related to a prior year’s audited financial statements, an engagement for which the member has not been paid. May the member refuse to provide information until the outstanding fees have been paid without violating Rule 501?

Answer: Yes. Interpretation 501-1 allows a member to require outstanding fees for a completed engagement to be paid before releasing the requested information. This provision does not extend to requests for client records such as those belonging to the client that were given to the member by or on behalf of the client.

Question: A member has terminated an audit engagement with a client before its completion. The client, who has partially paid the audit fee, has requested copies of the workpapers prepared thus far. Is the member required to provide copies of the workpapers?

Answer: No. Because the engagement was terminated before its completion, the member is not obligated to provide the former client with the workpapers. However, the client’s records must be returned upon request. (Client records are any records belonging to the client that were provided to the member by or on behalf of the client.)

Question: A member has been contacted by a former client requesting copies of tax returns and accounting records furnished by the client. The member refuses to release any information until fees owed by the client for tax services are paid in full. Can the member withhold all of this information?

Answer: No, only certain information. Under Rule 501 (Interpretation 501-1), the member has to make available original documents provided to the member by the client. Workpapers, such as journals, ledgers, adjusting entries, tax returns and supporting schedules, may be withheld if the client has not paid for the particular engagement. Therefore, if the member was not paid in full for the tax services provided, the member is under no obligation to provide a copy of the tax return and supporting schedules. Members are cautioned to contact their state boards of accountancy for the applicable law or regulation, which may differ.

Question: A member was hired by a corporation to supervise its accounting department in preparing financial statements and presenting them to senior management. Due to considerable time incurred on other financial activities, the member was unable to supervise the accounting staff adequately. It is later discovered the financial statements contain false and misleading information. Aside from any legal implications, could the member be in violation of Rule 501?

Answer: Yes. Under interpretation 501-4, a member who, through his or her negligence, makes or permits another to make false and misleading entries in the financial statements has committed an act discreditable to the profession in violation to Rule 501. The member also should consider the legal implications of such action.

Question: A member in industry discovered his or her employer committed an illegal act. Would the disclosure of such information be a violation of the Code of Professional Conduct?

Answer: No. However, the member may wish to consult legal counsel prior to any disclosure.

Question: A member was asked to disclose a former employer’s trade secret to gain employment with another company. Would the member’s disclosure of such information be a violation of the Code of Professional Conduct?

Answer: Yes. If a member in industry uses confidential information obtained from an employer for his or her personal benefit, disclosure of the information is considered an act discreditable to the profession in violation to Rule 501. The member also should consider the legal implications of such action.

Question: A member prepared the 1999 federal income tax return for an individual and provided the original return and a copy. Must the member supply additional copies upon the individual’s request?

Answer: No, the member is not required to provide additional copies.

Question: A review client has disengaged a member and has requested that the member make available to the successor accountant certain workpapers related to prior year’s review engagements. If no fees are due the member for the prior review services, must the member comply with the client’s request?

Answer: No, unless the workpapers requested consist of any accounting or other records belonging to the client or contain information that is not reflected in the client’s books and records, thus making the client’s financial information incomplete.

Question: A member prepared the 1999 federal income tax return for an individual and provided the original return and a copy. Must the member supply additional copies upon the individual’s request?

Answer: No, the member is not required to provide additional copies.
sary documents to determine whether the transaction is in compliance with GAAP. It is later discovered that the sale occurred after the reporting period and resulted in materially overstated earnings in the financial statements. Is the member in violation of the AICPA code?

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

_Question:_ A member who is a partner of a firm is leaving to form a new partnership with other CPAs. Is he prohibited by the Code of Professional Conduct from taking originals or making photocopies of the firm’s client files?

_Answer:_ No. Such an action is not specifically prohibited under the Code of Professional Conduct since the ownership of these files is a legal issue. Therefore, the CPA should consider consulting with counsel. (For nonowners who leave the firm, see Ethics Ruling 191, Member Removing Client Files from an Accounting Firm.)

Additionally the practitioner should obtain consent from his clients if he expects to share any confidential client information with anyone else, such as any of the employees or partners of the newly formed partnership (See Rule 301).

**Commissions and Referral Fees**

_Question:_ In 2000 a member recommended an investment to a tax client and received a commission from the promoter as a result of the client’s investment. The client now wishes to obtain financing and has asked the member to perform a review of its financial statements for the year ended December 31, 2000. May the member perform the engagement without violating the Code of Professional Conduct?

_Answer:_ No. The member would be in violation of Rule 503 because the recommendation of the investment and the receipt of the commission occurred during the period covered by the financial statements.

_Question:_ An attorney has agreed to refer clients needing tax services to a member for a fee. Is this permitted under the Code of Professional Conduct?

_Answer:_ Yes. Under Rule 503, a member may pay a referral fee to obtain a client but must disclose the payment to the client.

_Question:_ May a member accept a commission for the sale of a life insurance policy to a client for which he or she performs only tax services?

_Answer:_ Yes, provided that receipt of the commission is disclosed to the client.

_Question:_ A sole practitioner is a passive investor in a financial planning entity that provides investment advisory services to his firm’s attest clients. As the member does not control this entity (as defined in FASB Statement No. 94), can it accept commissions for the referral of products or services to the member’s attest clients?

_Answer:_ Yes. Since the member has no control over it, the entity, as well as its owners and employees, is not prohibited from accepting commissions from the member’s attest clients. However, the member himself is prohibited from accepting commissions from such clients. (See Interpretation 505-2 and Rule 503).

_Question:_ Members who own CPA firm X establish a joint venture with a group of financial planners in which they own 60% of Company Y, a financial advisory firm. The financial planners who own the other 40% of the entity provide all the services to Company Y clients. If Company Y receives commissions for referring financial products to audit and attest clients of CPA firm X, may the members accept their portion of such commissions without violating Rule 503, Commissions and Referral Fees, of the Code of Professional Ethics?

_Answer:_ No. Since members of CPA firm X control Company Y, they cannot accept any commissions for referral of financial products to audit and attest clients since such action would violate Rule 505 of the code. According to Interpretation 505-2 of Rule 505, Form of Organization and Name, all the owners and employees of firm X must comply with all the provisions of the code.
Chapter Questions

1. A CPA firm that hires from 15 to 20 new staff people a year obtains 90 percent of its new people from the four colleges in the area. For the last three years, the graduating classes of these colleges have been composed of 50 percent women and 50 percent men, with these percent ages holding true for each quartile of grade point average of the graduating class. Firm personnel interviewing on campus have let it be known that they do not wish to interview women applicants. The firm’s professional staff of approximately 140 people includes ten women. A woman who was denied an interview with the firm’s recruiter files a complaint with the AICPA Ethics Division charging discrimination by the firm against women. The probable action by the Ethics Division would be to

(a) check to see if the matter had been litigated or there has been a hearing on the matter before an administrative agency as the first step in its investigation.

(b) inform the woman that there is no specific rule against discrimination in the Code of Professional Conduct and therefore, there is nothing the Ethics Division can do.

2. In January, a member obtains as a client a new business that has been in operation for a year. The company does not have a bookkeeper and for the year’s operation they have only listings of the cash receipts, cash disbursements and sales. Using these records, bank statements, etc., the member prepares the necessary accounting records, financial statements and income tax returns for the business. Upon completing the engagement, the member submits a statement for his services. He is told by the owner that it is much too high, and the owner employs a new CPA to do the work for the next year. The owner then demands copies of the depreciation schedules and other schedules that support the figures shown in the financial statements. He refuses to pay the member for his services. The refusal to pay is not based on a shortage of funds but rather on a dispute as to the amount charged. In this situation, which of the following statements is correct?

(a) Even though he hasn’t received a penny for his work, the member must furnish schedules necessary to support the figures in the financial statements.

(b) He need not furnish the data until the former client has paid him.

3. A CPA has been charged with bribing a city inspector. At her trial, the evidence clearly shows that she did pay a bribe to the inspector. However, the judge dismisses the case because of a legal technicality. In such a situation, which of the following statements is correct?

(a) Since a court has dismissed the charge against the CPA, the Ethics Division may do nothing about the matter.

(b) The Ethics Division may proceed with their own investigation of the matter and, if the facts warrant it, bring the member before a Trial Board.

4. A member decides to retire and sells his practice to another member. The purchase price is set at 30 percent of the fees the purchaser collects from these clients over the next three years. Computing the sale price in such a manner is

(a) ethical.

(b) unethical.

5. A small CPA firm has had a client for the last ten years. During this period the client’s business has grown to the point where the CPA firm can no longer adequately handle the work. They offer to “sell” the account to a larger CPA firm for 10 percent of the fees that the new firm collects from this client over the next three years. They will recommend the new CPA firm to the client and will help in the transition of the work from one firm to the other. Such an arrangement ______ be ethical if the terms of the sale were disclosed to the client.

(a) would

(b) would not

6. A small CPA firm has a client which they have serviced for a number of years. The client has continued to grow, and the CPA firm no longer has the capabilities to properly handle the client’s needs in audit, tax and management consulting. The CPA firm tries in vain to sell this client to other larger CPA firms who could handle the work. Finally, in desperation they agree to sell this client’s account through a non-CPA broker, agreeing to pay this broker 30 percent of the sale price. Such an agreement ______ be ethical with disclosure to the client of the broker’s fee.

(a) would

(b) would not
7. Hawn, a member, refers office supplies for a commission to some of his tax only clients. A nonattest client furnishes the office supplies. Is this a violation of the Code of Professional Conduct?
   (a) This is not a violation if Hawn discloses the commissions he receives to these clients.
   (b) This is a violation because commissions from such clients are forbidden.

8. A bank has agreed to refer to Hecht its customers who need income tax advice and preparation of tax returns. The bank will receive a referral fee from Hecht for each client he obtains. Has Hecht, a member, violated the Code of Professional Conduct by paying these fees?
   (a) Yes, he has violated the Code by paying such a fee to a person not in the practice of public accounting.
   (b) No, he has not violated the code if he tells these new clients that he paid a referral fee to obtain their work.

9. A member is permitted or may be required to disclose confidential employer information when
   (a) Disclosure is permitted by law
   (b) Disclosure is required by law
Chapter Answers

1. (a) is correct. They would wait until a decision was made by a government agency before starting their investigation (Interpretation 501-2).
   (b) is incorrect because discrimination is an act discreditable (Interpretation 501-2).

2. (b) is correct. These schedules are not client records. Thus he need not furnish them to the client until he is paid (Interpretation 501-1).
   (a) would have been the right answer a few years ago. The interpretation was changed to allow the member to demand payment before furnishing the data.

3. (b) is correct. The Ethics Division may investigate it even though the court dismissed the charge (Acts Discreditable to the Profession).

4. (a) is correct. The selling price of a practice may be computed this way (Commissions and Referral Fees).

5. (a) is correct. A client may be sold this way (Commissions and Referral Fees).

6. (a) is correct. A non-CPA broker may be used and paid in this manner (Commissions and Referral Fees).

7. (a) is correct. There is no prohibition against receiving a commission on sales to a nonattest client. He must disclose the commission to the client (Rule 502 A and B and Staff Responses to Inquires).

8. (b) is correct. He may pay a referral fee to obtain a client. He must disclose the referral fee to the client (Rule 503 C and Staff Responses to Inquires).

9. (b) is correct. Disclosure is appropriate if required by law.
Chapter 10

Consulting Services

Definition
The term consulting services is difficult to define precisely. To some CPAs the term may mean any services done for management, including audits and tax work. Certainly, tax work and audits are services to management, but to most CPAs the meaning of consulting services is usually narrower. To them it means any service rendered by a CPA other than auditing and tax work. The AICPA’s Management Consulting Services Executive Committee has defined consulting as:

Consulting provides value by diagnosing, strategizing, designing, constructing, integrating, operating or implementing solutions. Consulting utilizes relevant knowledge, based on integrity and objectivity, in both expert and advisory roles.

They also define consulting services as:

Professional services that employ the practitioner’s technical skills, education, observations, experiences and knowledge of the consulting process.

Technology has complicated our economic system, and no one can be thoroughly knowledgeable with respect to all the management problems of today’s business. Businessmen need help and they must get it from those best qualified in that particular area.

To whom do businessmen turn for this assistance? Many use their CPAs. Because of a CPA’s training and experience with a variety of businesses in a number of technical areas, a CPA can often be valuable to clients. A manager may need help in planning, establishing control, and decision making, and the CPA can help. The CPA already knows how the organization functions through auditing the financial statements and is likely to be able to assist in ways that an outside consultant cannot. The CPA can relate specific problems to the already familiar financial structure.

Can the CPA assist management even if they are not an audit client? Yes, because of his/her experience with other similar businesses.

CPAs for competitive reasons often feel obliged to expand their consulting services. Here they face the problem of how to prepare to offer new services. A CPA may work under one knowledgeable in the area or independently to learn new fields of service, taking on simple problems before tackling complex ones. The CPA may study independently or take courses offered by a professional society or a university.

Independence
The question of whether performing consulting services for audit clients will impair a CPA’s independence has been studied by various groups over the years. In none of these studies has it ever been proven that performing consulting services impaired an auditor’s independence.

The Institute’s council has stated:

It is an objective of the AICPA, recognizing that management service activities are a proper function of CPAs, to encourage all CPAs to perform the entire range of management services consistent with their professional competence, ethical standards, and responsibility. CPAs are thus encouraged to expand the scope of their management services. The services should be limited only by competence and the ethical standards of the profession.

Principles, Article VI, Scope and Nature of Services, says in part that members should:

Determine, in their individual judgments, whether the scope and nature of other services provided to an audit client would create a conflict of interest in the performance of the audit function for that client.

Assess, in their individual judgments, whether an activity is consistent with their role as professionals.

Securities and Exchange Commission (SEC) and Government Accountability Office (GAO)
As described in more detail in Chapter 5 of this course, in mid-June 2002, the Sarbanes-Oxley Act of 2002 was enacted. This new law prohibits auditors from furnishing some consulting services to their audit clients and, in
effect, severely restricts the furnishing of other consulting services to those clients. There is a very good chance that some state regulators will adopt all or a portion of this law’s provisions for accounting firms that provide attest services to privately held entities. The GAO in 2002 and again in 2007 changed their independence rules. Among other things, the changes, both in 2002 and 2007, restrict the amount of nonaudit services that may be provided entities whose reports must comply with GAO standards.

Statement on Standards for Consulting Services

The Code of Professional Conduct applies to Consulting Services just as it does to all other areas of practice. The member or the member’s firm must have the professional competence to perform the work. In the performance of the service the member must maintain both objectivity and integrity.

By a resolution of Council, the AICPA Management Consulting Services Executive Committee is authorized to promulgate standards under Rule 201, General Standards, and Rule 202, Compliance with Standards, with respect to the offering of consulting services. These statements are enforceable under the Code of Professional Conduct.

By this same resolution of the AICPA Council the committee is not permitted to issue any standard dealing with the broad question of what, if any, services should be proscribed.

There are six basic forms of consulting services:

1. **Consultations**—practitioner provides counsel in a short time frame based on knowledge of the client, circumstance, technical matters involved, client representations and the intent of the parties.
2. **Advisory services**—practitioner develops findings, conclusions and recommendations for client decision making.
3. **Implementation services**—practitioner puts an action plan into effect.
4. **Transaction services**—practitioner provides services related to a client transaction, generally with a third party.
5. **Staff and other support services**—practitioner provides staff and other services to perform tasks specified by the client.
6. **Product services**—practitioner provides a product and associated professional services.

Conclusion

Members performing consulting services must comply with the Code of Professional Conduct, interpretations thereof and ethical rulings pertaining to the rules. In addition they must comply with the Statement on Standards for Consulting Services. In all of their work they must avoid assuming the role of an employee or management. They should check the rules of the state regulatory authorities to see if they have adopted any prohibitions on the type or amount of such services that may be provided. Members, whose clients are under the jurisdiction of the PCAOB, SEC or GAO, must comply with those agencies restrictive rules on furnishing nonattest or consulting services.
Statement on Standards for Consulting Services

Consulting Services: Definitions and Standards

Introduction

1. Consulting services that CPAs provide to their clients have evolved from advice on accounting-related matters to a wide range of services involving diverse technical disciplines, industry knowledge, and consulting skills. Most practitioners, including those who provide audit and tax services, also provide business and consulting services to their clients.

2. Consulting services differ fundamentally from the CPA’s function of attesting to the assertions of other parties. In an attest service, the practitioner expresses a conclusion about the reliability of a written assertion that is the responsibility of another party, the asserter. In a consulting service, the practitioner develops the findings, conclusions, and recommendations presented. The nature and scope of work is determined solely by the agreement between the practitioner and the client. Generally, the work is performed only for the use and benefit of the client.

3. Historically, CPA consulting services have been commonly referred to as management consulting services, management advisory services, business advisory services, or management services. A series of Statements on Standards for Management Advisory Services (SSMASs) previously issued by the AICPA contained guidance on certain types of consulting services provided by members. This Statement on Standards for Consulting Services (SSCS) supersedes the SSMASs and provides standards of practice for a broader range of professional services, as described in paragraph 5.

4. This SSCS and any subsequent SSCSs apply to any AICPA member holding out as a CPA while providing Consulting Services as defined herein.

Definitions

5. Terms established for the purpose of SSCSs are as follows:

Consulting Services Practitioner. Any AICPA member holding out as a CPA while engaged in the performance of a Consulting Service for a Client, or any other individual who is carrying out a Consulting Service for a client on behalf of any Institute member or member’s firm holding out as a CPA.

Consulting Process. The analytical approach and process applied in a Consulting Service. It typically involves some combination of activities relating to determination of client objectives, fact-finding, definition of the problems or opportunities, evaluation of alternatives, formulation of proposed action, communication of results, implementation, and follow-up.

Consulting Services. Professional services that employ the practitioner’s technical skills, education, observations, experience, and knowledge of the consulting process.¹

a. Consultations, in which the practitioner’s function is to provide counsel in a short time frame, based mostly, if not entirely, on existing personal knowledge about the client, the circumstances, the technical matters involved, client representations, and the mutual intent of the parties. Examples of consultations are reviewing and commenting on a client-prepared business plan and suggesting computer software for further client investigation.

b. Advisory services, in which the practitioner’s function is to develop findings, conclusions, and recommendations for client consideration and decision making. Examples of advisory services are an operational review and improvement study, analysis of an accounting system, assistance with strategic planning, and defining requirements for an information system.

c. Implementation services, in which the practitioner’s function is to put an action plan into effect. Client personnel and resources may be pooled with the practitioner’s to accomplish the implementation objectives. The practitioner is responsible to the client for the conduct and

¹ The definition of Consulting Services excludes the following:

a. Services subject to other AICPA Technical Standards such as Statements on Auditing Standards (SASs), Statements on Standards for Attestation Engagements (SSAEs), or Statements on Standards for Accounting and Review Services (SSARSs). (These excluded services may be performed in conjunction with Consulting Services, but only the Consulting Services are subject to the SSCS.)

b. Engagements specifically to perform tax return preparation, tax planning/advice, tax representation, personal financial planning or bookkeeping services; or situations involving the preparation of written reports or the provision of oral advice on the application of accounting principles to specified transactions or events, either completed or proposed, and the reporting thereof.

c. Recommendations and comments prepared during the same engagement as a direct result of observations made while performing the excluded services.
management of engagement activities. Examples of implementation services are providing computer system installation and support, executing steps to improve productivity, and assisting with the merger of organizations.

d. Transaction services, in which the practitioner’s function is to provide services related to a specific client transaction, generally with a third party. Examples of transaction services are insolvency services, valuation services, preparation of information for obtaining financing, analysis of a potential merger or acquisition, and litigation services.

e. Staff and other support services, in which the practitioner’s function is to provide appropriate staff and possibly other support to perform tasks specified by the client. The staff provided will be directed by the client as circumstances require. Examples of staff and other support services are data processing facilities management, computer programming, bankruptcy trusteeship, and controllership activities.

f. Product services, in which the practitioner’s function is to provide the client with a product and associated professional services in support of the installation, use, or maintenance of the product. Examples of product services are the sale and delivery of packaged training programs, the sale and the implementation of computer software, and the sale and installation of systems development methodologies.

Standards for Consulting Services

6. The general standards of the profession are contained in Rule 201 of the AICPA Code of Professional Conduct and apply to all services performed by members. They are as follows:

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

   Due professional care. Exercise due professional care in the performance of professional services.

   Planning and supervision. Adequately plan and supervise the performance of professional services.

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

7. The following additional general standards for all Consulting Services are promulgated to address the distinctive nature of Consulting Services in which the understanding with the client may establish valid limitations on the practitioner’s performance of services. These Standards are established under Rule 202 of the AICPA Code of Professional Conduct.

   Client Interest. Serve the client interest by seeking to accomplish the objectives established by the understanding with the client while maintaining integrity and objectivity.

   Understanding with Client. Establish with the client a written or oral understanding about the responsibilities of the parties and the nature, scope, and limitations of services to be performed, and modify the understanding if circumstances require a significant change during the engagement.

   Communication with Client. Inform the client of (a) conflicts of interest that may occur pursuant to interpretations of Rule 102 of the Code of Professional Conduct, (b) significant reservations concerning the scope or benefits of the engagement, and (c) significant engagement findings or events.

8. Professional judgment must be used in applying Statements on Standards for Consulting Services in a specific instance since the oral or written understanding with the client may establish constraints within which services are to be provided. For

2. Article III of the Code of Professional Conduct describes integrity as follows:

   “Integrity requires a member to be, among other things, honest and candid within the constraints of client confidentiality. Service and the public trust should not be subordinated to personal gain and advantage. Integrity can accommodate the inadvertent error and the honest difference of opinion; it cannot accommodate deceit or subordination of principle.”

Article IV of the Code of Professional Conduct differentiates between objectivity and independence as follows:

   “Objectivity is a state of mind, a quality that lends value to a member’s services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest. Independence precludes relationships that may appear to impair a member’s objectivity in rendering attestation services.”

3. Rule 102-2 on Conflicts of Interest states, in part, the following:

   “A conflict of interest may occur if a member performs a professional service for a client or employer and the member of his or her firm has a significant relationship with another person, entity, product, or service that could be viewed as impairing the member’s objectivity. If this significant relationship is disclosed to and consent is obtained from such client, employer, or other appropriate parties, the rule shall not operate to prohibit the performance of the professional service...”

4. AICPA independence standards relate only to the performance of attestation services; objectivity standards apply to all services. See footnote 2.
example, the understanding with the client may limit the practitioner’s effort with regard to gathering relevant data. The practitioner is not required to decline or withdraw from a consulting engagement when the agreed-upon scope of services includes such limitations.

**Consulting Services for Attest Clients**


   However, members and their firms performing attest services for a client should comply with applicable independence standards, rules and regulations issued by the AICPA, the state boards of accountancy, state CPA societies, and other regulatory agencies.

**Effective Date**

10. This Statement is effective for engagements accepted on or after January 1, 1992. Early application of the provisions of this Statement is permissible.
Chapter Questions

1. Technical Standards promulgated by the Management Consulting Services Executive Committee ________ enforceable under the *Code of Professional Conduct*.
   (a) are
   (b) are sometimes
   (c) are not

2. The AICPA’s Management Consulting Services Executive Committee ________ the authority to proscribe the consulting services members may not engage in.
   (a) has
   (b) does not have

3. A CPA, who is a consulting practitioner, is permitted to help a privately held client in the following areas:
   (a) Finances.
   (b) Operations.
   (c) Organization.
   (d) Personnel.
   (e) All of the above.

4. The AICPA Management Consulting Services Executive Committee is authorized by AICPA Council to promulgate standards under
   (a) Rules 202 and 203.
   (b) Rules 201 and 202.
   (c) Rules 201 and 203.

5. If the engagement with the client limits the member’s efforts with respect to gathering relevant data the member ________ withdraw or decline the engagement.
   (a) is not required to
   (b) must
Chapter Answers

1. (a) is correct. Statement on Standards for Consulting Services are enforceable under the *Code of Professional Conduct* (Statement on Standards for Consulting Services and Chapter 6, General and Technical Standards, AICPA Council Resolution, Consulting Services Executive Committee).

2. (b) is correct. They cannot say which services are proscribed (Statement on Standards for Consulting Services, and Chapter 6, General and Technical Standards, AICPA Council Resolution, Consulting Services Executive Committee).

3. (e) is correct. There are practically no restrictions on consulting services for privately held clients. Some services would cause a member to lose his independence with the client but the member may still provide them (Statement on Standards for Consulting Services, Definitions). Members whose client’s reports are filed with the SEC or the GAO have severe restrictions on which and how much consulting services they may furnish those clients.

4. (b) is correct. They can issue standards under Rule 201 General Standards and Rule 202 Compliance with Standards (Statements on Standard for Consulting Services and Chapter 6, General and Technical Standards, AICPA Council Resolution, Consulting Services Executive Committee).

5. (a) is correct. Even though the client limits the scope of the work the CPA need not decline the engagement (Statement on Standards for Consulting Services, Standards for Consulting Services 8).
Chapter 11

Tax Services

History

The Statements on Standards for Tax Services (SSTSs) that are included in this course became effective January 1, 2010. Interpretations 1-1 and 1-2 of Statement No. 1 became effective January 31, 2012. The statements were first issued in 2000 and were revised in 2009. They became enforceable standards under the AICPA Code of Professional Conduct in 2000. The standards are based on the Statements on Responsibilities in Tax Practice (SRTPs). The SRTPs had been issued by the AICPA Tax Executive Committee from 1964 to 1977 as advisory opinions on appropriate standards of tax practice. They outlined the member’s responsibilities to clients, the public, government and the profession.

Although the SRTPs were not enforceable under the Code of Professional Conduct, the courts, Internal Revenue Service, state accountancy boards and other professional organizations relied on them as the appropriate professional conduct for CPAs in tax practice. As the AICPA Tax Executive Committee has stated, the SRTPs in and of themselves had become de facto enforceable standards of professional practice. Tax practitioners were regularly held accountable for failure to follow them, through state disciplinary organizations and malpractice cases when their professional practice conduct failed to meet the prescribed guidelines of conduct defined in the SRTPs.

Treasury Department Rules

CPAs practice in their own domain when they give expert opinions on financial statements. However, when they practice before the Treasury Department representing taxpayers in dealings with the Internal Revenue Service they practice with people of varying backgrounds. Attorneys and CPAs are admitted to practice solely on the strength of their professional status. But another group includes former IRS employees who are admitted by virtue of their former employment. Another smaller group consists of those who have passed the Treasury Department's examination.

Many of the Treasury Department’s rules governing tax practice are contained in Treasury Department Circular No. 230 and in the penalty provisions of the Internal Revenue Code. They apply only to federal tax practice whereas the Statements on Standards for Tax Services apply to the entire field of tax practice by members.

Ethical Responsibility to Client in Tax Practice

In tax practice, the member owes his/her first allegiance to the client. It’s the tax practitioner’s responsibility to keep the client out of trouble with government agencies such as the IRS and state tax authorities. The CPA should advise the client to avoid underpayments, for they might lead to penalties or interest. The CPA should also advise the client not to conceal information since it might lead to charges of fraud.

No taxpayer owes more tax than the minimum which the law demands; consequently, CPAs have a duty to keep their clients’ taxes to the legal minimum. In this way they represent their client’s interest somewhat as lawyers represent their clients. Looking out for a client’s interest, moreover, is not a breach of independence. In fact, a former chairman of the Institute’s Committee on Federal Taxation has said that a CPA “is not expected to approach uncertain tax questions with the same lack of bias that he must apply in expressing an opinion on the fairness of presentation of financial statements.”

For example, if there are several legal ways to present an item of income or expense, the CPA should choose the method that best serves the client’s interest. The CPA should also tell the client that the government agency may question the use of the most favorable method. The various ways to present the item of income or expense should be discussed with the client. It is the client’s decision, not the CPA’s, as to which method is finally used.

Signatures on Tax Returns

When a CPA signs a tax return as a preparer, the CPA states that he or she has examined the return and its ac-

companying schedules and that they are “true, correct and complete” to the best of his or her knowledge. However, the phrase, “to the best of his knowledge,” does not mean that he or she has examined the data. The CPA may rely solely on the client’s figures. If the CPA has no reason to doubt them, he or she may sign the return in good conscience. If the CPA thinks that the client’s data are faulty, the CPA cannot sign the return. In fact, if he or she knows the information is faulty, the CPA should not prepare the return.

Much room for doubt lies between knowing that the information is accurate and knowing that it is faulty. The CPA need not check everything the client provides. But the client ought to be questioned if any information appears to be misleading. In tax practice the CPA performs services that others may do, but the CPA’s reputation as an auditor may lead many to think that the CPA’s signature attests to the creditability of the return.

Yet the problem remains; the CPA is in an awkward position. The CPA cannot check all of the client’s data, nor can he or she ignore any indication that the information is not “true, correct and complete.” Many CPAs agree that any CPA who values having a reputation for reliability and integrity should perform at least some minimum procedures of review and investigation before signing as the preparer of the return.

**Errors in Prior Returns**

What should a CPA do when he or she finds that the client, intentionally or not, has understated income in some prior years? Treasury Department Circular No. 230, Section 10.21 says:

A practitioner who, having been retained by a client with respect to a matter administered by the Internal Revenue Service, knows that the client has not complied with the revenue laws of the United States or has made an error in or omission from any return, document, affidavit, or other paper which the client submitted or executed under the revenue laws of the United States, must advise the client promptly of the fact of such noncompliance; error, or omission. The practitioner must advise the client of the consequences as provided under the Code and regulations of such noncompliance, error, or omission.

Or to state it more simply, “If a practitioner knows that a client has not complied with the revenue laws, or that the client has made an error or omission on any document required to be filed, the CPA must so inform the client.”

The CPA must also tell the client the possible penalties that may be imposed if the matter is not corrected.

The client who made an unintentional error will act to correct it. But if the CPA believes the client understated income intentionally, the CPA has further responsibilities. The CPA should inform the client that a CPA has no “privileged communication,” that the law might compel the CPA to testify concerning the client’s statements, and the CPA’s working papers and other documents might be subpoenaed. The CPA should, therefore, advise the client to seek legal counsel. If, thus informed, the client fails to correct the error, the CPA should consider withdrawing from the engagement. To take part in a criminal act would be to commit “an act discreditable to the profession.” The CPA should probably seek legal counsel in such a situation.

Neither the profession nor the income tax rules, however, require a CPA to inform the Treasury Department of an error in a previous year.

**Conclusion**

The member’s first duty in tax practice is to the client, to keep the client’s tax at the legal minimum, neither overpaying nor underpaying. When a member signs a tax return as the preparer, the member asserts that the information in the return is true, correct and complete to the best of his or her knowledge and belief. The CPA is not required to verify or examine supporting data for the return. If however, the preparer has reason to believe that any information is incorrect, incomplete, or inconsistent, he or she should make further inquiries. If the member finds an error in a prior year’s return, the member must promptly inform the client of the error and recommend measures to be taken. If the client refuses to take appropriate action to correct the error, the member should consider whether to maintain a professional relationship with that client.

Until 2000, when the Statements on Standards for Tax Services became enforceable under the Code of Professional Conduct, the Code included little if any mention of a member’s ethical responsibilities in tax practice. The Code’s silence as to specific rules did not imply that the profession was ignoring tax practice. The AICPA had in the past disciplined members in tax practice for conduct “discreditable to the profession.”
Statements on Standards for Tax Services

Statement No. 1, Tax Return Positions

Introduction
1. This statement sets forth the applicable standards for members when recommending tax return positions or preparing or signing tax returns (including amended returns, claims for refunds, and information returns) filed with any taxing authority. For purposes of these standards

   a. a tax return position is (i) a position reflected on a tax return on which a member has specifically advised a taxpayer or (ii) a position about which a member has knowledge of all material facts and, on the basis of those facts, has concluded whether the position is appropriate.

   b. a taxpayer is a client, a member’s employer or any other third-party recipient of tax services.

2. This statement also addresses a member’s obligation to advise a taxpayer of relevant tax return disclosure responsibilities and potential penalties.

3. In addition to the AICPA, various taxing authorities, at the federal, state, and local levels, may impose specific reporting and disclosure standards with regard to recommending tax return positions or preparing or signing tax returns. These standards can vary between taxing authorities and by type of tax.

Statement
4. A member should determine and comply with the standards if any, that are imposed by the applicable taxing authority with respect to recommending a tax position, or preparing or signing a tax return.

5. If the applicable taxing authority has no written standards with respect to recommending a tax return position or preparing or signing a tax return, or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

   a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits if challenged.

   b. Notwithstanding paragraph 5(a), a member may recommend a tax return position if the member

      (i) concludes that there is a reasonable basis for the position and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph 5(a), a member may prepare or sign a tax return that reflects a position if (i) the member concludes there is a reasonable basis for the position and (ii) the position is appropriately disclosed.

6. When recommending tax return positions and when preparing or signing a return on which a tax return position is taken, a member should, when relevant, advise the taxpayer regarding potential penalty consequences of such tax return position and the opportunity, if any, to avoid such penalties through disclosure.

7. A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows—

   a. exploits the audit selection process of a taxing authority

   b. serves as a mere arguing position advanced solely to obtain leverage in the bargaining process of settlement negotiation with a taxing authority.

8. When recommending a tax return position, a member has both the right and responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

Explanation
9. The AICPA and various taxing authorities impose specific reporting and disclosure standards with respect to tax return positions and preparing or signing tax returns. In a given situation, the standards, if any, imposed by the applicable taxing authority may be higher or lower than the standards set forth in paragraph 5. A member is to comply with the standards, if any, of the applicable taxing authority; if the applicable taxing authority has no standards or if its standards are lower than the standards set forth in paragraph 5, the standards set forth in paragraph 5 will apply.

10. Our self-assessment tax system can function effectively only if taxpayers file tax returns that are true, correct, and complete. A tax return is prepared based on a tax payer’s representation of facts, and the taxpayer has the final responsibility for positions taken
on the return. The standards that apply to a taxpayer may differ from those that apply to a member.

11. In addition to a duty to the taxpayer, a member has a duty to the tax system. However, it is well established that the taxpayer has no obligation to pay more taxes than are legally owed, and a member has a duty to the taxpayer to assist in achieving that result. The standards contained in paragraphs 4-8 recognize the members’ responsibilities to both the taxpayer and the tax system.

12. In reaching a conclusion concerning whether a given standard in paragraph 4 or 5 has been satisfied, a member may consider a well-reasoned construction of the applicable statute, well-reasoned articles or treatises, or pronouncements issued by the applicable taxing authority, regardless of whether such sources would be treated as authority under Internal Revenue Code Section 6662, Imposition of accuracy-related penalty on underpayments, and the regulations there under. A position would not fail to meet these standards merely because it is later abandoned for practical or procedural considerations during an administrative hearing or in the litigation process.

13. If a member has a good faith belief that more than one tax return position meets the standards set forth in paragraphs 4-5, a member’s advice concerning alternative acceptable positions may include a discussion of the likelihood that each such position might or might not cause the taxpayer’s tax return to be examined and whether the position would be challenged in an examination. In such circumstances, such advice is not a violation of paragraph 7.

14. A member’s determination of whether information is appropriately disclosed by the taxpayer should be based on facts and circumstances of the particular case and the disclosure requirements of the applicable taxing authority. If a member recommending a position, but not engaged to prepare or sign the related tax return, advises the taxpayer concerning appropriate disclosure of the position, then the member shall be deemed to meet the disclosure requirements of these standards.

15. If particular facts and circumstances lead a member to believe that a taxpayer penalty might be asserted, the member should so advise the taxpayer and should discuss with the taxpayer the opportunity to avoid such penalty by disclosing the position on the tax return. Although a member should advise the taxpayer with respect to disclosure, it is the taxpayer’s responsibility to decide whether and how to disclose.

16. For purposes of this statement, preparation of a tax return includes giving advice on events that have occurred at the time the advice is given if the advice is directly relevant to determining the existence, character, or amount of a schedule, entry, or other portion of a tax return.

Interpretation No. 1-1, “Reporting and Disclosure Standards,” of Statement on Standards for Tax Services No. 1, Tax Return Positions

Background

1. Statement on Standards for Tax Services (SSTS) No. 1, Tax Return Positions (AICPA, Professional Standards), contains the standards a member should follow when recommending tax return positions or preparing or signing tax returns.

2. A member should determine and comply with the reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return.

If the applicable taxing authority has no written standards that apply with respect to recommending a tax return position or preparing or signing a tax return or if its standards are lower than the standards set forth in this paragraph, the following standards will apply:

a. A member should not recommend a tax return position or prepare or sign a tax return taking a position unless the member has a good-faith belief that the position has at least a realistic possibility of being sustained administratively or judicially on its merits, if challenged (commonly referred to as the realistic possibility of success standard).

b. Notwithstanding paragraph 2(a), a member may recommend a tax return position if the member (i) concludes that there is a reasonable basis for the position, and (ii) advises the taxpayer to appropriately disclose that position. Notwithstanding paragraph 2(a), a member may prepare or sign a tax return that reflects a position if (i) the member concludes there is a reasonable basis for the position, and (ii) the position is appropriately disclosed.

3. Federal, state, local, and other taxing authorities may impose specific reporting and disclosure standards with respect to recommending tax return positions or preparing or signing tax returns that apply in addition to the AICPA standards. These standards vary among taxing jurisdictions and by type of tax. A member should refer to the current version
of Internal Revenue Code (IRC) Section 6694, “Understatement of Taxpayer’s Liability by Tax Return Preparer,” and the regulations thereunder to determine the reporting and disclosure standards applicable to preparers of federal tax returns.

4. When recommending a tax return position, or when preparing or signing a tax return on which a position is taken, a member should, when relevant, advise the taxpayer regarding the potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

5. A member should not recommend a tax return position or prepare or sign a tax return reflecting a position that the member knows exploits the audit selection process of a taxing authority or serves as a mere arguing position advanced solely to obtain leverage in a negotiation with a taxing authority.

6. When recommending a tax return position, a member has both the right and the responsibility to be an advocate for the taxpayer with respect to any position satisfying the aforementioned standards.

7. A member also should consider SSTs No. 3, Certain Procedural Aspects of Preparing Returns (AICPA, Professional Standards), regarding the obligation to examine or verify certain supporting data or consider information related to another taxpayer, when preparing a taxpayer’s tax return.

**General Interpretation**

8. As described in the preface, the realistic possibility of success standard is a lower standard than the substantial authority standard and the more likely than not standard, but it is a higher standard than the reasonable basis standard. Therefore, if the standard of the applicable taxing authority is, for example, substantial authority, more likely than not, or some other standard that is higher than the realistic possibility of success standard, then the member should comply with that higher standard. In that case, the member is held to a standard higher than realistic possibility of success.

If the standard of the applicable taxing authority is lower than the realistic possibility of success standard, then the member should comply with the realistic possibility of success standard, which is reflected in paragraph 2(a) of this interpretation, or the reasonable basis standard with appropriate disclosure, which is reflected in paragraph 2(b) of this interpretation.

For purposes of this interpretation, the reporting and disclosure standards that apply in a given situation in accordance with SSTs No. 1 and this interpretation will be referred to as the required reporting and disclosure standards.

9. A member should determine and comply with the rules of the applicable taxing authority regarding reliance on authorities (cases, rulings, regulations, treatises, and so forth). However, notwithstanding the rules of the applicable taxing authority, in determining whether a tax return position satisfies the realistic possibility of success standard or the reasonable basis standard with appropriate disclosure for purposes of paragraph 2(a)–(b) of this interpretation, a member may rely on authorities in addition to those evaluated when determining whether substantial authority exists for a return position or whether a position is more likely than not to prevail under IRC Section 6662. For purposes of paragraph 2(a)–(b) of this interpretation, a member may rely on well-reasoned treatises, articles in recognized professional tax publications, and other reference tools and sources of tax analyses commonly used by tax advisers and preparers of returns. A member should exercise caution in relying on materials, such as treatises, that may not be accepted as authorities in all situations, such as under federal tax law.

10. If particular facts and circumstances lead a member to believe that a taxpayer penalty could be asserted, then the member should so advise the taxpayer and should discuss with the taxpayer the opportunity, if any, to avoid such penalty by disclosing the position on the tax return. Although a member should so advise the taxpayer with respect to disclosing, it is the taxpayer’s responsibility to decide whether and how to disclose.

11. In determining if the required reporting and disclosure standards have been satisfied, a member should do all of the following:

- Establish the relevant background facts.
- Consider the reasonableness of the assumptions and representations.
- Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
- Apply the pertinent authorities to the relevant facts.
- Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
• Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.3
• Arrive at a conclusion supported by the authorities.

12. A member should consider the weight of each authority to determine whether the required reporting and disclosure standards have been satisfied. In determining the weight of an authority, a member should consider its source, relevance, and persuasiveness. Therefore, the type of authority is a significant factor. Other important factors include whether the facts stated by the authority are distinguishable from those of the taxpayer’s situation and whether the authority contains an analysis of the issue or merely states a conclusion.

13. A standard may be satisfied despite the absence of certain types of authority. For example, a member may conclude that the substantial authority standard has been satisfied when the position is supported only by a well-reasoned construction of the applicable statutory provision.

14. In determining whether the required reporting and disclosure standards have been satisfied, the extent of research required is left to the professional judgment of the member, given the facts and circumstances known to the member. A member may conclude that more than one position satisfies a given reporting standard, such as the substantial authority standard.

Specific Illustrations

15. The following illustrations address general fact patterns only. Accordingly, the application of guidance, as discussed in the previous section, “General Interpretation,” to variations in such general fact patterns or to particular facts or circumstances may lead to different conclusions. In each illustration, no authority exists other than that which is indicated. A decision regarding what are the required reporting and disclosure standards for tax return positions should be consistent with the provisions of SSTs No. 1, as explained in the previous section, “Background.”

Determination of the Standards

16. Illustration 1. A member is preparing a U.S. income tax return at a time when the federal reporting standard is substantial authority for undisclosed positions and reasonable basis for disclosed positions.4 One of the issues the member needs to address in preparing the return is the deductibility of a particular expenditure.

17. Conclusion. The federal standard of substantial authority is higher than the realistic possibility of success standard; therefore, the member is required to comply with the federal standard of substantial authority for undisclosed positions on the return. If the member analyzes the law and applicable authorities regarding whether the expenditure is deductible and concludes that there is not substantial authority to support taking a deduction for the expenditure, the member should not prepare the return taking the deduction as an undisclosed position.

If the member concludes that there is sufficient authority to provide a reasonable basis for claiming the deduction, the member may prepare the return claiming the deduction if that position is appropriately disclosed.

18. Illustration 2. A member is preparing a state inheritance tax return and needs to address the deductibility of a particular expenditure. The state does not have specific tax return reporting standards that apply.

19. Conclusion. Because the applicable taxing authority (the state) does not have written tax return reporting standards that apply, the realistic possibility of success standard for an undisclosed position and the reasonable basis standard for an appropriately disclosed position apply. The member can prepare the return claiming the deduction if either of these is satisfied.

20. Illustration 3. A taxpayer wants to take a position that a member has determined does not satisfy the reasonable basis standard. The taxpayer maintains that even if the taxing authority examines the return, the issue will not be raised.

21. Conclusion. The member should not consider the likelihood of the issue being raised on examination when determining whether any reporting or disclosure standard has been satisfied. The member should not prepare or sign a return that contains a position that does not satisfy the reasonable basis standard, even if the position is disclosed.

22. Illustration 4. A taxpayer wants to take a position on a federal tax return without disclosure; the member concludes that the position satisfies the substantial authority standard provided an assumption regarding an underlying nontax legal issue is appropriate. The member recommends that the taxpayer seek

3 See, for example, Treasury Regulation Section 1.6011-4(b).

4 See the preface for a description of the various reporting standards.
advice from its legal counsel, and the taxpayer’s attorney gives an opinion on the nontax legal issue that is consistent with the assumption.

23. **Conclusion.** A member may, in general, rely on a legal opinion on a nontax legal issue. A member should use professional judgment when relying on a legal opinion. If, on its face, the opinion of the taxpayer’s attorney appears to be unreasonable, unsubstantiated, or unwarranted, the member, with appropriate consents from the taxpayer, should consult the member’s attorney before relying on the opinion. A member should also refer to the illustrations in Interpretation No. 1-2, “Tax Planning,” of SSTS No. 1 regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

24. **Illustration 5.** A taxpayer has obtained from its attorney an opinion on the tax treatment of an item and requests that a member rely on the opinion.

25. **Conclusion.** If a member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the legal opinion, then the member may rely on that opinion when determining whether the required reporting and disclosure standards have been satisfied. The member should also refer to the illustrations in Interpretation No. 1-2 of SSTS No. 1 regarding the circumstances in which it is appropriate to rely on an opinion of legal counsel.

**Application of the Taxing Authority’s Standards**

26. As noted previously, SSTS No. 1 requires a member to determine and comply with the required reporting and disclosure standards, if any, that are imposed by the applicable taxing authority with respect to recommending a tax return position or preparing or signing a tax return. These standards, and the methods in which they are to be applied, vary among taxing authorities based on the laws and regulations of the relevant jurisdictions; therefore, illustrating all specific taxing authority standards is beyond the scope of this interpretation. To assist members in their analysis of whether the standards of an applicable taxing authority have been satisfied, the preface contains a description of the most common tax return reporting standards, the nature of the analysis to be applied, and the common requirements for appropriate disclosure.

**Application of the Realistic Possibility of Success and the Reasonable Basis Standards**

27. If the applicable taxing authority has no written tax return reporting or disclosure standards that apply or if its standards are lower than the realistic possibility of success standard for undisclosed positions or the reasonable basis standard for appropriately disclosed positions, SSTS No. 1 requires a member to comply with these latter standards, as stated in paragraph 2(a)–(b) of this interpretation.

The following illustrations pertain to situations in which a member is required to comply with these standards because the applicable taxing authority either has no written standards that apply or has standards that are lower than those described in paragraph 2(a)–(b) of this interpretation.

28. **Illustration 6.** A taxpayer has engaged in a transaction that is adversely affected by a new statutory provision. Prior law supports a position favorable to the taxpayer. The taxpayer believes, and the member concurs, that the new statute is inequitable as applied to the taxpayer’s situation. The statute is constitutional, clearly drafted, and unambiguous. The legislative history discussing the new statute contains general comments that do not specifically address the taxpayer’s situation.

29. **Conclusion.** The member cannot recommend the return position that is contrary to the new statute. A position contrary to a constitutional, clear, and unambiguous statute would ordinarily be considered a frivolous position and, even if appropriately disclosed, would not satisfy the reasonable basis standard.

30. **Illustration 7.** The facts are the same as in illustration 6 except that the legislative history discussing the new statute specifically addresses the taxpayer’s situation and supports a position favorable to the taxpayer.

31. **Conclusion.** In a case in which the statute is clearly and unambiguously against the taxpayer’s position but a contrary position exists based on legislative history specifically addressing the taxpayer’s situation, a return position based either on the statutory language or on the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

32. **Illustration 8.** The facts are the same as in illustration 6 except that the legislative history can be interpreted to provide some evidence or authority in support of the taxpayer’s position; however, the legislative history does not specifically address the taxpayer’s situation.
33. **Conclusion.** In a case in which the statute is clear and unambiguous, a contrary position based on an interpretation of the legislative history that does not explicitly address the taxpayer’s situation does not satisfy the realistic possibility of success standard. However, because the legislative history provides some support or evidence for the taxpayer’s position, a member may recommend the position to the taxpayer if the member determines that there is a reasonable basis for the position and advises the taxpayer to adequately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

34. **Illustration 9.** A taxpayer is faced with an issue involving the interpretation of a new statute. Following its passage, the statute was widely recognized to contain a drafting error, and a technical correction proposal has been introduced. The taxing authority issues a pronouncement indicating how it will administer the provision. The pronouncement interprets the statute in accordance with the proposed technical correction.

35. **Conclusion.** A return position based on either the existing statutory language or the taxing authority’s pronouncement satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

36. **Illustration 10.** The facts are the same as in illustration 9 except that no taxing authority pronouncement has been issued.

37. **Conclusion.** In the absence of a taxing authority pronouncement interpreting the statute in accordance with the proposed technical correction, only a return position based on the existing statutory language will satisfy the realistic possibility of success standard. A member may recommend the position to the taxpayer if, based on the facts and circumstances, the member determines that a reasonable basis exists for the position and advises the taxpayer to adequately disclose the position. Also, a member may prepare a return for the taxpayer taking such a position if, based on the facts and circumstances, the member determines that there is a reasonable basis for the position, and the position is appropriately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

38. **Illustration 11.** A taxpayer is seeking advice from a member regarding a recently amended statute. The member has reviewed the statute, the legislative history that specifically addresses the issue, and a recently published notice issued by the taxing authority. No cases, rulings, or other pronouncements exist regarding the statute. The member has concluded in good faith that, based on the statute and the legislative history, the taxing authority’s position as stated in the notice does not reflect legislative intent.

39. **Conclusion.** A return position supported by the statute and the legislative history satisfies the realistic possibility of success standard. (It also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

40. **Illustration 12.** The facts are the same as in illustration 11 except that the taxing authority’s pronouncement is a temporary regulation.

41. **Conclusion.** In determining whether a tax return position satisfies the realistic possibility of success standard, a member should determine the weight to be given the temporary regulation by analyzing factors, such as whether the regulation is legislative or interpretative and if it is consistent with the statute. If the member concludes that the position does not satisfy the realistic possibility of success standard, the member may still recommend the position if the member determines that it satisfies the reasonable basis standard and the member advises the taxpayer to adequately disclose the position. The member may prepare a return for the taxpayer taking that position if the member determines that the position satisfies the reasonable basis standard, and the position is adequately disclosed. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

42. **Illustration 13.** A statute is passed requiring the capitalization of certain expenditures. The taxpayer believes, and the member concurs, that to comply fully, the taxpayer will have to acquire new computer hardware and software and implement a number of new accounting procedures. The taxpayer and member agree that the costs of full compliance will
be significantly greater than the resulting increase in tax due under the new provision. Because of these cost considerations, the taxpayer makes no effort to comply. The taxpayer wants the member to prepare and sign a return on which the new requirement is simply ignored.

43. Conclusion. The return position desired by the taxpayer is frivolous, a standard below reasonable basis. The member should not prepare or sign the return.

44. Illustration 14. The facts are the same as in illustration 13 except that the taxpayer has made a good-faith effort to comply with the law by calculating an estimate of expenditures to be capitalized under the new provision.

45. Conclusion. In this situation, assuming the taxpayer complied with the statutory and regulatory provisions classifying expenditures to be capitalized and those to be expensed and made a good-faith effort to determine the appropriate amounts to be capitalized and expensed, the realistic possibility of success standard would be satisfied for the return positions. (The substantial authority standard also may be satisfied.) When using estimates in the preparation of a return, a member should refer to SSTS No. 4, Use of Estimates (AICPA, Professional Standards). A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

46. Illustration 15. On a given issue, a member has located and weighed two authorities concerning the treatment of a particular expenditure. The taxing authority has issued an administrative ruling that requires the expenditure to be capitalized and amortized over several years. On the other hand, a court opinion permits the current deduction of the expenditure. The member has concluded that these are the relevant authorities, considered the source of both authorities, and concluded that both are persuasive and relevant.

47. Conclusion. The realistic possibility of success standard is met by either position. (Either or both also may satisfy the substantial authority standard.) A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

48. Illustration 16. A tax statute is silent on the treatment of an item. However, the legislative history explaining the statute directs the taxing authority to issue regulations that will require a specific treatment of the item. No regulations have been issued at the time the member must recommend a position on the tax treatment of the item.

49. Conclusion. The position supported by the legislative history satisfies the realistic possibility of success standard. A member should, when relevant, advise the taxpayer regarding potential penalty consequences of the tax return position and the opportunity, if any, to avoid such penalties through disclosure.

Interpretation No. 1-2, “Tax Planning,” of Statement on Standards for Tax Services No. 1, Tax Return Positions

Background

1. Statements on Standards for Tax Services (SSTSs) are enforceable standards that govern the conduct of AICPA members in tax practice. A significant area of many members’ tax practices involves assisting taxpayers in tax planning. Two of the seven SSTSs issued as of the date of this interpretation’s release (that is, the revised SSTSs that became effective on January 1, 2010) directly set forth standards that affect the most common activities in tax planning. Several other SSTSs set forth standards related to specific factual situations that may arise while a member is assisting a taxpayer in tax planning. The two SSTSs that are most typically relevant to tax planning are SSTS No. 1, Tax Return Positions (AICPA, Professional Standards), including Interpretation No. 1-1, “Reporting and Disclosure Standards,” and SSTS No. 7, Form and Content of Advice to Taxpayers (AICPA, Professional Standards).

2. Taxing authorities, courts, the AICPA, and other professional organizations have struggled with defining and regulating tax shelters and abusive transactions. Crucial to the debate is the difficulty of clearly distinguishing between transactions that are abusive and transactions that are aggressive and legitimate. At the same time, it must be recognized that taxpayers have a legitimate interest in arranging their affairs so that they pay no more than the taxes they owe. Tax professionals, including AICPA members, have a role to play in advancing these efforts.

3. This interpretation is part of the AICPA’s continuing efforts at self-regulation of its members in tax practice. It has its origins in the AICPA’s desire to provide adequate guidance to its members with respect to providing services in connection with tax planning. This interpretation does not change
or elevate any level of conduct prescribed by any standard. Its goal is to clarify existing standards, recognizing the compelling need for a comprehensive interpretation of a member’s responsibilities in connection with tax planning. This guidance is intended to clarify how those standards would apply across the spectrum of tax planning, including those situations involving tax shelters, regardless of how that term is defined.

General Interpretation

4. Tax planning encompasses a wide variety of situations. It includes situations in which the member provides advice on prospective or completed transactions, whether or not the advice reflects favorable or unfavorable treatment to the taxpayer. When providing professional services that include tax planning, a member should determine and comply with any applicable standards for reporting and disclosing tax return positions or for providing written tax advice. See SSTS No. 1 and Interpretation No. 1-1; SSTS No. 7; U.S. Treasury Department Circular 230, Regulations Governing the Practice of Attorneys, Certified Public Accountants, Enrolled Agents, Enrolled Actuaries, Enrolled Retirement Plan Agents, and Appraisers before the Internal Revenue Service; and any other standards that may apply. A member may still recommend a position that does not satisfy the realistic possibility standard if (a) a reasonable basis exists for the position, (b) the member recommends appropriate disclosure, and (c) a higher standard is not required under applicable taxing authority rules. For purposes of this interpretation, the reporting and disclosure standards that apply in a given situation in accordance with SSTS No. 1 and Interpretation No. 1-1 will be referred to as the “required reporting and disclosure standards.”

5. For purposes of this interpretation, tax planning includes, both with respect to prospective and completed transactions, recommending or expressing an opinion (whether written or oral) on (a) a tax return position or (b) a specific tax plan developed by the member, the taxpayer, or a third party. For tax planning with respect to a completed transaction, the member may be considered a nonsigning tax return preparer with respect to the items for which the tax planning is undertaken that subsequently are reflected on the taxpayer’s tax return. The member should comply with tax return preparer standards promulgated by the applicable taxing authority.

6. When issuing an opinion to reflect the results of the tax planning service, a member should do all of the following:
   • Establish the relevant background facts.
   • Consider the reasonableness of the assumptions and representations.
   • Consider applicable regulations and standards regarding reliance on information and advice received from a third party.
   • Apply the pertinent authorities to the relevant facts.
   • Consider the business purpose and economic substance of the transaction, if relevant to the tax consequences of the transaction. (Mere reliance on a representation that there is a business purpose or economic substance generally is insufficient.)
   • Consider whether the issue involves a listed transaction or a reportable transaction (or their equivalents) as defined by the applicable taxing authority.\textsuperscript{6}
   • Consider other regulations and standards applicable to written tax advice promulgated by the applicable taxing authority.
   • Arrive at a conclusion supported by the authorities.
   • The member also should consider SSTS No. 1, SSTS No. 7, Treasury Department Circular 230, and any other standards that may apply.

7. In assisting a taxpayer in a tax planning transaction in which the taxpayer has obtained an opinion from a third party and is looking to the member for an evaluation of the opinion, the member should be satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion, which would include considering whether the opinion indicates the third party did all of the following:
   • Established the relevant background facts.
   • Considered the reasonableness of the assumptions and representations.
   • Considered applicable regulations and standards.
   • Applied the pertinent authorities to the relevant facts.
   • Considered the business purpose and economic

\textsuperscript{5} Title 31, Money and Finance: Treasury of U.S. Code of Federal Regulations.

\textsuperscript{6} See, for example, Treasury Regulation Section 1.6011-4(b).
10. When engaged in tax planning, the member should understand the business purpose and economic substance of the transaction when relevant to the tax consequences. If a transaction has been proposed by a party other than the taxpayer, the member should consider whether the assumptions made by the third party are consistent with the facts of the taxpayer’s situation. If written advice is to be rendered concerning a transaction, the business purpose for the transaction generally should be described. If the business reasons are relevant to the tax consequences, it is not sufficient to assume merely that a transaction is entered into for valid business reasons without specifying what those reasons are. Similarly, if economic substance is relevant to the tax consequences, it is insufficient to assume merely that a transaction has economic substance without specifying the basis for making that determination. In providing written advice on these issues, the member should consider the written advice regulations and standards, if any, promulgated by the applicable taxing authority. The member also should consider SSTs No. 1, SSTs No. 7, Treasury Department Circular 230, and any other standards that may apply.

11. The scope of the engagement should be appropriately determined, and the member should consider the necessity for an engagement letter. The member should be diligent in applying such procedures as are appropriate under the circumstances to understand and evaluate the entire transaction. The specific procedures to be performed in this regard will vary with the circumstances and the scope of the engagement.

Specific Illustrations

12. The following illustrations address general fact patterns. Accordingly, the application of the guidance that is discussed in the previous section, “General Interpretation,” to variations in such general fact patterns or to particular facts or circumstances, may lead to different conclusions. In each illustration, no authority exists other than that which is indicated.

Illustration 1. The relevant tax code imposes penalties on taxpayers for substantial underpayments that are not associated with tax shelters as defined in such code, unless the tax returns resulting in the underpayments are supported by substantial authority.

Conclusion. In assisting the taxpayer in tax planning in which any associated underpayment would be considered substantial, the member should inform the taxpayer of the penalty risks associated with the tax return position recommended with respect to any plan under consideration if that position does not satisfy the substantial authority standard. The member also should inform the taxpayer of the opportunities, if any, to avoid such penalties through appropriate disclosure. In such a situation, applicable standards may prohibit the member from preparing the tax return without appropriate disclosure.

Illustration 2. The relevant tax code imposes penalties on taxpayers for underpayments attributable to tax shelters as defined in such code unless the taxpayer concludes that a position taken on a tax return associated with such a tax shelter is more likely than not the correct position.

Conclusion. In assisting the taxpayer in tax planning, the member should inform the taxpayer of the penalty risks associated with the tax return position recommended with respect to any plan under consider-
concludes the associated tax return position satisfies the required reporting and disclosure standards, and reasonable grounds exist for the taxpayer’s position with respect to the attachment. In this regard, the member should consider SSTS No. 2, *Answers to Questions on Returns* (AICPA, *Professional Standards*), which provides that the term questions, as used in the standard, “includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question,” and that a “member should not omit an answer merely because it might prove disadvantageous to a taxpayer.” The member also should consider SSTS No. 1 and Interpretation No. 1-1.

21. **Illustration 5.** The relevant tax regulations provide that the details of certain potentially abusive transactions that are designated as listed transactions are required to be disclosed in attachments to tax returns (enhanced disclosure), regardless of the support for the associated tax return position (for example, even if the applicable taxing authority’s standard is satisfied). Under the regulations, if the enhanced disclosure requirements for a listed transaction are not satisfied, the taxpayer will have additional penalty risks, including the possibility of a nonrescindable penalty. While researching the tax consequences of a proposed transaction, a member concludes that the transaction is a listed transaction.

22. **Conclusion.** Notwithstanding the member’s conclusion that the transaction is a listed transaction, the member may still recommend a tax return position with respect to the transaction if he or she concludes that the position satisfies the required reporting and disclosure standards (other than the enhanced disclosure). However, the member should inform the taxpayer of the enhanced disclosure requirements of listed transactions and the additional penalty risks for noncompliance, including the potential for enhanced or nonrescindable penalties or both.

23. **Illustration 6.** The same regulations apply as in Illustration 5. The member first becomes aware that a taxpayer entered into a transaction while preparing the taxpayer’s return for the year of the transaction. While researching the tax consequences of the transaction, the member concludes that the taxpayer’s transaction is a listed transaction.

24. **Conclusion.** The member should inform the taxpayer of the enhanced disclosure requirements and the additional penalty risks for noncompliance. If the taxpayer agrees to make the enhanced disclosure required by the regulation, the member may sign the return if the member concludes the associated tax return position also satisfies the required reporting and disclosure standards.
disclosure standards. The member should not sign the return if the enhanced disclosure requirements are not satisfied. If the member is a nonsigning preparer of the return, the member should recommend that the taxpayer comply with the enhanced disclosure requirements regarding the transaction.

25. Illustration 7. The same regulations apply as in illustration 5. The member first becomes aware that a taxpayer entered into a transaction while preparing the taxpayer’s return for the year of the transaction. While researching the tax consequences of the transaction, the member concludes that there is uncertainty about whether the taxpayer’s transaction is a listed transaction.

26. Conclusion. The member should inform the taxpayer of the enhanced disclosure requirements and the additional penalty risks for noncompliance. If the taxpayer agrees to make the enhanced disclosure required by the relevant regulations, the member may sign the return if the member concludes the associated tax return position also satisfies the required reporting and disclosure standards. If the taxpayer does not want to provide the enhanced disclosure of the transaction because of the uncertainty about whether it is a listed transaction, the member may sign the return if the member concludes the associated tax return position satisfies the required reporting and disclosure standards (other than the enhanced disclosure requirements), and reasonable grounds exist for the taxpayer’s position with regard to not providing enhanced disclosure of the transaction. In this regard, the member should consider SSTS No. 2, which indicates that the degree of uncertainty regarding the meaning of a question on a return may affect whether reasonable grounds exist for not responding to the question.

27. Illustration 8. A member advises a taxpayer concerning the tax consequences of a proposed transaction involving a loan from a U.S. bank. In the process of reviewing documents associated with the proposed transaction, the member uncovers a reference to a deposit the taxpayer will make with an overseas branch of the U.S. bank. The transaction documents appear to indicate that this deposit is linked to the U.S. bank’s issuance of the loan.

28. Conclusion. The member should consider the effect, if any, of the deposit in advising the taxpayer about the tax consequences of the proposed transaction and with respect to other tax compliance matters reasonably likely to be at issue (for example, foreign bank account reporting).

29. Illustration 9. Under the relevant tax law, the tax consequences of a leasing transaction depend on whether the property to be leased is reasonably expected to have a residual value of 15 percent of its value at the beginning of the lease. The member has relied on a taxpayer’s instruction to use a particular assumption concerning the residual value.

30. Conclusion. Such reliance on the taxpayer’s instructions may be appropriate if the assumption is supported by the expertise of the taxpayer, by the member’s review of information provided by the taxpayer or a third party, or through the member’s own knowledge or analysis.

31. Illustration 10. A member is assisting a taxpayer with evaluating a proposed equipment leasing transaction in which the estimated residual value of the equipment at the end of the lease term is critical to the tax consequences of the lease. The broker arranging the leasing transaction has prepared an analysis that sets out an explicit assumption concerning the equipment’s estimated residual value.

32. Conclusion. The member should consider whether it is appropriate to rely on the broker’s assumption concerning the estimated residual value of the equipment instead of obtaining a representation from the broker concerning estimated residual value or performing other procedures to validate the amount to be used as an estimate of residual value in connection with the member’s advice. In evaluating the appropriateness of the broker’s assumption, the member should consider, for example, factors such as the broker’s experience in the area, the broker’s methodology, and whether alternative sources of information are reasonably available.

33. Illustration 11. The tax consequences of a particular reorganization depend, in part, on the majority shareholder of a corporation not disposing of stock received in the reorganization in a manner that would prevent the transaction from qualifying as a reorganization.

34. Conclusion. The member should consider whether it is appropriate in rendering tax advice to assume that such a disposition will not occur or whether, under the circumstances, it is appropriate to request written representations regarding the intent of the shareholder and any other parties to the reorganization concerning this requirement, as a condition to issuing an opinion on the reorganization.

35. Illustration 12. A taxpayer is considering a proposed transaction. The taxpayer and the taxpayer’s attorney advise the member that the member is responsible for advising the taxpayer on the tax consequences of the transaction.

36. Conclusion. In addition to complying with the requirements of paragraph 6 of this interpretation, the member generally should review all relevant draft transaction documents in formulating the member’s tax advice relating to the transaction.
Illustration 13. A member is responsible for advising a taxpayer on the tax consequences of the taxpayer’s estate plan.

Conclusion. Under the circumstances, the member should review the will and all other relevant documents to assess whether there appear to be any tax issues raised by the formulation or implementation of the estate plan.

Illustration 14. A member is assisting a taxpayer in connection with a proposed transaction that has been recommended by an investment bank. To support its recommendation, the investment bank offers a law firm’s opinion on the tax consequences. The member reads the opinion and notes that it is based on a hypothetical statement of facts rather than the taxpayer’s facts.

Conclusion. The member may rely on the law firm’s opinion when determining whether the required reporting and disclosure standards have been satisfied with respect to the tax consequences of the hypothetical transaction if the member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion. However, the member should be diligent in taking such steps as are appropriate under the circumstances to understand and evaluate the transaction as it applies to the taxpayer’s specific situation. See paragraph 7 of this interpretation.

Illustration 15. A member is assisting a taxpayer in connection with a proposed transaction that has been recommended by an investment bank. To support that recommendation, the investment bank offers a law firm’s opinion about the tax consequences. The member reads the opinion and notes that unlike the opinion described in illustration 14, it is carefully tailored to the taxpayer’s facts.

Conclusion. The member may rely on the opinion when determining whether the required reporting and disclosure standards have been satisfied with respect to the taxpayer’s participation in the transaction if the member is satisfied about the source (for example, the knowledge and expertise of the issuer), relevance, and persuasiveness of the opinion. In making that determination, the member should consider whether the opinion indicates the law firm performed the steps listed in paragraph 7 of this interpretation.

Illustration 16. A member is assisting a taxpayer with year-end planning in connection with the taxpayer’s proposed contribution of stock in a closely held corporation to a charitable organization. The taxpayer instructs the member to calculate the anticipated tax savings assuming a contribution of 500 shares to a tax-exempt organization and assuming the stock has a fair market value of $100 per share. The member is aware that on the taxpayer’s gift tax returns for the prior year, the taxpayer reported that her stock in the corporation, gifted to her daughter, was worth $50 per share.

Conclusion. The member’s calculation of the anticipated tax savings is subject to the general interpretations described in paragraphs 8 and 9 of this interpretation. Accordingly, even though this potentially may be a case in which the value of the stock substantially appreciated during the year, the member should consider the reasonableness of the assumption and consistency with other information known to the member in connection with preparing the projection. The member should consider whether to document discussions concerning the increase in value of the stock with the taxpayer. The member also should consider the applicability of the Statements on Standards for Valuation Services (AICPA, Professional Standards).

Illustration 17. The tax consequences to Target Corporation’s shareholders of an acquisition turn, in part, on Acquiring Corporation’s continuance of the trade or business of Target Corporation for some time after the acquisition. The member is preparing a tax opinion addressed to Target’s shareholders. The opinion is based on a written representation from Acquiring Corporation that Acquiring Corporation will continue Target’s business for two years following the acquisition.

Conclusion. In conducting the due diligence necessary to establish the relevant background facts, the member should consider the reasonableness of the representation before determining that it is appropriate to rely on the representation from Acquiring Corporation.

Illustration 18. The member receives a telephone call from a taxpayer who is the sole shareholder of a corporation. The taxpayer indicates that he is thinking about exchanging his stock in the corporation for stock in a publicly traded business. During the call, the member explains how the transaction could be structured so it will qualify as a tax-free acquisition.

Conclusion. Although oral advice may serve a taxpayer’s needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar-value, or complicated transactions. The member should use professional judgment about the need to document oral advice. (See SSTS No. 7).

Illustration 19. The member receives a telephone call from a taxpayer who wants to know whether he or she should lease or purchase a car. During
the call, the member explains how the arrangement should be structured so that it helps achieve the taxpayer’s objectives.

50. Conclusion. In this situation, the member’s response is in conformity with this interpretation in view of the routine nature of the inquiry and the well-defined tax issues. However, the member should evaluate whether other considerations, such as avoiding misunderstanding with the taxpayer, suggest that the conversation should be documented.

Statement No. 2, Answers to Questions on Returns

Introduction
1. This statement sets forth the applicable standards for members when signing the preparer’s declaration on a tax return if one or more questions on the return have not been answered. The term questions includes requests for information on the return, in the instructions, or in the regulations, whether or not stated in the form of a question.

Statement
2. A member should make a reasonable effort to obtain from the taxpayer the information necessary to provide appropriate answers to all questions on a tax return before signing as preparer.

Explanation
3. It is recognized that the questions on tax returns are not of uniform importance, and often they are not applicable to the particular taxpayer. Nevertheless, there are at least three reasons why a member should be satisfied that a reasonable effort has been made to obtain information to provide appropriate answers to the questions on the return that are applicable to a taxpayer:
   a. A question may be of importance in determining taxable income or loss, or the tax liability shown on the return, in which circumstance an omission may detract from the quality of the return.
   b. A request for information may require a disclosure necessary for a complete return or to avoid penalties.
   c. A member often must sign a preparer’s declaration stating that the return is true, correct, and complete.
4. Reasonable grounds may exist for omitting an answer to a question applicable to a taxpayer. For example, reasonable grounds may include the following:
   a. The information is not readily available and the answer is not significant in terms of taxable income or loss, or the tax liability shown on the return.
   b. Genuine uncertainty exists regarding the meaning of the question in relation to the particular return.
   c. The answer to the question is voluminous; in such cases, a statement should be made on the return that the data will be supplied upon examination.
5. A member should not omit an answer merely because it might prove disadvantageous to a taxpayer.
6. A member should consider whether the omission of an answer to a question may cause the return to be deemed incomplete or result in penalties.
7. If reasonable grounds exist for omission of an answer to an applicable question, a taxpayer is not required to provide on the return an explanation of the reason for the omission.

Statement No. 3, Certain Procedural Aspects of Preparing Returns

Introduction
1. This statement sets forth the applicable standards for members concerning the obligation to examine or verify certain supporting data or to consider information related to another taxpayer when preparing a taxpayer’s tax return.

Statement
2. 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 in correct, in complete, 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.
3. If the tax law or regulations impose a condition with respect to deductibility or other tax treatment of an item, such as taxpayer maintenance of books and records or substantiating documentation to support the reported deduction or tax treatment, a member should make appropriate inquiries to determine to the member’s satisfaction whether such condition has been met.
4. When preparing a tax return, a member should consider information actually known to that member from the tax return of another taxpayer if the information is relevant to that tax return and its consideration is necessary to properly prepare that tax return. In using such information, a member should consider any limitations imposed by any law or rule relating to confidentiality.

**Explanation**

5. The preparer’s declaration on a tax return often states that the information contained therein is true, correct, and complete to the best of the preparer’s knowledge and belief based on all information known by the preparer. This type of reference should be understood to include information furnished by the taxpayer or by third parties to a member in connection with the preparation of the return.

6. The preparer’s declaration does not require a member to examine or verify supporting data; a member may rely on information furnished by the taxpayer unless it appears to be incorrect, incomplete, or inconsistent. However, there is a need to determine by inquiry that a specifically required condition, such as maintaining books and records or substantiating documentation, has been satisfied and to obtain information when the material furnished appears to be incorrect, incomplete, or inconsistent. Although a member has certain responsibilities in exercising due diligence in preparing a return, the taxpayer has ultimate responsibility for the contents of the return. Thus, if the taxpayer presents unsupported data in the form of lists of tax information, such as dividends and interest received, charitable contributions, and medical expenses, such information may be used in the preparation of a tax return without verification unless it appears to be incorrect, incomplete, or inconsistent either on its face or on the basis of other facts known to a member.

7. Even though there is no requirement to examine underlying documentation, a member should encourage the taxpayer to provide supporting data where appropriate. For example, a member should encourage the taxpayer to submit underlying documents for use in tax return preparation to permit full consideration of income and deductions arising from security transactions and from pass-through entities, such as estates, trusts, partnerships, and S corporations.

8. The source of information provided to a member by a taxpayer for use in preparing the return is often a pass-through entity, such as a limited partnership, in which the taxpayer has an interest but is not involved in management. A member may accept the information provided by the pass-through entity without further inquiry, unless there is reason to believe it is incorrect, incomplete, or inconsistent, either on its face or on the basis of other facts known to the member. In some instances, it may be appropriate for a member to advise the taxpayer to ascertain the nature and amount of possible exposure to tax deficiencies, interest, and penalties, by taxpayer contact with management of the pass-through entity.

9. A member should make use of a taxpayer’s returns for one or more prior years in preparing the current return whenever feasible. Reference to prior returns and discussion of prior year tax determinations with the taxpayer should provide information to determine the taxpayer’s general tax status, avoid the omission or duplication of items, and afford a basis for the treatment of similar or related transactions. As with the examination of information supplied for the current year’s return, the extent of comparison of the details of income and deduction between years depends on the particular circumstances.

**Statement No. 4, Use of Estimates**

**Introduction**

1. This statement sets forth the applicable standards for members when using the taxpayer’s estimates in the preparation of a tax return. A member may advise on estimates used in the preparation of a tax return, but the taxpayer has the responsibility to provide the estimated data. Appraisals or valuations are not considered estimates for purposes of this statement.

**Statement**

2. Unless prohibited by statute or by rule, a member may use the taxpayer’s estimates in the preparation of a tax return if it is not practical to obtain exact data and if the member determines that the estimates are reasonable based on the facts and circumstances known to the member. The taxpayer’s estimates should be presented in a manner that does not imply greater accuracy than exists.

**Explanation**

3. Accounting requires the exercise of professional judgment and, in many instances, the use of approximations based on judgment. The application of such accounting judgments, as long as not in conflict with methods set forth by a taxing authority, is acceptable. These judgments are not estimates within the purview of this statement. For example,
a federal income tax regulation provides that if all other conditions for accrual are met, the exact amount of income or expense need not be known or ascertained at yearend if the amount can be determined with reasonable accuracy.

4. When the taxpayer’s records do not accurately reflect information related to small expenditures, accuracy in recording some data may be difficult to achieve. Therefore, the use of estimates by a taxpayer in determining the amount to be deducted for such items may be appropriate.

5. When records are missing or precise information about a transaction is not available at the time the return must be filed, a member may prepare a tax return using a taxpayer’s estimates of the missing data.

6. Estimated amounts should not be presented in a manner that provides a misleading impression about the degree of factual accuracy.

7. Specific disclosure that an estimate is used for an item in the return is not generally required; however, such disclosure should be made in unusual circumstances where nondisclosure might mislead the taxing authority regarding the degree of accuracy of the return as a whole. Some examples of unusual circumstances include the following:
   a. A taxpayer has died or is ill at the time the return must be filed.
   b. A taxpayer has not received a Schedule K-1 for a flow-through entity at the time the tax return is to be filed.
   c. There is litigation pending (for example, a bankruptcy proceeding) that bears on the return.
   d. Fire, computer failure or natural disaster has destroyed the relevant records.

Statement No. 5, Departure from a Position Previously Concluded in an Administrative Proceeding or Court Decision

Introduction
1. This statement sets forth the applicable standards for members in recommending a tax return position that departs from the position determined in an administrative proceeding or in a court decision with respect to the taxpayer’s prior return.

2. For purposes of this statement, administrative proceeding also includes an examination by a taxing authority or an appeals conference relating to a return or a claim for refund.

3. For purposes of this statement, court decision means a decision by any court having jurisdiction over tax matters.

Statement
4. The tax return position with respect to an item as determined in an administrative proceeding or court decision does not restrict a member from recommending a different tax position in a later year’s return, unless the taxpayer is bound to a specified treatment in the later year, such as by a formal closing agreement. Therefore, the member may recommend a tax return position or prepare or sign a tax return that departs from the treatment of an item as concluded in an administrative proceeding or court decision with respect to a prior return of the taxpayer, provided the requirements of Statement on Standards for Tax Services (SSTS) No. 1, Tax Return Positions, are satisfied.

Explanation
5. If an administrative proceeding or court decision has resulted in a determination concerning a specific tax treatment of an item in a prior year’s return, a member will usually recommend this same tax treatment in subsequent years. However, departures from consistent treatment may be justified under such circumstances as the following:
   a. Taxing authorities tend to act consistently in the disposition of an item that was the subject of a prior administrative proceeding but generally are not bound to do so. Similarly, a taxpayer is not bound to follow the tax treatment of an item as consented to in an earlier administrative proceeding.
   b. The determination in the administrative proceeding or the court’s decision may have been caused by a lack of documentation. Supporting data for the later year may be appropriate.
   c. A taxpayer may have yielded in the administrative proceeding for settlement purposes or not appealed the court decision even though the position met the standards in SSTS No. 1.
   d. Court decisions, rulings, or other authorities that are more favorable to a taxpayer’s current position may have developed since the prior administrative proceeding was concluded or the prior court decision was rendered.

6. The consent in an earlier administrative proceeding and the existence of an unfavorable court decision are factors that the member should consider in evaluating whether the standards in SSTS No. 1 are met.
Statement No. 6, Knowledge of Error:
Return Preparation

Introduction
1. This statement sets forth the applicable standards for a member who becomes aware of (a) an error in a taxpayer’s previously filed tax return; (b) an error in a return that is the subject of an administrative proceeding, such as an examination by a taxing authority or an appeals conference; or (c) a taxpayer’s failure to file a required tax return. As used herein, the term error includes any position, omission, or method of accounting that, at the time the return is filed, fails to meet the standards set out in Statement of Standards for Tax Services (SSTS) No. 1, Tax Return Positions. The term error also includes a position taken on a prior year’s return that no longer meets these standards due to legislation, judicial decisions, or administrative pronouncements having retroactive effect. However, an error does not include an item that has an insignificant effect on the taxpayer’s tax liability. The term administrative proceeding does not include a criminal proceeding.

2. This statement applies whether or not the member prepared or signed the return that contains the error.

3. Special considerations may apply when a member has been engaged by legal counsel to provide assistance in a matter relating to the counsel’s client.

Statement
4. A member should inform the taxpayer promptly upon becoming aware of an error in a previously filed return, an error in a return that is the subject of an administrative proceeding, or a taxpayer’s failure to file a required return. A member also should advise the taxpayer of the potential consequences of the error and recommend the corrective measures to be taken. Such advice and recommendation may be given orally. The member is not allowed to inform the taxing authority without the taxpayer’s permission, except when required by law.

5. If a member is requested to prepare the current year’s return and the taxpayer has not taken appropriate action to correct an error in a prior year’s return, the member should consider whether to withdraw from preparing the return and whether to continue a professional or employment relationship with the taxpayer. If the member does prepare such current year’s return, the member should take reasonable steps to ensure that the error is not repeated.

6. If a member is representing a taxpayer in an administrative proceeding with respect to a return that contains an error of which the member is aware, the member should request the taxpayer’s agreement to disclose the error to the taxing authority. Lacking such agreement, the member should consider whether to withdraw from representing the taxpayer in the administrative proceeding and whether to continue a professional or employment relationship with the taxpayer.

Explanation
7. While performing services for a taxpayer, a member may become aware of an error in a previously filed return or may become aware that the taxpayer failed to file a required return. The member should advise the taxpayer of the error and the potential consequences, and recommend the measures to be taken. Similarly, when representing the taxpayer before a taxing authority in an administrative proceeding with respect to a return containing an error of which the member is aware, the member should advise the taxpayer to disclose the error to the taxing authority and of the potential consequences of not disclosing the error. Such advice and recommendation may be given orally.

8. It is the taxpayer’s responsibility to decide whether to correct the error. If the taxpayer does not correct an error, a member should consider whether to withdraw from the engagement and whether to continue a professional or employment relationship with the taxpayer. Although recognizing that the taxpayer may not be required by statute to correct an error by filing an amended return, a member should consider whether a taxpayer’s decision not to file an amended return or otherwise correct an error may predict future behavior that might require termination of the relationship.

9. Once the member has obtained the taxpayer’s consent to disclose an error in an administrative proceeding, the disclosure should not be delayed to such a degree that the taxpayer or member might be considered to have failed to act in good faith or to have, in effect, provided misleading information. In any event, disclosure should be made before the conclusion of the administrative proceeding.

10. A conflict between the member’s interests and those of the taxpayer may be created by, for example, the potential for violating Code of Professional Conduct Rule 301, Confidential Client Information (relating to the member’s confidential client relationship); the tax law and regulations; or laws on privileged communications, as well as by the potential adverse impact on a taxpayer of a member’s withdrawal. Therefore, a member should consider consulting
with his or her own legal counsel before deciding upon recommendations to the taxpayer and whether to continue a professional or employment relationship with the taxpayer.

11. If a member believes that a taxpayer may face possible exposure to allegations of fraud or other criminal misconduct, the member should advise the taxpayer to consult with an attorney before the taxpayer takes any action.

12. If a member decides to continue a professional or employment relationship with the taxpayer and is requested to prepare a tax return for a year subsequent to that in which the error occurred, the member should take reasonable steps to ensure that the error is not repeated. If the subsequent year’s tax return cannot be prepared without perpetuating the error, the member should consider withdrawal from the return preparation. If a member learns that the taxpayer is using an erroneous method of accounting and it is past the due date to request permission to change to a method meeting the standards of SSTS No. 1, the member may sign a tax return for the current year, providing the tax return includes appropriate disclosure of the use of the erroneous method.

13. Whether an error has no more than an insignificant effect on the taxpayer’s liability is left to the professional judgment of the member based on all the facts and circumstances known to the member. In judging whether an erroneous method of accounting has more than an insignificant effect, a member should consider the method’s cumulative effect, as well as its effect on the current year’s tax return or the tax return that is the subject of the administrative proceeding.

14. If a member becomes aware of the error while performing services for a taxpayer that do not involve tax return preparation or representation in an administrative proceeding, the member’s responsibility is to advise the taxpayer of the existence of the error and to recommend that the error be discussed with the taxpayer’s tax return preparer. Such recommendation may be given orally.

Statement No. 7, Form and Content of Advice to Taxpayers

Introduction

1. This statement sets forth the applicable standards for members concerning certain aspects of providing advice to a taxpayer and considers the circumstances in which a member has a responsibility to communicate with a taxpayer when subsequent developments affect advice previously provided. The statement does not, however, cover a member’s responsibilities when the expectation is that the advice rendered is likely to be relied on by parties other than the taxpayer.

Statement

2. A member should use professional judgment to ensure that tax advice provided to a taxpayer reflects competence and appropriately serves the taxpayer’s needs. When communicating tax advice to a taxpayer in writing, a member should comply with relevant taxing authorities’ standards, if any, applicable to written tax advice. A member should use professional judgment about any need to document oral advice. A member is not required to follow a standard format when communicating or documenting oral advice.

3. A member should assume that tax advice provided to a taxpayer will affect the manner in which the matters or transactions considered would be reported or disclosed on the taxpayer’s tax returns. Therefore, for tax advice given to a taxpayer, a member should consider, when relevant (a) return reporting and disclosure standards applicable to the related tax return position and (b) the potential penalty consequences of the return position. In ascertaining applicable return reporting and disclosure standards, a member should follow the standards in Statement on Standards for Tax Services (SSTS) No. 1, Tax Return Positions.

4. A member has no obligation to communicate with a taxpayer when subsequent developments affect advice previously provided with respect to significant matters, except while assisting a taxpayer in implementing procedures or plans associated with the advice provided or when a member undertakes this obligation by specific agreement.

Explanation

5. Tax advice is recognized as a valuable service provided by members. The form of advice may be oral or written and the subject matter may range from routine to complex. Because the range of advice is so extensive and because advice should meet the specific needs of a taxpayer, neither a standard format nor guidelines for communicating or documenting advice to the taxpayer can be established to cover all situations.

6. Although oral advice may serve a taxpayer’s needs appropriately in routine matters or in well-defined areas, written communications are recommended in important, unusual, substantial dollar value, or
complicated transactions. The member may use professional judgment about whether, subsequently, to document oral advice.

7. In deciding on the form of advice provided to a taxpayer, a member should exercise professional judgment and should consider such factors as the following:
   a. The importance of the transaction and amounts involved.
   b. The specific or general nature of the taxpayer’s inquiry.
   c. The time available for development and submission of the advice.
   d. The technical complexity involved.
   e. The existence of authorities and precedents.
   f. The tax sophistication of the taxpayer.
   g. The need to seek other professional advice.
   h. The type of transaction and whether it is subject to heightened reporting or disclosure requirements.
   i. The potential penalty consequences of the tax return position for which the advice is rendered.
   j. Whether any potential applicable penalties can be avoided through disclosure.
   k. Whether the member intends for the taxpayer to rely upon the advice to avoid potential penalties.

8. A member may assist a taxpayer in implementing procedures or plans associated with the advice offered. When providing such assistance, the member should review and revise such advice as warranted by new developments and factors affecting the transaction.

9. Sometimes a member is requested to provide tax advice but does not assist in implementing the plans adopted. Although such developments as legislative or administrative changes or future judicial interpretations may affect the advice previously provided, a member cannot be expected to communicate subsequent developments that affect such advice unless the member undertakes this obligation by specific agreement with the taxpayer.

10. Taxpayers should be informed that (a) the advice reflects professional judgment based upon the member’s understanding of the facts, and the laws existing as of the date the advice is rendered and (b) subsequent developments could affect previously rendered professional advice. Members may use precautionary language to the effect that their advice is based on facts as stated and authorities that are subject to change.

11. In providing tax advice, a member should be cognizant of applicable confidentiality privileges.
Chapter Questions

1. A member could be tried and convicted by a trial board on a charge of violating one of the Statements on Standards for Tax Services. The preceding statement is
   (a) true.
   (b) false.

2. Olson, a member, has been preparing Walker’s income tax return. Walker is the sole owner of a manufacturing plant. He insists that Olson take a position with respect to a material item on his tax return that Olson does not agree with. In fact, Olson believes that the position Walker is insisting on cannot be sustained if challenged on review either administratively or judicially. What action would Olson take?
   (a) He should finish preparing the return but refuse to sign it.
   (b) He should not prepare or sign the return.
   (c) He should finish preparing the return and he should sign it. The return is Walker’s responsibility and Olson has told Walker his opinion on the item.

3. Milano, a member, prepares the tax returns for the owners and various executives of a company. The owners are all related. The owners and other executives are in various other ventures. Ownership percentages vary and not all are in each investment. Provided it does not break any law or the Code of Professional Conduct, may Milano consider the information from one or more of these people in preparing the returns of others in this group?
   (a) No, he may not consider information from one client in preparing another client’s return.
   (b) Yes, he may consider it but is not required to do so.
   (c) Yes, he should consider such information.

4. Macke, a member, is preparing Jacobs’ tax return from information submitted by Jacobs. The information appears to be correct and complete. How much verification of the information should Macke do?
   (a) He must spot check some of the data.
   (b) He is not required to verify any of the information.

5. Kanter, a tax client of Zeman, a member, received an unfavorable court decision some five years ago on a tax position he had taken with respect to some business expenses. Kanter wants to once more take the same position on business expenses that he did five years ago. Must Zeman insist that the earlier court decision be followed in filing this year’s tax return?
   (a) Yes.
   (b) No.

6. Korzon, a member, does the annual audit of Bates & Co. He does not do the tax return. The return is prepared by Mitchell. In performing the year-end audit, Korzon finds a material error in the prior year’s income tax return that was filed for Bates & Co. Korzon should
   (a) report the error to Mitchell, as a matter of courtesy, so that Mitchell can talk to management of Bates & Co. about it.
   (b) advise management of Bates & Co. about the error and recommend that they talk to Mitchell about it.
   (c) keep quiet about it so he doesn’t get Mitchell in trouble. Make sure that this year’s tax provision and liability for income taxes is large enough to cover the additional taxes that will be due if the IRS finds the error.

7. Who has the final responsibility for positions taken with respect to controversial matters on the tax return?
   (a) The taxpayer since the tax return is primarily the taxpayer’s representations of facts.
   (b) The member who prepared and signed the return. He is the professional charged with knowing the tax laws and regulations.

8. What is a “frivolous position”?
   (a) A position that is knowingly advanced in bad faith and is patently improper.
   (b) A position without much precedent except that the taxpayer lost a judicial case on the same issue some years ago.
   (c) A position without much precedent except that the taxpayer lost a judicial case on the same issue some years ago.
   (d) A position taken on a minor matter on which there is no precedent.
9. Is a taxpayer bound to follow the tax treatment of an item as consented to in an earlier administrative proceeding?
   (a) Yes.
   (b) No.

10. If reasonable grounds exist for omission of an answer to an applicable question on a tax return, is the member required to provide on the return an explanation of the reason for the omission?
    (a) Yes.
    (b) No.

11. Stolf a, a member, finds that an error was made in the return that he prepared for Russo last year. The error is discovered as he is preparing the current year’s return. Stolf a should
    (a) inform the IRS and state tax authorities about the error.
    (b) tell Russo about the error and what steps are needed by way of amended returns to inform the taxing authorities about it.
Chapter Answers

1. (a) is correct. Statements on Standards for Tax Services are enforceable under the *Code of Professional Conduct* (History).

2. (b) is correct. The member should not prepare or sign the return. The statements say that if a member believes a position does not have a realistic possibility of being sustained judicially or administratively, the member should not prepare or sign the return. Thus (a) and (c) are incorrect (Statement No. 1, Statement 5 a and 5 b).

3. (c) is correct. Milano should consider the information. Statements say that he should consider information known to him from the tax returns of others. Thus (a) and (b) are incorrect (Statement No. 3, Statement 4).

4. (b) is correct. Macke is not required to verify any of the information. Many members however believe that some review and verification should be done (Signatures on Tax Returns and Statement No. 3, Statement 2).

5. (b) is correct. Kanter need not follow the earlier court decision and Zeman may prepare and sign the return if he believes there is a realistic possibility the expenses would be allowed this time. (Statement No. 5, Statement)

6. (b) is correct. Korzon should tell the client and recommend they talk to Mitchell, the tax preparer about it.

   (a) is incorrect. Korzon has no authority to talk to Mitchell about Bates & Co. affairs, without first obtaining Bates & Co. permission to do so.

   (c) is incorrect because he should not cover up for someone else’s error (Statement No. 6, Explanation 14).

7. (a) is correct. The taxpayer has final responsibility for the positions taken in the tax return (Statement No. 1, Explanation 10).

8. (a) is correct. A frivolous position is a position taken in bad faith and patently improper (Interpretation No. 1-1 Conclusion to Illustration 6).

   (b) is incorrect because a taxpayer may try the same position again. There may be subsequent cases that might support him now. As such, it would not be patently improper.

   (c) is incorrect because if there is no precedent, the taxpayer may take the position.

9. (b) is correct. They need not follow the treatment consented to in earlier administrative proceeding (Statement No. 5, Statement and Explanation).

10. (b) is correct. When reasonable grounds exist for the omission of an answer in a tax return, no explanation on the return is required for the omission (Statement No 2, Explanation 7).

11. (b) is correct. He should inform the taxpayer of the error and what needs to be done to rectify it (Statement No 6, Statement 4).

   (a) is incorrect. He is not allowed to inform the tax authorities about it (Statement No. 6, Statement 4).
Chapter 12

Form of Organization and Name

History
For years, partnerships were the approved form of organization in which more than one member of a profession could practice. Every partner in the firm was the agent of the partnership and of every other partner. Thus, each partner was individually liable for all partnership obligations. Under AICPA rules, a member could have a non-CPA as a partner if the non-CPA’s principal occupation was public accounting. Most state accountancy laws required at that time that all the partners in the public accounting partnership be CPAs. State laws now permit partnerships composed of both CPAs and non-CPAs.

Some years later, the rules were changed to allow members to practice public accounting in professional corporations. After a few more years, the rules were again modified and now members are allowed to practice public accounting in any form of organization permitted by law or regulation whose characteristics conform to resolutions of council. Thus, they now can practice in general corporations and limited liability entities provided those entities conform to resolutions of council.

State laws and state boards of accountancy rules now allow either limited liability partnerships (LLPs) or limited liability corporations (LLCs) or both.

The following excerpts taken from an article in The CPA Letter explains the need for these changes.

Since the 1960s, when the current version of Rule 505 was adopted, the profession has changed significantly. CPAs have been called upon to provide more diverse services to clients operating in ever-expanding geographic areas. At the same time, court decisions have increasingly expanded the definition of accountants’ liability, making CPAs more susceptible than ever to litigation. Frequently, CPAs not involved in any wrongdoing are being held personally liable for the negligence of their partners.

The change to Rule 505 was designed to help members run their practices efficiently and effectively in what is often a volatile economic, regulatory, and legal environment. Quite simply, the amendment to Rule 505 provides members with more choices—choices that may help to limit the personal liability of shareholders who have no involvement with a negligent act done in the name of a firm. The result will be a profession better equipped to meet current and future challenges and one that will be more attractive to those potentially new CPAs who will no longer have to face the possibility of losing their life savings for a career in public accounting.

Under partnership law, each partner is jointly and severally liable for debts, obligations, and wrongful acts committed in the course of the partnership’s business. Under a legal concept known as vicarious liability, a partner’s personal assets are at risk regardless of the extent of his or her interest in the partnership or involvement in the matter in question.

In a corporation, on the other hand, a stockholder’s liability for a negligent act of the corporation or a fellow stockholder is limited to the innocent stock-holder’s equity in the corporation. The innocent stock-holder has no vicarious liability.

Although state laws permit CPAs to organize as PCs, CPAs who select this form of practice may also face an unreasonable amount of liability exposure. In some states, CPAs practicing in PCs face the same unlimited personal liability as those in partnerships. Additionally, CPAs in a PC may have extensive exposure to liability for their actions as supervisors or executives of the firm, as well as for all the contractual obligations of the firm, as well as for all the contractual obligations of the PC.

CPAs who organize themselves as PCs also face nearly universal restrictions on interstate practice. Such restrictions adversely affect their ability to serve clients with operations in several states. Practicing in a general corporate form or in an LLC provides CPA owners with greater protection from vicarious liability than the PC form and will facilitate, rather than hinder, a firm’s ability to establish a multi-state practice.

The revisions of the Rule did not change in any way the member’s:

a. Commitment to quality performance.
b. Responsibility to act in the public interest.
c. Having to adhere to professional standards.
d. Duty to meet Institute membership requirements.
e. Participation in a practice-monitoring program.
f. Remaining personally liable for their own negligent acts.

Council’s resolution concerning the form of organization and name has also changed over the years. For a few years, Council required that two-thirds of the owners of a public accounting firm had to be CPAs. This was later modified so that now only a majority of the ownership in terms of financial interests and voting rights must be CPAs. Those specialists who practice in consulting, tax, etc. may now be part owners of a public accounting firm.

As to non-CPA owners:
• They must be actively engaged as firm members in providing services to the firm’s clients.
• They cannot have final responsibility for attest or compilation engagements.
• They cannot be members of the AICPA.

Members may be owners or employed in firms that do not meet the requirements of Council’s resolution. If the firm performs compilations of financial statements in accordance with Statements on Standards for Accounting and Review Services, a CPA must have ultimate responsibility for such services. In addition, a CPA must sign any compilation report individually.

Alternative Practice Structures

Recently, a new form of business association has emerged. An accounting firm (A) sells its non-attest services to a company (B) which may be publicly traded. The purchaser (B) employs all the CPAs and staff of the old firm (A) but it does not do attest work. Firm (A) may then be dissolved and a new firm (C) established to do attest work. Firm (C) may have any number of partners, but no employees. It leases the employees it needs and other operational items from (B). Although (B) does no compilation, review or audit work, it does do consulting, tax advice and preparation and other non-attest services. CPAs and staff may work for the same clients in both firm (B) and firm (C). Clients are referred between (B) and (C) depending upon what work is needed.

Interpretation 505-3, Application of Rule 505 to Alternative Practice Structures, addresses questions raised by this type of association.

Firm Names

No firm title need name every owner. Such a requirement could become awkward and even unworkable. The firm may use the names of all or some of the owners: “Wilson and White” or “Finch, Fredericks and Smith.” Or the firm may follow the name of one or more owners with designations “Company,” “and Company,” or “Associates.” Thus, the firm “Finch, Fredericks and Smith” could choose instead to describe itself (among other possibilities) as “The David Finch Company,” “David Finch and Company,” “Finch, Fredericks and Associates,” or “Finch, Fredericks and Company.”

The firm name is a valuable asset, protected by law; it represents the professional competence and reliability of each member of the firm, whether the member’s own name is included in the title or not. No wonder the firm is slow to change it—even when individual owners die, retire or strike out on their own. Rule 505 acknowledges this concern for continuity by saying that names of one or more past owners may be included in the firm name of a successor organization.

An owner surviving the death or withdrawal of all other owners may continue to practice under a name which includes the names of past owners.

Fictitious Names

The rules in prior years consistently prohibited the use of fictitious names or names that indicated a specialty. In 1977 the ban on advertising was eliminated. Also, in 1981 members were allowed for the first time to include in their advertising comparison with other CPAs if the comparisons were based on verifiable facts. Finally, in 1986 members were permitted to start using testimonials and endorsements in their advertising.

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

Suppose several CPAs in partnership adopt the firm name “Pacific Accountants.” The name is dignified, businesslike, descriptive, eye-catching without being misleading. Thus, ethically it is permitted.

Interpretation 505-4 advises members to consider the rules and regulations of their State Board(s) of Accountancy regarding misleading firm names as these rules may be more restrictive than the rules prescribed under AICPA ethics interpretations.

Finally, Interpretation 505-5 prescribes rules under which a common network brand can be used in a firm name. The use of a common network brand is not considered to be misleading if the firm is a network firm as defined under Definitions.
Association Without Partnership
Sometimes two or more CPAs or CPA firms may cooperate informally in limited activities short of a partnership. They may benefit by helping one another on particular projects or in sharing office space, secretaries, or computer or other services. Usually such informal associations are entirely ethical, if they avoid certain pitfalls.

First, the associates should avoid loose, general oral understandings; instead, they should express in writing the specific conditions of any cooperative arrangement. This makes it a matter of record. For example, each person should receive specific compensation for all time spent on professional services for the other.

Second, the associates should give the public no grounds to believe they are partners. A client needs to know who is accountable for professional services rendered, since, unlike a partner, an associate has no unlimited responsibility for the acts of another. Thus, two CPAs who shared an office and staff asked if a joint letterhead would be proper, if the letterhead showed them as individual CPAs. The Committee on Professional Ethics ruled:

In these circumstances the public would assume that a partnership existed. If any reports were to be issued under the joint heading, Rule 505 would be violated.

Members should not use a letterhead showing the names of two accountants when a partnership does not exist.

Now and then a firm may wish to work with another firm in a limited way as “Associates.” Yet confusion is almost an inevitable result. The AICPA Ethics Division Executive Committee recommends that the association be either dissolved or upgraded into a partnership. For example they said:

Q. Three CPA firms wish to form an association—not a partnership—to be known as “Smith, Jones & Assoc.” Is there any impropriety in this?

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

Licensing Requirements
In most, if not all states, CPAs who are proprietors or partners or shareholders of public accounting firms are required to be licensed by the state wherein they practice both as individual CPAs and as a firm (proprietorship, partnership or professional corporation). CPAs who are staff employees of such public accounting firms may not need to be licensed. However, they or their firms may desire that they obtain a license.

Relations with the Legal Profession
Of all relationships with other professions, the CPA’s relations with lawyers command the closest examination. Several attempts have been made to mark off the different areas of professional responsibility; the national organizations of each profession, a joint National Conference of Lawyers and Certified Public Accountants, committees of CPAs and lawyers in many states, and even the U.S. Treasury Department have sought to define the relationship of the practice of accounting and law. Certain guidelines have emerged.

A CPA is authorized to practice accounting; an attorney, to practice law. Each professional, it is expected, will respect the special field of the other and will not encroach upon it. Tax practice cases, especially, demonstrate the difficulty of this restraint. Precisely where does a “question of accounting” become a “question of law?” The conferences and rulings have stopped short of a hard-and-fast definition of that elusive boundary. They tend to leave the decision to the individual CPA or lawyer, who must weigh each situation on its merits. But they do offer one solid guideline: the concept of professional competence. As a rule, the CPA agrees to perform only those professional services he or she can handle in a skillful, workmanlike manner. This is a professional judgment that can only be made by the individual CPA. A CPA should be careful not to practice law. Clients should be referred to professionals who have the skills and background the CPA lacks. If the services requested are those that require a lawyer—not a CPA—the CPA owes it to the client to refer the client to a lawyer.

Joint Practice of Law and Accounting
With the dividing line between law and accounting so hard to distinguish, joint practice in such areas as tax consultation would at first glance seem reasonable. A CPA who is also an attorney may wish to offer the specialized services of both professions.

The AICPA’s Code of Professional Conduct and its interpretations do not forbid joint practice. Under this Code and the American Bar Association Rules, a CPA who is a lawyer may practice both professions.

Under the AICPA Code he or she may practice both from the same office and may state on their letterhead that he or she is both a CPA and a lawyer. Prior to taking such a step, the CPA should consult the rules of the applicable Bar Association in the local area.

Conclusion
CPAs’ personal responsibility for their acts is central to their professional role, yet their work requires them increasingly to cooperate with others within and beyond the profession.
Members may practice public accounting in any form of organization that is permitted by laws and regulations. However, the organization’s characteristics must conform to resolutions of council. If a member’s firm was a limited liability company, the member’s liability for a negligent act by other members of the firm would be limited to the member’s equity in the corporation. He or she would of course have unlimited liability for the member’s own negligent acts.

Owners practice in the name of the firm which is usually composed of the names of one or more current or former owners. It is not unethical for the firm title to contain the name of an owner no longer associated with the firm. Individual member CPAs, partnerships composed entirely of member CPAs, and qualifying corporations in which all the CPA shareholders are members are allowed by Rule 505 to use the professional designation, “Members of the American Institute of Certified Public Accountants.”

A member’s firm name cannot be misleading in any way and, as such, should consider rules and regulations of the applicable State Board(s) of Accountancy as well as AICPA ethics interpretations. Finally, common network brand names can be used as part of a firm’s name as long as the firm is a network member as defined.

Individual CPAs may cooperate informally as long as neither practices in the other’s name in violation of Rule 505 or otherwise creates a false impression that they are partners.

A CPA may practice accounting and law jointly, if qualified and if the state bar rules permit.

These regulations on operating practices sometimes stress fine distinctions or apparently small points. But there is nothing small about what they protect: the CPA’s good name and personal accountability.
Rule, Interpretations, Rulings, AICPA Council Resolution

Rule 505, Form of Organization and Name

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

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

A firm may not designate itself as “Members of the American Institute of Certified Public Accountants” unless all of its CPA owners are members of the Institute. (See Appendix B.)

Interpretations under Rule 505—Form of Organization and Name

505-2—Application of rules of conduct to members who own a separate business.

A member in the practice of public accounting may own an interest in a separate business that performs for clients any of the professional services of accounting, tax, personal financial planning, litigation support services, and those services for which standards are promulgated by bodies designated by Council (see ET section 92.06). If the member, individually or collectively with his or her firm or with members of his or her firm controls the separate business (as defined by in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation), the entity and all its owners (including the member) and employees must comply with all of the provisions of the Code of Professional Conduct. For example, in applying Rule 503, Commissions and Referral Fees [ET section 503.01], if one or more members individually or collectively can control the separate business, such business would be subject to rule 503 [ET section 503.01], its interpretations and rulings. With respect to an attest client, rule 101 [ET section 101.01] and all its interpretations and rulings would apply to the separate business, its owners and employees.

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

505-3—Application of Rule 505 to alternative practice structures.

Rule 505, Form of Organization and Name [ET section 505.01], states, “A member may practice public accounting only in a form of organization permitted by law or regulation whose characteristics conform to resolutions of Council.” The Council Resolution (the Resolution) requires, among other things, that a majority of the financial interests in a firm engaged in attest services (as defined therein) be owned by CPAs. In the context of alternative practice structures (APS) in which (1) the majority of the financial interests in the attest firm is owned by CPAs and (2) all or substantially all of the revenues are paid to another entity in return for services and the lease of employees, equipment, and office space, questions have arisen as to the applicability of rule 505 [ET section 505.01].

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

- Compliance with all aspects of applicable state law or regulation
- Enrollment in an AICPA-approved practice monitoring program
- Compliance with the independence rules prescribed by Rule 101, Independence [ET section 101.01]
- Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, Compliance With Standards [ET section 202.01]) and all other provisions of the Code, including ET section 91, Applicability

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

505-4—Misleading Firm Names

Rule 505 [sec. 505 par. .01] prohibits a member from practicing public accounting under a firm name that is misleading. A firm name would be considered misleading if the name contains any representation that would be likely to cause a reasonable person to misunderstand, or be confused about, the legal form of the firm or who the owners or members of the firm are, such as a reference to a type of organization or an abbreviation thereof that does not accurately reflect the form under which the firm is organized.
In addition, the member should consider the rules and regulations of his or her state board(s) of accountancy concerning misleading firm names that may be more restrictive than the requirements contained in this ethics interpretation.

505-5—Common Network Brand in Firm Name
Firms within a network sometimes share the use of a common brand or share common initials as part of the firm name. The sharing of a common brand name or common initials of a network as part of the member’s firm name would not be considered misleading, provided the firm is a network firm, as defined in paragraph .24 of ET section 92, Definitions.

The sharing of a common brand name or common initials of a network as the entire name of the member’s firm would not be considered misleading, provided the firm is a network firm, as defined in paragraph .24 of ET section 92, and shares one or more of the following characteristics with other firms in the network:

- Common control (as defined in Financial Accounting Standards Board Accounting Standards Codification 810, Consolidation) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the network; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration amongst the firms whereby the firms are responsible for implementing the network’s strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that are monitored by the network

Members should refer to Interpretation No. 101-17, “Networks and Network Firms,” under Rule 101, Independence [ET sec. 101 par. .19], for independence requirements applicable to network firms.

Ethics Rulings on Form of Organization and Name
3. Employment by Non-CPA Firm
Question: A member is considering employment with a public accounting firm made up of one or more non-CPA practitioners. If he is employed by such a firm, what are his responsibilities under the Rules of Conduct?
Answer: A member so employed must comply with all the Rules of Conduct. If he becomes a partner in such a firm, he will then in addition be held responsible for compliance with the Rules of Conduct by all persons associated with him.

136. Audit with Former Partner
Question: A member’s firm consisting of one certified and one noncertified partner has been dissolved. One account was retained which the two practitioners plan to continue to service together. Should the audit report be submitted on partnership stationery?
Answer: It would appear proper for the audit to be carried out jointly by the two former partners. The opinion should be presented on plain paper and signed somewhat as follows:

John Doe, Certified Public Accountant
Richard Roe, Accountant

Such a signature would leave no doubt as to whether a partnership existed, and the client and others would have the assurance that both accountants participated in the audit.

137. Nonproprietary Partners
Question: A member’s firm wishes to institute the designation “nonproprietary partner” to describe certain high-ranking staff who were former partners of merged firms who did not qualify for partnership in the merging firm. With this title, they would be eligible to participate in the firm’s pension plan. In holding themselves out to the public they would be required to use this designation. Is there any impropriety in the proposed title?
Answer: The use of the designation “partner” should be restricted to those members of the firm who are legally partners. Those who are not parties to the partnership agreement should not hold themselves out in any manner which might lead others to believe that they are partners. The use of the designation “nonproprietary partner” by one who is not in fact a partner is considered misleading and therefore is not permitted.

138. Partner Having Separate Proprietorship
Question: May a member be a partner of a firm of public accountants, all other members of which are noncertified, and at the same time retain for himself or herself a practice of his or her own as a CPA?
Answer: Rule 505 [ET section 505.01] would not prohibit such a practice. However, clients and others interested should be advised about the dual position of the member to prevent any misunderstanding or misrepresentation.

141. Responsibility for Non-CPA Partner
Question: Is a member who has formed a partnership with a noncertified public accountant ethically responsible for all the acts of the partnership?
**Council Resolution Concerning Rule 505: Form of Organization and Name**

**A. RESOLVED:** That with respect to a member engaged in the practice accounting in a firm or organization which performs (1) any audit or other engagement performed in accordance with the Statements on Auditing Standards, (2) any review of a financial statement performed in accordance with the Statements on Standards for Accounting and Review Services, or (3) any examination of prospective financial information performed in accordance with the Statements on Standards for Attestation Engagements, or which holds itself out as a firm of certified public accountants or uses the term “certified public accountant(s)” or the designation “CPA” in connection with its name, the characteristics of such a firm or organization under rule 505 [ET section 505.01] are as set forth below.

1. A majority of the ownership of the firm in terms of financial interests and voting rights must belong to CPAs. Any non-CPA owner would have to be actively engaged as a member of the firm or its affiliates. Ownership by investors or commercial enterprises not actively engaged as members of the firm or its affiliates is against the public interest and continues to be prohibited.

2. There must be a CPA who has ultimate responsibility for all the services described in A above, compilation services and other engagements governed by Statements on Auditing Standards or Statements on Standards for Accounting and Review Services and non-CPA owners could not assume ultimate responsibility for any such services or engagements.

3. Non-CPA owners would be permitted to use the title “principal,” “owner,” “officer,” “member” or “shareholder,” or any other title permitted by state law, but not hold themselves out to be CPAs.

4. A member shall not knowingly permit a person, whom the member has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the rules. Further, a member may be held responsible for the acts of all persons associated with him or her in the practice of public accounting whom the member has the authority or capacity to control.

5. Owners shall at all times own their equity in their own right and shall be the beneficial owners of the equity capital ascribed to them. Provision would have to be made for the ownership to be transferred, within a reasonable period of time, to the firm or to other qualified owners if the owner ceases to be actively engaged in the firm or its affiliates.

6. Non-CPA owners would not be eligible for regular membership in the AICPA unless they meet the requirements in BL section 2.2.1.1

**B. RESOLVED:** The characteristics of all other firms or organizations are deemed to be whatever is legally permissible under applicable law or regulation except as otherwise provided in paragraph C below.

**C. RESOLVED:** That with respect to a member engaged in the practice of public accounting in a firm or organization which is not within the description of a firm or organization set forth in paragraph A above, but who performs compilations of financial statements performed in accordance with the Statements on Standards for Accounting and Review Services, the characteristics of such a firm or organization under rule 505 [ET section 505.01] are as set forth below.

1. There must be a CPA who has ultimate responsibility for any financial statement compilation services provided by the firm and by each business unit performing such compilation services and non-CPA owners could not assume ultimate responsibility for any such services.

2. Any compilation report must be signed individually by a CPA, and may not be signed in the name of the firm or organization.

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1. The change to this subsection is an administrative change to conform to section 2.2.1 of the bylaws.
AICPA Staff Responses to Inquiries

Form of Organization and Name

Question: May a sole proprietor or sole practitioner use the plural pronoun “we” in reports on financial statements?

Answer: Yes, provided the practitioner has at least one other individual working in the firm.

Question: A member who is a sole proprietor in public practice plans to establish a separate business that will provide management consulting services. May he or she operate both businesses simultaneously?

Answer: Yes. However, the member will be in public practice with respect to the operation of the management consulting firm and, therefore, must comply with the Code of Professional Conduct in connection with both businesses.

Question: A member’s firm is currently named Jones, Smith & Company. The partners wish to change the firm name to one that reflects the services offered, for example, Litigation Support Consultants. Would the proposed firm name be permissible under Rule 505?

Answer: Yes. Rule 505 no longer prohibits a member from practicing public accounting under a fictitious firm name. Only misleading firm names are prohibited.

Question: Is it permissible for a newly merged firm to practice under a title that includes the name of a partner who had retired from one of the two firms before the merger?

Answer: Rule 505 of the Code provides that a partnership may practice under a firm title that includes the name or names of former partners. Therefore, it would be proper for a retired partner’s name to appear in the title of a newly created firm.

Question: Two members, A and B, are sole proprietors and would like to work together on a client engagement. Although A and B have not legally formed a partnership, they would like to use a joint letterhead (“A&B, CPAs”) in connection with the engagement. Is this permissible under the Code of Professional Conduct?

Answer: No. Use of the letterhead would be considered misleading because a true partnership does not exist.

Question: A member is not an owner of a firm but shares in its profits and has overall responsibility for certain client accounts. The member has been promised a partnership interest in the firm in the near future. Would it be proper to include the member’s name on the firm’s letterhead under the caption “Partners”?

Answer: No. Until the member is legally a partner, it would be misleading to so include the member’s name.

Question: May John Smith, a sole proprietor who employs no professional employees, name his firm “John Smith & Company, Certified Public Accountant?”

Answer: Yes, provided he has at least one other individual working in the firm. The use of the term “& Company, Certified Public Accountant” may be used by a sole proprietor in the firm’s name. However, the use of the term “Certified Public Accountants” to imply that more than one CPA is an owner of, or is employed by, the firm would be considered a knowing misrepresentation of fact in violation of Rule 102—Integrity and Objectivity of the Code of Professional Conduct.
Chapter Questions

1. Which describes all of the forms of practice members are permitted to use?
   (a) Any form of organizations permitted by law or regulation whose characteristics conform to resolutions of council.
   (b) Proprietorship, partnership or professional corporation whose characteristics conform to resolutions of council.

2. Under partnership law
   (a) the accountability of each partner for the firm’s obligation is limited.
   (b) each partner is individually liable for all partnership obligations.

3. In a mixed partnership of members (CPAs) and non-CPAs, the members _______ be held ethically responsible for the acts of the non-CPAs.
   (a) may not
   (b) may

4. In a mixed partnership of CPAs and non-CPAs, the CPAs are all members of the AICPA. May this firm designate itself as “Members of the American Institute of Certified Public Accountants”?
   (a) Yes.
   (b) No.

5. The Ethics Committee _______ the use of the term “& Company” after a CPA’s name when the CPA is a sole practitioner, and there is at least one other individual working with the practitioner.
   (a) approves
   (b) disapproves

6. If a partner in a two-member partnership withdraws or dies, the remaining partner may continue to practice under the established firm title which includes the former partner’s name
   (a) for a reasonable period of time, not to exceed two years.
   (b) indefinitely.
   (c) for five years.

7. A public accounting firm’s owners are six CPAs and four non-CPAs. The non-CPAs are in charge of the tax department. The most senior of the non-CPAs gives final review and approval to all tax returns and to the few compilation reports that are issued with the tax returns. The compilation reports do not disclose a lack of independence.

8. Could two CPAs who share an office and staff ethically have a joint letterhead?
   (a) No. The public would assume a partnership existed.
   (b) Yes, if the letterhead shows them as individual CPAs.
   (c) Yes, if the word “Associates” is not used in such a way as to imply partnership.

9. Ownership of the firm may be divided as follows:
   (a) CPAs and non-CPAs may each own 50%.
   (b) CPAs must own a majority of financial and voting interests.
   (c) Ownership may be divided in any manner the owners desire.

10. It is proposed that a 10% interest in the firm be sold to a local investor. This investor would share in the profits but would have nothing to do with servicing the clients.
    Operating the accounting business in this manner _____ violate the Code of Professional Conduct.
    (a) would
    (b) would not

11. If a member’s firm name is not considered misleading under AICPA ethics rules and interpretations but is considered misleading under applicable State Board of Accountancy rules and regulations, the firm name would be considered
    (a) misleading
    (b) not misleading
Chapter Answers

1. (a) is correct. A member may practice public accounting in any form permitted by law or regulation as long as its characteristics conform to resolutions of AICPA Council (Rule 505).

2. (b) is correct. Each partner in a partnership is liable for all of the partnership debts (History).

3. (b) is correct. The member may be held responsible under the Code of Professional Conduct for the actions of non-CPA owners (Council Resolution Concerning Rule 505 A. 4.).

4. (a) is correct. If all CPA owners are members of the AICPA, then the firm may be designated “Members of the AICPA” (Rule 505).

5. (a) is correct. If the CPA has one other employee, he may use “& Company” in his firm’s name (Staff Responses to Inquiries).

6. (b) is correct. The firm’s name may contain the deceased partner’s name forever (Rule 505). A few years ago there was a limit of two years. That was changed and now there is no time limit.
   Thus (a) and (c) are incorrect.

7. (a) is correct. Compilation statements are attest engagements since they require one to be independent (Lesson 2, Definitions, Attest engagement and Lesson 3, Ruling 74). Non-CPA owners may not have ultimate responsibility for any attest engagements (Council Resolution Concerning Rule 505, A.2.).

8. (a) is correct. The public would be justified in assuming a partnership existed when there was no partnership (Ruling 134).
   (b) is incorrect because the Ethics Division has stated that a letterhead should not show the names of two members when a partnership does not exist (Ruling 134). (c) is incorrect because the Ethics Division has said that the use of such a title is not permitted (Ruling 135).

9. (b) is correct. CPAs must own a majority of the firm (Council Resolution Concerning Rule 505, A.1.).

10. (a) is correct. Ownership by investors not engaged in providing services to the firm’s clients is prohibited (Council Resolution Concerning Rule 505 A.1.).

11. (a) is correct. Per Interpretation 505-4, a member must consider whether applicable State Board(s) of Accountancy rules are more restrictive than the AICPA ethics rulings and interpretations regarding misleading firm names.
Introduction
For years the accounting profession has insisted on high ethical standards. Several organizations such as individual State Boards of Accountancy, Securities and Exchange Commission, Internal Revenue Service and Government Accountability Office have imposed strict rules for conducting and practicing accounting. Most recently the Sarbanes-Oxley Act of 2002 created the Public Company Accounting Oversight Board. This board has broad powers to impose sanctions against both accounting firms and individuals.

Law-making bodies can protect the general health, welfare and safety of the people. The rules promulgated serve the public interest. While restrictions are necessary in any profession, there is another side to the coin. How much do rules, regulations, laws, and codes of ethics restrict freedom of speech or freedom of action? For example, the California Society of Certified Public Accountants has said, “The primary purpose of the State Board of Accountancy is to protect the public interest. The professional societies’ primary purpose is to further the interests of the profession. This includes protecting the public interest and developing professional attitudes in relations with clients and fellow practitioners.”

Sanctions Imposed by Public Opinion
The auditor’s place in American society is important, permeating all levels of society from the national budget and tax structure to the various industries and utilities, transportation and distribution. The profession has had an excellent reputation. But an image can only reflect reality. If ever there comes a time when auditors lose their integrity and no longer deal fairly and honestly, that image would surely vanish and the public would react accordingly.

A spate of bankruptcies of major companies, accusations of fraud by management of some of the largest companies, and allegations of fraud on the part of some accountants resulted in the Sarbanes-Oxley Act of 2002. Some have now expressed concerns that this act was hastily drawn, went too far, costs of implementation are too great and it really doesn’t present a cure for preventing management fraud. The act shows what may happen when public opinion is aroused and there is a feeling that something must be done. AICPA and state CPA societies are working diligently to repair damage to the profession’s reputation.

Public opinion can be as swift and drastic for individuals. Human beings make up professions, and the best of us err now and then. Errors may involve professional practice, or may be entirely unrelated—such as irregular personal conduct, or involvement in scandals or crimes involving moral turpitude. Apart from other sanctions that the law or the profession may impose, the auditor may first feel public condemnation. Clients may believe that an auditor whose integrity has been questioned or impeached cannot serve them well any longer; hence, they may terminate the CPA’s services. Thus, the CPA who gets himself unfavorably talked about, innocently or otherwise, may damage his practices’ irrevocably. At the same time, he may harm his profession.

Sanctions Imposed by Professional Organizations

Individuals
The American Institute of Certified Public Accountants is the national accounting organization which promulgates professional ethics standards. The AICPA insists that its members maintain an appropriate level of professional competence and integrity. Because of this, membership reflects a certain prestige.

To maintain the desired prestige, the Institute must review the members’ qualifications when they join, and it must have the power to expel or suspend any who later fall short of the standards.

The AICPA Bylaws provide for the suspension or expulsion without a hearing of any member convicted of:

1. a crime punishable by imprisonment for more than one year;

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(2) the willful failure to file any income tax return which he, as an individual taxpayer, is required by law to file;
(3) the filing of a false or fraudulent income tax return on his or a client’s behalf; or
(4) the willful aiding in the preparation and presentation of a false and fraudulent income tax return of a client; and shall be terminated in like manner upon the similar filing of a final judgment of conviction.

Revocation of a member’s CPA certificate/license by his state board of accountancy will also result in termination of his membership in the AICPA.

The AICPA members in October 2003 changed the Bylaws to speed up the process of ethics enforcement and its transparency. One change allows the Professional Ethics Executive Committee (PEEC) to automatically sanction a member without an investigation if the member was disciplined by any government agency or other organizations that had been approved by the AICPA. Examples include the Securities and Exchange Commission (SEC), the Public Company Accounting Oversight Board (PCAOB), Internal Revenue Service (IRS) and the Government Accountability Office (GAO). The second change allows the PEEC to disclose more information on the matters it has investigated, including informing the complainant of the results of an investigation.

State CPA societies can also discipline members. Usually the society Bylaws contain a provision that a society member may be suspended or expelled if a court has found the member guilty of a fraud or felony or if the member is guilty of a crime punishable by imprisonment for more than one year.

The AICPA Bylaws and most state society Bylaws provide for disciplining of members by the AICPA Joint Trial Board. The most severe punishment that a Trial Board may impose is expulsion.

The AICPA and almost all state CPA societies are members of the Joint Ethics Enforcement Plan. Under this plan, alleged violations of the Code of Professional Conduct by a CPA who is a member of the AICPA and a participating state society are investigated and, when required, presented before a Trial Board on behalf of both the AICPA and the applicable state society.

If the AICPA Joint Trial Board were to expel the member, the member would lose membership in both the AICPA and the applicable state society.

If a state society is not a member of the Joint Ethics Enforcement Program, then both the AICPA and the state society could conduct separate Trial Board proceedings. In such situations, the sanctions imposed may vary between the AICPA and the state society. The state society would also have to form its own Trial Board.

The AICPA’s professional ethics committee, when confronted with a complaint that demonstrates on its face a violation of the Code of Professional Conduct, may offer to settle the matter without a full investigation if the respondent agrees to specified corrective actions or discipline. If the settlement with the member is suspension or termination, it must be endorsed by the Joint Trial Board. In addition, the Joint Trial Board may accept without a hearing a guilty plea from any member summoned to appear at a disciplinary hearing. The advantage of the preceding to members, AICPA and state CPA societies is a saving of both time and out-of-pocket expenses.

The AICPA Ethics Division and most state society ethics committees may impose on a member lesser sanctions than expulsion, suspension or admonishment. This lesser sanction is called a “letter of required corrective action.” This letter may or may not require the member to take certain professional development courses. These sanctions are not publicly reported, however, failure or refusal to take such courses will usually result in the members being brought before a trial board.

Again, for those state societies participating in the Joint Ethics Enforcement Program, this lesser sanction would be imposed on behalf of both the AICPA and the state society.

Expulsion or suspension need not result from a member’s unethical or criminal activities alone. The Institute provides (Section 7.2 of the Bylaws): “The board of directors may, in its discretion, terminate the membership of a member who fails to pay dues or any other obligation to the Institute within five months after such debt has become due and terminate the membership of a member who fails to comply with the practice monitoring or continuing education membership retention requirements.”

No sanction applied against individual members by the American Institute or any state society involves fine, imprisonment, or damages, as court action might. However, no member takes lightly the loss of reputation, the notoriety, and the embarrassment caused by an unfavorable verdict. Even though the public may take little note of such action, it is known in the profession and is bound to affect the flow of referral business. Also, such a sanction may prevent the practitioner from obtaining employment with firms which know that the professional association has rejected the practitioner.
Firms

As shown in the prior section, a member is subject—as an individual only—to ethical requirements governing compliance with both accounting and auditing standards and behavioral standards. Firms were previously outside the jurisdiction of the professional body. Some years ago this was changed, and firms may now be sanctioned by the AICPA for violation of technical and behavioral standards.

Sanctions Imposed by State Boards

As we have previously seen, what the professional society gives its members, it can also take away. The same holds true of the state which licenses an auditor. It too may rescind what it has bestowed. Under several names, all the states have boards of accountancy which regulate the profession of accountancy, protect the public, and set up rules and standards which enable more uniform practice. All can directly or indirectly discipline licensees.

Other Sanctions

CPAs commonly appear on behalf of their clients before the Internal Revenue Service or before state taxing authorities which exercise a quasi-judicial authority. They also practice before the Securities and Exchange Commission, as well as various state taxing authorities and other governmental bureaus, state and federal, where accounting expertise or facts are needed. These bodies may bar an auditor from further practice before them in cases of improper behavior, including lack of independence. Such bodies as the SEC and the IRS, moreover, have their own disciplinary proceedings.

As previously mentioned, the new Public Company Accounting Oversight Board has broad powers to investigate and sanction both individuals and firms.

Publicity

Years ago, a conviction by a trial board was publicized only if the trial board voted to do so. Very seldom did the trial board ever vote to publish it. As a result the public had no way of knowing whether the AICPA was taking action against those that violated its ethics code. The Bylaws were changed to require publication of all trial board convictions, automatic suspensions or expulsions for the criminal conviction of a member or the suspension or revocation of a member’s CPA certificate or license to practice and settlement proceedings that call for suspension or expulsion. The reporting includes the member’s name and punishment along with a link for additional details of the case. This information is available on the AICPA website at www.aicpa.org under the “For the Public” tab. A member or member’s firm termination of participation in an AICPA-approved Peer Review program is also reported in the same location. Since this information is readily available to the public and to members of the profession, no member or firm wants this kind of adverse publicity.

Conclusion

CPAs practice under many rules, often interrelated. The Code of Professional Conduct and the codes of professional societies are only one aspect of ethical practice. State boards and various government departments have similar rules. These rules, however, often differ somewhat from those of the profession. To ensure an ethical practice, CPAs must know all the rules affecting their practice, and they must abide by them to avoid possible sanctions.

Public opinion imposes sanctions against groups and individuals who violate the public interest. Similarly, professional societies impose sanctions against individuals who are guilty of unprofessional conduct. State Boards of Accountancy, too, have procedures for disciplinary action. Various federal authorities, such as the IRS, PCAOB, and the SEC, may also discipline practitioners for improper behavior.

In view of all the rules and sanctions which may be imposed, the CPA has a definite responsibility to know the rules and to practice accordingly. The CPA is expected to conduct his or her practice with integrity and competence, as demanded by the letter and the spirit of the Code.
Chapter Questions

1. A CPA will be expelled from the AICPA for
   (a) having his or her certificate as a CPA revoked by the authority of any state.
   (b) being convicted of a crime punishable by imprisonment for more than one year.
   (c) both (a) and (b).

2. Can most state associations discipline members?
   (a) No, only the American Institute can.
   (b) Yes.
   (c) No, only a few state associations can.

3. Can the Institute expel a member for not paying dues and other obligations?
   (a) Yes, five months after the due date.
   (b) No, not just for that offense.
   (c) Yes, and require a fine also.

4. Any sanctions applied against a member by the AICPA or state CPA associations can involve
   (a) a fine only.
   (b) a fine and imprisonment.
   (c) neither (a) nor (b).

5. Mr. Robert Jones, a member of the AICPA and of a state society that is a member of the Joint Ethics Enforcement Program, is found guilty by a Trial Board of violating the Code. The Trial Board’s punishment is a six-month suspension. This suspension will be effective for
   (a) his AICPA membership.
   (b) his state society membership.
   (c) both (a) and (b).

6. Assume the same set of facts as in question 15 above, except that the punishment is censure. Which of the following statements is true?
   (a) Since the punishment was only a censure, there will be no publicity about the Trial Board’s findings and punishment.
   (b) The public and members of the profession, via posting on the AICPA website, will be informed that Robert Jones was found guilty by a Trial Board of violating the Code and that the Trial Board censured him.
   (c) The public and members of the profession, via posting on the AICPA website, will be informed that a member was found guilty by a Trial Board of violating the Code and that the member was censured. They will not be told that the member was Robert Jones.
Chapter Answers

1. (c) is correct. AICPA Bylaws provide for automatic expulsion if a person is convicted of a crime punishable by imprisonment for more than one year. Note that the sentence does not have to be that long, just that it could be that long. If his or her CPA certificate or license to practice is revoked by the state board of accountancy, the person will also be automatically expelled (Sanctions Imposed by Accounting Profession Organizations).

2. (b) is correct. State CPA societies may also discipline members (Sanctions Imposed by Accounting Profession Organizations).
   (a) and (c) are therefore incorrect.

3. (a) is correct. The AICPA Bylaws say that the Board of Directors may, at their discretion, terminate the membership of members who fail to pay their dues or other debts to the AICPA within five months after they became due (Sanctions Imposed by Accounting Profession Organizations).
   (b) is incorrect because failure to pay is enough grounds for expulsion.
   (c) is incorrect because the AICPA has no authority to levy fines.

4. (c) is correct. Neither the AICPA nor state CPA societies may levy fines or impose imprisonment (Sanctions Imposed by Accounting Profession Organizations).
   (a) and (b) are therefore incorrect.

5. (c) is correct. In states belonging to the Joint Ethics Enforcement program, a finding by a trial board applies to both his state society membership and his AICPA membership (Sanctions Imposed by Accounting Profession Organizations).

6. (b) is correct. The AICPA Bylaws require that all Trial Board convictions be publicized with the member’s name given (Publicity).
   (a) is incorrect because the degree of punishment makes no difference in the publicity given.
   (c) is also incorrect since the AICPA Bylaws require that the name be published.
Chapter 14

California Accountancy Act and CBA Regulations

Introduction
Certified Public Accountants may find themselves obligated to comply with more than one set of rules, such as the AICPA Code of Professional Conduct, SEC Rules, Statements on Standards for Tax Services, etc. In addition, CPA licenses are granted by individual states and licensees must comply with laws, rules and regulations promulgated by the state where they are licensed. Occasionally various standards promulgated by differing bodies may differ. What should a CPA do when confronted by different rules? If and when the professional conduct rules are different (e.g., the acceptance of commissions), a California CPA’s first allegiance is to the California Accountancy Act and Accountancy Rules and Regulations. A good rule of thumb, however, is to strive to comply with the most strict set of rules, thus complying with all the rules. Some California licensees mistakenly believe they can avoid the obligation of complying with AICPA rules by not joining the AICPA. However, Rule 9, Section 58 of the California Accountancy Rules and Regulations state otherwise: “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.”

Sources of Requirements
California licensees are responsible for compliance with two main sources of regulations: The California Accountancy Act (Business and Professions Code; Division 3, Chapter 1, Sections 5000–5158) and Accountancy Rules and Regulations (California Code of Regulations; Title 16, Division 1, State Board of Accountancy). The former is legislation (law) and may only be changed by the California legislature. The latter are regulations which can be changed by the California Board of Accountancy (CBA). This chapter provides a brief outline of both sources’ contents, as well as some portions of the California Accountancy Act and Accountancy Rules and Regulations as of September 30, 2012. For changes after that date visit the following web site: www.dca.ca.gov.

This chapter should not be read as a whole. Rather, you should skim the section headings and make note of the type of requirements contained in the various sections. Then you should turn to the practice questions at the end of the chapter and research the answers, utilizing the outline of the California Accountancy Act and the Accountancy Rules and Regulations shown below.

The sections of the California Accountancy Act and Accountancy Rules and Regulations which are reproduced in this chapter are highlighted in bold in the outlines below.

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California Accountancy Act

ARTICLE 1.5: Continuing Education

Continuing Education

Section 5026. The Legislature has determined it is in the public interest to require that certified public accountants and public accountants licensed under provisions of this chapter comply with continuing education requirements adopted by the board as a prerequisite to the renewal of public accountancy licenses on and after December 31, 1974.

Continuing Education Regulations

Section 5027. The board shall by regulation prescribe, amend, or repeal rules including, but not limited to, all of the following:

(a) A definition of basic requirements for continuing education.

(b) A licensee who plans, directs, or approves any financial or compliance audit report on any governmental agency shall complete a minimum of 24 hours of qualifying continuing education in the area of governmental accounting and auditing or related subjects during the two-year license renewal period.

(c) A licensee who provides audit, review, other attestation services, or issues compiled financial statement reports shall, during the two-year license renewal period, complete a minimum of 24 hours of qualifying continuing education in the area of accounting and auditing related to reporting on financial statements.

(d) A licensee with a valid permit to practice public accountancy shall, within a six-year period, complete a continuing education course on the provisions of this chapter and the rules of professional conduct.

(e) A licensee on inactive status shall complete the continuing education course required by subdivision (d) prior to reentering public practice.

(f) A delineation of qualifying programs for maintaining competency.

(g) A system of control and compliance reporting.

In exercising its power under this section for the interests of consumer protection, the board shall establish standards which will assure reasonable currency of knowledge as a basis for a high standard of practice by licensees. The standards shall be established in a manner to assure that a variety of alternatives are available to licensees to comply with the continuing education requirements for renewal of licenses and taking cognizance of specialized areas of practice.

Exceptions from Continuing Education Requirements

Section 5028. The board may, in accordance with the intent of this article, make exceptions from continuing education requirements for licensees not engaged in public practice, or for reasons of health, military service, or other good cause; provided, however, that if such licensee returns to the practice of public accounting he shall meet such continuing education requirements as the board may determine.

Continuing Education Committee

Section 5029. The board may establish an advisory continuing education committee of nine members, six of whom shall be certified public accountants, two of whom shall be board members, one of whom is a public member of the board, and one of whom shall be a public accountant, to perform any of the following duties:

(a) To evaluate programs and advise the board as to whether they qualify under the regulations adopted by the board pursuant to subdivision (f) of Section 5027. Educational courses offered by professional accounting societies shall be accepted by the board as qualifying if the courses are approved by the committee as meeting the requirements of the board under the regulations.

(b) To consider applications for exceptions as permitted under Section 5028 and provide a recommendation to the board.

(c) To consider other advisory matters relating to the requirements of this article as the board may assign to the committee.
ARTICLE 2: General Powers and Definitions

“Board” Defined
Section 5030. “Board” means the “State Board of Accountancy.”

“Committee” Defined
Section 5031. “Committee” means any committee created under the provisions of Article 1 (commencing at Section 5000).

“State” Defined
Section 5032. “State” when not specifically referring to this State, means any state, territory or insular possession of the United States, or the District of Columbia.

“Certified Public Accountant” Defined
Section 5033. “Certified public accountant” means any person who has received from the board a certificate of certified public accountant and who holds a valid permit to practice under the provisions of this chapter.

“License” includes “Certificate”
Section 5033.1. For purposes of this chapter, “license” shall also include “certificate.”

“Public Accountant” Defined
Section 5034. “Public accountant” means any person who has registered with the board as a public accountant and who holds a valid permit for the practice of public accountancy.

“Person” Defined
Section 5035. “Person” includes individual, partnership, firm, association, limited liability company, or corporation, unless otherwise provided.

“Firm” Defined
Section 5035.1. “Firm” means a sole proprietorship, a corporation, or a partnership.

“Client” Defined
Section 5035.2. “Client”, as used in any context in this chapter, means any person for whom public accountancy services are performed or to whom financial products, financial services, or securities are sold or provided at the license’s public accountancy practice or through referral to any other location or business in which the certified public accountant has a material interest.

“Firm” Includes
Section 5035.3. For purposes of subdivision (b) of Section 5050 and Sections 5054 and 5096.12, “firm” includes any entity that is authorized or permitted to practice public accountancy as a firm under the laws of another state.

Preparation of State Documents
Section 5036. Whenever any statute requires that any reports, financial statements, and other documents for any department, division, board, commission, or agency of this state be prepared by certified public accountants, the requirement shall be construed to mean a licensee or licensees with a valid permit to practice public accountancy.

Ownership of Accountants’ Work Papers
Section 5037.
(a) All statements, records, schedules, working papers and memoranda made by a licensee or a partner, shareholder, officer, director, or employee of a licensee, incident to, or in the course of, rendering services to a client in the practice of public accountancy, except the reports submitted by the licensee to the client and except for records which are part of the client’s records, shall be and remain the property of the licensee in the absence of an express agreement between the licensee and the client to the contrary. No such statement, record, schedule, working paper, or memoranda shall be sold, transferred, or bequeathed, without the consent of the client or his or her personal representative or assignee, to anyone other than one or more surviving partners or stockholders or new partners or stockholders of the licensee, or any combined or merged firm or successor in interest to the licensee.

(b) A licensee shall furnish to his or her client or former client, upon request and reasonable notice:

(1) A copy of the licensee’s working papers, to the extent that those working papers include records that would ordinarily constitute part of the client’s records and are not otherwise available to the client.

(2) Any accounting or other records belonging to, or obtained from or on behalf of, the client which the licensee removed from the client’s premises or received for the client’s account. The licensee may make and retain copies of documents of the client when they form the basis for work done by him or her.

Construction of Licensees’ Obligations Under Section 5037
Section 5037.1. Nothing in subdivision (k) of Section 17406 of the Financial Code or subdivision (a) of Section 17406.1 of the Financial Code shall be construed to impair or impede a licensee’s rights, duties, and obligations under Section 5037.

Partial Invalidity of Chapter
Section 5038. If any provisions of this chapter or the application thereof to any person or circumstances is held invalid, the remainder of the chapter and the application of such provision to other persons or circumstances shall not be affected thereby.
Voluntary Taxpayer Contributions
Section 5040. The Legislature finds and declares that it is important to inform taxpayers that they may make voluntary contributions to certain funds or programs, as provided on the state income tax return. The Legislature further finds and declares that many taxpayers remain unaware of the voluntary contribution check-offs on the state income tax return. Therefore, it is the intent of the Legislature to encourage all persons who prepare state income tax returns, including accountants, to inform their clients in writing, prior to the completion of any state income tax return, that they may make a contribution to any voluntary contribution check-off on the state income tax return if they so choose.

ARTICLE 3: Application of Chapter
Practice Without Permit: Temporary Practice, Out-of-State Applicant
Section 5050.
(a) Except as provided in subdivisions (b) and (c) of this section, in subdivision (a) of Section 5054, and in Section 5096.12, no person shall engage in the practice of public accountancy in this state unless the person is the holder of a valid permit to practice public accountancy issued by the board or a holder of a practice privilege pursuant to Article 5.1 (commencing with Section 5096).
(b) Nothing in this chapter shall prohibit a certified public accountant, a public accountant, or a public accounting firm lawfully practicing in another state from temporarily practicing in this state incident to practice in another state, provided that an individual providing services under this subdivision may not solicit California clients, may not assert or imply that the individual is licensed to practice public accountancy in California, and may not engage in the development, implementation, or marketing to California consumers of any abusive tax avoidance transaction, as defined in subdivision (c) of Section 19753 of the Revenue and Taxation Code. A firm providing services under this subdivision that is not registered to practice public accountancy in California may not solicit California clients, may not assert or imply that the firm is licensed to practice public accountancy in California, and may not engage in the development, implementation, or marketing to California consumers of any abusive tax avoidance transaction, as defined in subdivision (c) of Section 19753 of the Revenue and Taxation Code. This subdivision shall become inoperative on January 1, 2011.
(c) Nothing in this chapter shall prohibit a person who holds a valid and current license, registration, certificate, permit, or other authority to practice public accountancy from a foreign country, and lawfully practicing therein, from temporarily engaging in the practice of public accountancy in this state incident to an engagement in that country, provided that:
(1) The temporary practice is regulated by the foreign country and is performed under accounting or auditing standards of that country.
(2) The person does not hold himself or herself out as being the holder of a valid California permit to practice public accountancy or the holder of a practice privilege pursuant to Article 5.1 (commencing with Section 5096).

Consent to Board’s Jurisdiction
Section 5050.1.
(a) Any person that engages in any act that is the practice of public accountancy in this state consents to the personal, subject matter, and disciplinary jurisdiction of the board. This subdivision is declarative of existing law.
(b) Any person engaged in the practice of public accountancy under subdivision (a) is deemed to have appointed the regulatory authority of the state or foreign jurisdiction that issued the person’s permit, certificate, license or other authorization to practice as the person’s agent on whom notice, subpoenas, or other process may be served in any action or proceeding by or before the board against or involving that person.

Discipline of Out-of-State or Foreign Accountant Firm
Section 5050.2.
(a) The board may revoke, suspend, issue a fine pursuant to Article 6.5 (commencing with Section 5116), or otherwise restrict or discipline the holder of an authorization to practice under subdivision (b) or (c) of Section 5050, subdivision (a) of Section 5054, or Section 5096.12 for any act that would be a violation of this code or grounds for discipline against a licensee or holder of a practice privilege, or grounds for denial of a license or practice privilege under this code. The provisions of the Administrative Procedure Act, including, but not limited to, the commencement of a disciplinary proceeding by the filing of an accusation by the board shall apply to this section. Any person whose authorization to practice under subdivision (b) or (c) of Section 5050, subdivision (a) of Section 5054, or Section 5096.12 has been revoked may apply for reinstate-
ment of the authorization to practice under subdivision (b) or (c) of Section 5050, subdivision (b) of Section 5054, or Section 5096.12 not less than one year after the effective date of the board’s decision revoking the authorization to practice unless a longer time, not to exceed three years, is specified in the board’s decision revoking the authorization to practice.

(b) The board may administratively suspend the authorization of any person to practice under subdivision (b) or (c) of Section 5050, subdivision (a) of Section 5054, or Section 5096.12 for any act that would be grounds for administrative suspension under Section 5096.4 utilizing the procedures set forth in that section.

“Public Accountancy” Defined

Section 5051. Except as provided in Sections 5052 and 5053, a person shall be deemed to be engaged in the practice of public accountancy within the meaning and intent of this chapter if he or she does any of the following:

(a) Holds himself or herself out to the public in any manner as one skilled in the knowledge, science and practice of accounting, and as qualified and ready to render professional service therein as a public accountant for compensation.

(b) Maintains an office for the transaction of business as a public accountant.

(c) Offers to prospective clients to perform for compensation, professional services that involve or require an audit, examination, verification, investigation, certification, presentation, or review, of financial transactions and accounting records.

(d) Prepares or certifies for clients reports on audits or examinations of books or records of account, balance sheets, and other financial, accounting and related schedules, exhibits, statements, or reports which are to be used for publication or for the purpose of obtaining credit or for filing with a court or law or with any governmental agency, or for any other purpose.

(e) In general or as an incident to that work renders professional services to clients for compensation in any or all matters relating to accounting procedure and to the recording, presentation, or certification of financial information or data.

(f) Keeps books, makes trial balances, or prepares statements, makes audits, or prepares reports, all as a part of bookkeeping operations for clients.

(g) Prepares or signs as the tax preparer, tax returns for clients.

(h) Prepares personal financial or investment plans or provides to clients products or services of others in implementation of personal financial or investment plans.

(i) Provides management consulting services to clients. The activities set forth in subdivisions (f) to (i), inclusive, are “public accountancy” only when performed by a certified public accountant or public accountant, as defined in this chapter.

A person is not engaged in the practice of public accountancy if the only services he or she engages in are those defined by subdivisions (f) to (i), inclusive, and he or she does not hold himself or herself out, solicit, or advertise for clients using the certified public accountant or public accountant designation. A person is not holding himself or herself out, soliciting or advertising for clients within the meaning of this section solely by reason of displaying a CPA or PA certificate in his or her office or identifying himself or herself as a CPA or PA on other than, signs, advertisements, letterhead, business cards, publications directed to clients or potential clients, or financial or tax documents of a client.

Person Excepted

Section 5052. Nothing in this chapter shall apply to any person who as an employee, independent contractor, or otherwise, contracts with one or more persons, organizations, or entities, for the purpose of keeping books, making trial balances, statements, making audits or preparing reports, all as a part of bookkeeping operations, provided that such trial balances, statements, or reports are not issued over the name of such person as having been prepared or examined by a certified public accountant or public accountant.

Nothing contained in this chapter shall affect, limit or be construed as affecting or limiting the rights of any public accountant who met the requirements of prior statutes and who was registered with the board as a public accountant on or before December 31, 1955.

Exceptions of Certain Employees and Assistants; Attorney at Law Excepted

Section 5053. Nothing contained in this chapter precludes a person who is not a certified public accountant or public accountant from serving as an employee of, or as assistant to, a certified public accountant or public accountant or partnership or a corporation composed of certified public accountants or public accountants holding a permit to practice pursuant to the provisions of this chapter if the employee or assistant works under the control and supervision of a certified public accountant, or a public accountant authorized to practice public accountancy pursuant to the provisions of this chapter and
if the employee or assistant does not issue any statement over his or her name.

This section does not apply to an attorney at law in connection with his or her practice of law.

**Exception for Certain Tax Preparers**

Section 5054.

(a) Notwithstanding any other provision of this chapter, an individual or firm holding a valid and current license, certificate, or permit to practice public accountancy from another state may prepare tax returns for natural persons who are California residents or estate tax returns for the estates of natural persons who were clients at the time of death without obtaining a permit to practice public accountancy issued by the board under this chapter or a practice privilege pursuant to Article 5.1 (commencing with Section 5096) provided that the individual or firm does not physically enter California to practice public accountancy pursuant to Section 5051, does not solicit California clients, and does not assert or imply that the individual or firm is licensed or registered to practice public accountancy in California.

(b) The board may, by regulation, limit the number of tax returns that may be prepared pursuant to subdivision (a).

**Title of Certified Public Accountant**

Section 5055. Any person who has received from the board a certificate of certified public accountant may, subject to Section 5051, be styled and known as a “certified public accountant” and may also use the abbreviation “C.P.A.” No other person, except a firm registered under this chapter, shall assume or use that title, designation, or abbreviation or any other title, designation, sign, card or device tending to indicate that the person using it is a certified public accountant.

**Title of Public Accountant**

Section 5056. Any person who has received from the board a certificate of public accountant may, subject to Section 5051, be styled and known as a “public accountant” and may also use the abbreviation “P.A.” No other person, except a firm registered under this chapter, shall assume or use that title, designation, or abbreviation or any other title, designation, sign, card or device tending to indicate that the person using it is a public accountant.

**Licensure & Practice Privilege Exemption**

Section 5057. Notwithstanding any other provision of law, an individual holding a valid and current license, certificate, or permit to practice public accountancy from another state shall be exempt from the requirement to obtain a permit to practice public accountancy issued by the board under this chapter or to secure a practice privilege pursuant to Article 5.1 (commencing with Section 5096) if all of the following conditions are satisfied:

(a) The individual’s client is located in another state.

(b) The individual’s engagement with the client relates to work product to be delivered in another state.

(c) The individual does not solicit California clients, or have his or her principal place of business in this state.

(d) The individual does not assert or imply that he or she is licensed to practice public accountancy in California.

(e) The individual’s practice of public accountancy in this state on behalf of the client located in another state is of a limited duration, not extending beyond the period required to service the engagement for the client located in another state.

(f) The individual’s practice of public accountancy in this state specifically relates to servicing the engagement for the client located in another state.

**Use of Confusing Titles or Designations Prohibited**

Section 5058. No person or partnership shall assume or use the title or designation “chartered accountant,” “certified accountant,” “enrolled accountant,” “registered accountant” or “licensed accountant,” or any other title or designation likely to be confused with “certified public accountant” or “public accountant,” or any of the abbreviations “C.A.,” “E.A.,” “R.A.,” or “L.A.,” or similar abbreviations likely to be confused with “C.P.A.,” or “P.A.”; provided, that any person qualified as a certified public accountant under this chapter who also holds a comparable title granted under the laws of another country may use such title in conjunction with the title of “certified public accountant” or “C.P.A.” and provided, that any person enrolled to practice before the Internal Revenue Service and recognized as an enrolled agent may use the abbreviation “E.A."

**Titles in Conjunction with Certified Public Accountant or Public Accountant**

Section 5058.1. A person or firm may not use any title or designation in connection with the designation “certified public accountant” or “public accountant” that is false or misleading. The board may adopt regulations covering the use of titles or designations.

**Inactive Designation**

Section 5058.2. The holder of an inactive license issued by the board pursuant to Section 462, when lawfully using the title “certified public accountant,” the CPA designation, or any other reference that would suggest
that the person is licensed by the board on materials such as correspondence, Internet Web sites, business cards, nameplates, or name plaques, shall place the term “inactive” immediately after that designation.

Retired Designation

Section 5058.3. The holder of a retired license issued by the board pursuant to Section 5070.1, when lawfully using the title “certified public accountant,” the CPA designation, or any other reference that would suggest that the person is licensed by the board on materials such as correspondence, Internet Web sites, business cards, nameplates, or name plaques, shall place the term “retired” immediately after that title, designation, or reference.

ARTICLE 3.5: Standards of Professional Conduct

Name of Firm

Section 5060.

(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.

Commissions

Section 5061.

(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 for a commission or from receiving a commission from a client during the period in which the person also performs for that client 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.

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.

Report Conforming to Professional Standards
Section 5062. A licensee shall issue a report which conforms to professional standards upon completion of a compilation, review or audit of financial statements.

Restrictions on Accepting Employment with an Audit Client
Section 5062.2. 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.

Reportable Events
Section 5063

(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 statement, 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 of 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.

**Reporting by Courts**

Section 5063.1. 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.

**Reporting by Insurers**

Section 5063.2. 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.

**Disclosure of Confidential Client Information Prohibited**

Section 5063.3.

(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.
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.

**Restatements**

Section 5063.10.

(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 4: Applications, Registrations, Permits Generally
Public Accountancy Permits and Certificates
Section 5070. Permits to engage in the practice of public accountancy in this state shall be issued by the board only to holders of the certificate of certified public accountant issued under this chapter and to those partnerships, corporations, and other persons who, upon application approved by the board, are registered with the board under this chapter. All applicants for registration shall furnish satisfactory evidence that the applicant is entitled to registration and shall pay the fee as provided in Article 8 (commencing with Section 5130). Every partnership, corporation, and other person to whom a permit is issued after December 31, 1962, shall, in addition to any other fee which may be payable, pay the initial permit fee provided in Article 8 (commencing with Section 5130).

Each partnership, corporation, and other person issued a permit by the board to practice as a certified public accountant or as a public accountant shall be furnished with a suitable certificate evidencing such registration.

Retired Status
Section 5070.1.
(a) The board may establish, by regulation, a system for the placement of a license on a retired status, upon application, for certified public accountants and public accountants who are not actively engaged in the practice of public accountancy or any activity which requires them to be licensed by the board.
(b) No licensee with a license on a retired status shall engage in any activity for which a permit is required.
(c) The board shall deny an applicant’s application for a retired status license if the permit is canceled or if the permit is suspended, revoked, or otherwise prospectively restricted by the board or subject to disciplinary action under this chapter.
(d) Beginning one year from the effective date of the regulations adopted pursuant to subdivision (a), if an applicant’s permit is delinquent, the board shall deny an applicant’s application for a retired status license.
(e) The board shall establish minimum qualifications for a retired status license.
(f) The board may exempt the holder of a retired status license from the renewal requirements described in Section 5070.5.
(g) The board shall establish minimum qualifications for the restoration of a license in a retired status to an active status. These minimum qualifications shall include, but are not limited to, continuing education and payment of a fee as provided in subdivision (h) of Section 5134.

Expiration of Permits; Renewal; Continuing Education Requirements
Section 5070.5.
(a) A permit issued under this chapter to a certified public accountant or a public accountant expires at 12 midnight on the last day of the month of the legal birthday of the licensee during the second year of a two-year term if not renewed. To renew an unexpired permit, a permit holder shall, before the time at which the permit would otherwise expire, apply for renewal on a form prescribed by the board, pay the renewal fee prescribed by this chapter and give evidence satisfactory to the board that he or she has complied with the continuing education provisions of this chapter.
(b) A permit to practice as an accountancy partnership or an accountancy corporation expires at 12 midnight on the last day of the month in which the permit was initially issued during the second year of a two-year term if not renewed. To renew an unexpired permit, the permit holder shall, before the time at which the permit would otherwise expire, apply for renewal on a form prescribed by the board, pay the renewal fee prescribed by this chapter, and provide evidence satisfactory to the board that the accountancy partnership or accountancy corporation is in compliance with this chapter.

Renewal of Expired Permit and Effective Date of Renewal of Such Permits
Section 5070.6. Except as otherwise provided in this chapter, an expired permit may be renewed at any time within five years after its expiration upon the filing of an application for renewal on a form prescribed by the board, payment of all accrued and unpaid renewal fees and providing evidence satisfactory to the board of compliance as required by Section 5070.5. If the permit is renewed after its expiration, its holder, as a condition precedent to renewal, shall also pay the delinquency fee prescribed by
this chapter. Renewal under this section shall be effective on the date on which the application is filed, on the date on which the accrued renewal fees are paid, or on the date on which the delinquency fee, if any, is paid, whichever last occurs. If so renewed, the permit shall continue in effect through the date provided in Section 5070.5 that next occurs after the effective date of the renewal, when it shall expire if it is not again renewed.

Failure to Renew Within Five Years
Section 5070.7.

(a) A permit that is not renewed within five years following its expiration may not be renewed, restored, or reinstated thereafter, and the certificate of the holder of the permit shall be canceled immediately upon expiration of the five-year period, except as provided in subdivision (e).

(b) A partnership or corporation whose certificate has been canceled by operation of this section may obtain a new certificate and permit only if it again meets the requirements set forth in this chapter relating to registration and pays the registration fee and initial permit fee.

(c) A certified public accountant whose certificate is canceled by operation of this section may apply for and obtain a new certificate and permit if the applicant:

1. Is not subject to denial of a certificate and permit under Section 480.
2. Pays all of the fees that would be required of him or her if he or she were then applying for the certificate and permit for the first time.
3. Takes and passes the examination which would be required of him or her if he or she were then applying for the certificate for the first time.

The examination may be waived in any case in which the applicant establishes to the satisfaction of the board, that, with due regard for the public interest, he or she is qualified to engage in practice as a certified public accountant.

(d) The board may, by appropriate regulation, provide for the waiver or refund of all or any part of the application fee in those cases in which a certificate is issued without an examination under this section.

(e) Revoked permits may not be renewed, but may be reinstated by the board, without regard to the length of time that has elapsed since the permit was revoked, and with conditions and restriction as the board shall determine.

Expiration of Suspended or Revoked Permits
Section 5070.8. A permit which has been suspended is subject to expiration, and shall be renewed as provided in this article, but such renewal does not entitle the holder of the permit, while it remains suspended, and until it is reinstated, to engage in the practice of accountancy, or in any other activity or conduct in violation of the order or judgment by which the permit was suspended.

A permit which has been revoked is subject to expiration, but it may not be renewed. If it is reinstated after its expiration, the holder of the permit, as a condition precedent to its reinstatement, shall pay a reinstatement fee which shall be in an amount equal to the renewal fee in effect on the last regular renewal date before the date on which it is reinstated, plus the delinquency fee, if any, accrued at the time of its revocation.

Requirements for Registration as a Partnership
Section 5072.

(a) No persons shall engage in the practice of accountancy as a partnership unless the partnership is registered by the board.

(b) A partnership, other than a limited partnership, may be registered by the board to engage in the practice of public accountancy provided it meets the following requirements:

1. At least one general partner shall hold a valid permit to practice as a certified public accountant, public accountant, or accountancy corporation, or shall be an applicant for a certificate as a certified public accountant under Sections 5087 and 5088.

2. Each partner personally engaged within this state in the practice of public accountancy as defined by Section 5051 shall hold a valid permit to practice in this state or shall have applied for a certificate as a certified public accountant under Sections 5087 and 5088.

3. Each partner not personally engaged in the practice of public accountancy within this state shall be a certified public accountant in good standing of some state, except as permitted by Section 5079.

4. Each resident manager in charge of an office of the firm in this state shall be a licensee in good standing of this state, or shall have applied for a certificate as a certified public accountant under Sections 5087 and 5088.

Partnership Applications
Section 5073.

(a) Application for registration of a partnership shall be made upon a form prescribed by the board. The board shall in each case determine whether the applicant is eligible for registration.
Peer Review
Section 5076. (a) In order to renew its registration, a firm, as defined in Section 5035.1, shall have a peer review report of its accounting and auditing practice accepted by a board-recognized peer review program no less frequently than every three years.

(b) For purposes of this article, the following definitions apply:

1. “Peer review” means a study, appraisal, or review conducted in accordance with professional standards of the professional work of a firm, and may include an evaluation of other factors in accordance with the requirements specified by the board in regulations. The peer review report shall be issued by an individual who has a valid and current license, certificate, or permit to practice public accountancy from this state or another state and is unaffiliated with the firm being reviewed.

2. “Accounting and auditing practice” includes any services that are performed using professional standards defined by the board in regulations.

(c) The board shall adopt regulations as necessary to implement, interpret, and make specific the peer review requirements in this section, including, but not limited to, regulations specifying the requirements for board recognition of a peer review program, standards for administering a peer review, extensions of time for fulfilling the peer review requirement, exclusions from the peer review program, and document submission.

(d) The board shall adopt emergency regulations in accordance with the Administrative Procedure Act (Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code) to establish policies, guidelines, and procedures as outlined in subdivision (c). The adoption of the regulations shall be considered by the Office of Administrative Law to be necessary for the immediate preservation of the public peace, health and safety, or general welfare. The emergency regulations shall be submitted to the Office of Administrative Law for filing with the Secretary of State and publication in the California Code of Regulations, and shall be replaced in accordance with the Administrative Procedure Act.

(e) Nothing in this section shall prohibit the board from initiating an investigation and imposing discipline against a firm or licensee, either as the result of a complaint that alleges violations of statutes, rules, or regulations, or from information contained in a peer review report received by the board.

(f) A firm issued a substandard peer review report, as defined by the board in regulation, shall submit a copy of that report to the board. The board shall establish in regulation the time period that a firm must submit the report to the board. This period shall not exceed 60 days from the time the report is accepted by a board-recognized peer review program provider to the date the report is submitted to the board.

(g) (1) A board-recognized peer review program provider shall file a copy with the board of all substandard peer review reports issued to California-licensed firms. The board shall establish in regulation the time period that a board-recognized peer review program provider shall file the report with the board. This period shall not exceed 60 days from the time the report is accepted by a board-recognized peer review program provider to the date the report is filed with the board. These reports may be filed with the board electronically.

(2) Nothing in this subdivision shall require a board-recognized peer review program provider, when administering peer reviews in another state, to violate the laws of that state.
(h) The board shall, by January 1, 2010, define a substandard peer review report in regulation.

(i) Any requirements imposed by a board-recognized peer review program on a firm in conjunction with the completion of a peer review shall be separate from, and in addition to, any action by the board pursuant to this section.

(j) Any report of a substandard peer review submitted to the board in conjunction with this section shall be collected for investigatory purposes.

(k) Nothing in this section affects the discovery or admissibility of evidence in a civil or criminal action.

(l) Nothing in this section requires any firm to become a member of any professional organization.

(m) A peer reviewer shall not disclose information concerning licensees or their clients obtained during a peer review, unless specifically authorized pursuant to this section, Section 5076.1, or regulations prescribed by the board.

(n) (1) By January 1, 2015, the board shall provide the Legislature and Governor with a report regarding the peer review requirements of this section that includes, without limitation:

   (A) The number of peer review reports completed to date and the number of reports which were submitted to the board as required in subdivision (f).

   (B) The number of enforcement actions that were initiated as a result of an investigation conducted pursuant to subdivision (j).

   (C) The number of firms that were recommended to take corrective actions to improve their practice through the mandatory peer review process, and the number of firms that took corrective actions to improve their practice following recommendations resulting from the mandatory peer review process.

   (D) The extent to which mandatory peer review of accounting firms enhances consumer protection.

   (E) The cost impact on firms undergoing mandatory peer review and the cost impact of mandatory peer review on the firm’s clients.

   (F) A recommendation as to whether the mandatory peer review program should continue.

   (G) The extent to which mandatory peer review of small firms or sole practitioners that prepare nondisclosure compiled financial statements on an other comprehensive basis of accounting enhances consumer protection.

   (H) The impact of peer review required by this section on small firms and sole practitioners that prepare nondisclosure compiled financial statements on an other comprehensive basis of accounting.

   (I) The impact of peer review required by this section on small businesses, nonprofit corporations, and other entities that utilize small firms or sole practitioners for the purposes of non-disclosure compiled financial statements prepared on an other comprehensive basis of accounting.

   (J) A recommendation as to whether the preparation of non-disclosure compiled financial statements on an other comprehensive basis of accounting should continue to be a part of the mandatory peer review program.

   (2) A report to the Legislature pursuant to this section shall be submitted in compliance with Section 9795 of the Government Code.

Peer Review Oversight Committee
Section 5076.1.

(a) The board shall appoint a peer review oversight committee of certified public accountants of this state who maintain a license in good standing and who are authorized to practice public accountancy to provide recommendations to the board on any matter upon which it is authorized to act to ensure the effectiveness of mandatory peer review.

(b) The committee may request any information from a board-recognized peer review program provider deemed necessary to ensure the provider is administering peer reviews in accordance with the standards adopted by the board in regulations. Failure of a board-recognized peer review program provider to respond to the committee shall result in referral by the committee of the provider to the board for further action. Any information obtained by the board, its representatives, or the peer review oversight committee in conjunction with its review of peer review program providers shall not be a public record, and shall be exempt from public disclosure, provided, however, this information may be disclosed under any of the following circumstances:

   (1) In connection with disciplinary proceedings of the board.

   (2) In connection with legal proceedings in which the board is a party.

   (3) In response to an official inquiry by a federal or state governmental regulatory agency.

   (4) In compliance with a subpoena or summons enforceable by court order.

   (5) As otherwise specifically required by law.

(c) The members of the committee shall be appointed to two-year terms and may serve a maximum of four consecutive terms.
(d) The board may adopt, as necessary, regulations further defining the minimum qualifications for appointment as a committee member and additional administrative elements designed to ensure the effectiveness of mandatory peer review.

Offices Not Under Personal Management of Certified Public Accountant or Public Accountant; Supervision

Section 5078. In each office of a certified public accountant or public accountant in this state which is not under the personal management of such an accountant, respectively, work shall be supervised by a certified public accountant or public accountant.

Nonlicensee Ownership of Firms

Section 5079.

(a) Not withstanding any other provision of this chapter, any firm lawfully engaged in the practice of public accountancy in this state may have owners who are not licensed as certified public accountants or public accountants if the following conditions are met:

1. Nonlicensee owners shall be natural persons or entities, such as partnerships, professional corporations, or others, provided that each ultimate beneficial owner of an equity interest in that entity shall be a natural person materially participating in the business conducted by the firm or an entity controlled by the firm.

2. Nonlicensee owners shall materially participate in the business of the firm, or an entity controlled by the firm, and their ownership interest shall revert to the firm upon the cessation of any material participation.

3. Licensees shall in the aggregate, directly or beneficially, comprise a majority of owners, except that firms with two owners may have one owner who is a nonlicensee.

4. Licensees shall in the aggregate, directly or beneficially, hold more than half of the equity capital and possess majority voting rights.

5. Nonlicensee owners shall not hold themselves out as certified public accountants or public accountants and each licensed firm shall disclose actual or potential involvement of nonlicensee owners in the services provided.

6. There shall be a certified public accountant or public accountant who has ultimate responsibility for each financial statement attest and compilation service engagement.

7. Except as permitted by the board in the exercise of its discretion, a person may not become a nonlicensee owner or remain a nonlicensee owner if the person has done either of the following:

   (A) Been convicted of any crime, an element of which is dishonesty or fraud, under the laws of any state, of the United States, or of any other jurisdiction.

   (B) Had a professional license or the right to practice revoked or suspended for reasons other than nonpayment of dues or fees, or has voluntarily surrendered a license or right to practice with disciplinary charges or a disciplinary investigation pending, and not reinstated by a licensing or regulatory agency of any state, or of the United States, including, but not limited to, the Securities and Exchange Commission or Public Company Accounting Oversight Board, or of any other jurisdiction.

(b) (1) A nonlicensee owner of a licensed firm shall report to the board in writing of the occurrence of any of the events set forth in paragraph (7) of subdivision (a) within 30 days of the date the nonlicensee owner has knowledge of the event. 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) A California nonlicensee owner of a licensed firm shall report to the board in writing the occurrence of any of the following events occurring on or after January 1, 2006, within 30 days of the date the California nonlicensee owner has knowledge of the events:

   (A) Any notice of the opening or initiation of a formal investigation of the nonlicensee owner by the Securities and Exchange Commission or its designee, or any notice from the Securities and Exchange Commission to a nonlicensee owner requesting a Wells submission.

   (B) Any notice of the opening or initiation of an investigation of the nonlicensee owner by the Public Company Accounting Oversight Board or its designee.

   (C) Any notice of the opening or initiation of an investigation of the nonlicensee owner by another professional licensing agency.

(3) The report required by paragraphs (1) and (2) shall be signed by the nonlicensee owner and set forth the facts that constitute the report-
able event. If the reportable event involves the action of an administrative agency or court, the report shall identify the name of the agency or court, the title of the matter, and the date of occurrence of the event.

(4) Notwithstanding any other provision of law, reports received by the board pursuant to paragraph (2) shall not be disclosed to the public pursuant to the California Public Records Act (Chapter 3.5 (commencing with Section 6250) of Division 7 of Title 1 of the Government Code) other than (A) in the course of any disciplinary proceeding by the board after the filing of a formal accusation, (B) in the course of any legal action to which the board is a party, (C) in response to an official inquiry from a state or federal agency, (D) in response to a subpoena or summons enforceable by order of a court, or (E) when otherwise specifically required by law.

(5) Nothing in this subdivision shall impose a duty upon any licensee or nonlicensee owner to report to the board the occurrence of any events set forth in paragraph (7) of subdivision (a) or paragraph (2) of this subdivision either by or against any other nonlicensee owner.

(c) For purposes of this section, the following definitions apply:

(1) “Licensee” means a certified public accountant or public accountant in this state or a certified public accountant in good standing in another state.

(2) “Material participation” means an activity that is regular, continuous, and substantial.

(d) All firms with nonlicensee owners shall certify at the time of registration and renewal that the firm is in compliance with this section.

(e) The board shall adopt regulations to implement, interpret, or make specific this section.

**ARTICLE 5.5: Audit Documentation**

**Audit Documentation Requirements**

Section 5097.

(a) Audit documentation shall be a licensee’s records of the procedures applied, the tests performed, the information obtained, and the pertinent conclusions reached in an audit engagement. Audit documentation shall include, but is not limited to, programs, analyses, memoranda, letters of confirmation and representation, copies or abstracts of company documents, and schedules or commentaries prepared or obtained by the licensee.

(b) Audit documentation shall contain sufficient documentation to enable a reviewer with relevant knowledge and experience, having no previous connection with the audit engagement, to understand the nature, timing, extent, and results of the auditing or other procedures performed, evidence obtained, and conclusions reached, and to determine the identity of the persons who performed and reviewed the work.

(c) Failure of the audit documentation to document the procedures applied, tests performed, evidence obtained, and relevant conclusions reached in an engagement shall raise a presumption that the procedures were not applied, tests were not performed, information was not obtained, and relevant conclusions were not reached. This presumption shall be a rebuttable presumption affecting the burden of proof relative to those portions of the audit that are not documented as required in subdivision (b). The burden may be met by a preponderance of the evidence.

(d) Audit documentation shall be maintained by a licensee for the longer of the following:

(1) The minimum period of retention provided in subdivision (e).

(2) A period sufficient to satisfy professional standards and to comply with applicable laws and regulations.

(e) Audit documentation shall be maintained for a minimum of seven years which shall be extended during the pendency of any board investigation, disciplinary action, or legal action involving the licensee or the licensee’s firm. The board may adopt regulations to establish a different retention period for specific categories of audit documentation where the board finds that the nature of the documentation warrants it.

(f) Licensees shall maintain a written documentation retention and destruction policy that shall set forth the licensee’s practices and procedures complying with this article.

**Audit Documentation Regulations**

Section 5098. The board may adopt regulations to implement, interpret, and make specific provisions relating to the following:

(a) Requirements for licensees maintaining an audit documentation retention policy and procedures for review and approval of audit documentation destruction.

(b) Procedures for the identification, dating, and retention of audit documentation.
ARTICLE 6: Disciplinary Proceedings

Discipline in General
Section 5100. After notice and hearing the board may revoke, suspend or refuse to renew any permit or certificate granted under Article 4 (commencing with Section 5070) and Article 5 (commencing with Section 5080), or may censure the holder of that permit or certificate for unprofessional conduct which includes, but is not limited to, one or any combination of the following causes:

(a) Conviction of any crime substantially related to the qualifications, functions and duties of a certified public accountant or a public accountant.

(b) A violation of Section 478, 498, or 499 dealing with false statements or omissions in the application for a license, or in obtaining a certificate as a certified public accountant or in obtaining registration under this chapter or in obtaining a permit to practice public accountancy under this chapter.

(c) Dishonesty, fraud, gross negligence, or repeated negligent acts committed in the same or different engagements, for the same or different clients, or any combination of engagements or clients, each resulting in a violation of applicable 87 that indicate a lack of competency in the practice of public accountancy or in the performance of the bookkeeping operations described in Section 5052.

(d) Cancellation, revocation, or suspension of a certificate, or other authority to practice as a certified public accountant or a public accountant, refusal to renew the certificate or other authority to practice as a certified public accountant or a public accountant, or any other discipline by any other state or foreign country.

(e) Violation of Section 5097.

(f) Violation of Section 5120.

(g) Willful violation of this chapter or any rule or regulation promulgated by the board under the authority granted under this chapter.

(h) Suspension or revocation of the right to practice before any governmental body or agency.

(i) Fiscal dishonesty or breach of fiduciary responsibility of any kind.

(j) Knowing preparation, publication, or dissemination of false, fraudulent, or materially misleading financial statements, reports, or information.

(k) Embezzlement, theft, misappropriation of funds or property, or obtaining money, property, or other valuable consideration by fraudulent means or false pretenses.

(l) The imposition of any discipline, penalty, or sanction on a registered public accounting firm or any associated person of such firm, or both, or on any other holder of a permit, certificate, license, or other authority to practice in this state, by the Public Company Accounting Oversight Board or the United States Securities and Exchange Commission, or their designees under the Sarbanes-Oxley Act of 2002 or other federal legislation.

(m) Unlawfully engaging in the practice of public accountancy in another state.

Discipline of Partnership
Section 5101. After notice and hearing the board shall revoke the registration and permit to practice of a partnership if at any time it does not have all the qualifications prescribed by the section of this chapter under which it qualified for registration. After notice and hearing the board may revoke, suspend or refuse to renew the permit to practice of a partnership or may censure the holder of such permit for any of the causes enumerated in Section 5100 and for the following additional causes:

(a) The revocation or suspension of the certificate or registration or the revocation or suspension of or refusal to renew the permit to practice of any partner.

(b) The cancellation, revocation or suspension of certificate or other authority to practice or refusal to renew the certificate or other authority of the partnership or any partner thereof to practice public accountancy in any other state.

Powers and Proceedings
Section 5102. The proceedings under this article shall be conducted in accordance with Chapter 5 (commencing at Section 11500) of Part 1 of Division 3 of title 2 of the Government Code, and the board shall have all the powers granted therein.

Investigations
Section 5103.

(a) Notwithstanding any other provision of law, the board may inquire into any alleged violation of this chapter or any other state or federal law, regulation, or rule relevant to the practice of accountancy.

(b) The board, or its executive officer pursuant to a delegation of authority from the board, is authorized to perform the following functions:

(1) To receive and investigate complaints and to conduct investigations or hearings, with or without the filing of any complaint, and to obtain information and evidence relating to any matter involving the conduct of licensees, as directed by the board, or as directed by the
executive officer pursuant to a delegation of authority from the board.

(2) To receive and investigate complaints and to conduct investigations or hearings, with or without the filing of any complaint, and to obtain information and evidence relating to any matter involving any violation or alleged violation of this chapter by licensees, as directed by the board, or as directed by the executive officer pursuant to a delegation of authority from the board.

Notice of Formal Accusations
Section 5103.5.

(a) The board shall post on its Internet Web site, in an easily marked and identifiable location, notice of all formal accusations. The notice of any formal accusation shall contain a link to where a person may request and have sent to him or her a copy of the formal accusation, and the basis for the accusation and alleged violations filed by the board against a licensee.

(b) The link to where a person may request and have sent to him or her a copy of the formal accusation shall be clearly and conspicuously located on the same Internet Web site page on which the notice is posted and shall authorize a person to request and receive the information described in subdivision (a) by regular mail or electronic mail.

(c) The board shall develop a statement that informs any person requesting a copy of a formal accusation and any person receiving a copy of a formal accusation that any allegations contained in the accusation are not a final determination of wrongdoing and are subject to adjudication and final review by the board pursuant to the Administrative Procedure Act (Chapter 3.5 (commencing with Section 11340) of Part 1 of Division 3 of Title 2 of the Government Code). This statement shall be provided to a person requesting and receiving a copy of a formal accusation in a manner to be determined by the board.

Relinquishment of Certificate or Permit
Section 5104. Any certified public accountant or public accountant whose certificate, registration, or permit has been revoked or suspended shall upon request of the board relinquish his or her certificate or permit. However, upon the expiration of the period of suspension, the board shall immediately return any suspended certificate or permit which has been relinquished.

Delinquency in Payment of Renewal Fee
Section 5105. Any certified public accountant or public accountant who is delinquent in the payment of his renewal fee shall upon request of the board relinquish his certificate and permit; provided, however, the board shall reissue any certificate and permit which has been relinquished for nonpayment of renewal fees if the permit is renewed as provided in Section 5070.6.

Conviction Defined
Section 5106. A plea or verdict of guilty or a conviction following a plea of nolo contendere is deemed to be a conviction within the meaning of this article. The record of the conviction shall be conclusive evidence thereof. The board may order the certificate or permit suspended or revoked, or may decline to issue a certificate or permit, when the time for appeal has elapsed, or the judgment of conviction has been affirmed on appeal or when an order granting probation is made, suspending the imposition of sentence, irrespective of a subsequent order under the provisions of Section 1203.4 of the Penal Code allowing such person to withdraw his plea of guilty and to enter a plea of not guilty, or setting aside the verdict of guilty or dismissing the accusation, information or indictment.

Payment of Disciplinary Costs; Conditional Renewal
Section 5107

(a) The executive officer of the board may request the administrative law judge, as part of the proposed decision in a disciplinary proceeding, to direct any holder of a permit or certificate found to have committed a violation or violations of this chapter to pay to the board all reasonable costs of investigation and prosecution of the case, including, but not limited to, attorneys’ fees. The board shall not recover costs incurred at the administrative hearing.

(b) A certified copy of the actual costs, or a good faith estimate of costs where actual costs are not available, signed by the executive officer, shall be prima facie evidence of reasonable costs of investigation and prosecution of the case.

(c) The administrative law judge shall make a proposed finding of the amount of reasonable costs of investigation and prosecution of the case when requested to do so by the executive officer pursuant to subdivision (a). Costs are payable 120 days after the board’s decision is final unless otherwise provided for by the administrative law judge or if the time for payment is extended by the board.

(d) The finding of the administrative law judge with regard to cost shall not be reviewable by the board to increase the cost award. The board may reduce or eliminate the cost award, or remand to the administrative law judge where the proposed decision fails to make a finding on costs requested by the executive officer pursuant to subdivision (a).
(e) The administrative law judge may make a further finding that the amount of reasonable costs awarded shall be reduced or eliminated upon a finding that respondent has demonstrated that he or she cannot pay all or a portion of the costs or that payment of the costs would cause an unreasonable financial hardship which cannot be remedied through a payment plan.

(f) When an administrative law judge makes a finding that costs be waived or reduced, he or she shall set forth the factual basis for his or her finding in the proposed decision.

(g) Where an order for recovery of costs is made and timely payment is not made as directed by the board’s decision, the board may enforce the order for payment in any appropriate count. This right of enforcement shall be in addition to any other rights the board may have as to any holder of a permit or certificate directed to pay costs.

(h) In any judicial action for the recovery of costs, proof of the board’s decision shall be conclusive proof of the validity of the order of payment and the terms of payment.

(i) All costs recovered under this section shall be deposited in the Accountancy Fund.

(j) (1) Except as provided in paragraph (2), the board shall not renew or reinstate the permit or certificate of any holder who has failed to pay all of the costs ordered under this section.

(2) Notwithstanding, paragraph (1), the board may, in its discretion, conditionally renew or reinstate for a maximum of one year the permit or certificate of any holder who demonstrates financial hardship and who enters into a formal agreement with the board to reimburse the board within that one year period for those unpaid costs.

(k) Nothing in this section shall preclude the board from seeking recovery of costs in an order or decision made pursuant to an agreement entered into between the board and the holder of any permit or certificate.

(l) (1) Costs may not be recovered under this section as a result of a citation issued pursuant to Section 125.9 and its implementing language if the licensee complies with the citation.

(2) The Legislature hereby finds and declares that this subdivision is declaratory of existing law.

Subpoenas
Section 5108. In connection with any investigation or action authorized by this chapter, the board may issue subpoenas for the attendance of witnesses and the production of papers, books, accounts, documents and testimony pertinent or material to its inquiry, investigation, hearing, proceeding, or action conducted in any part of the state.

Jurisdiction Over Expired, Cancelled, Forfeited, Suspended, or Surrendered License
Section 5109. The expiration, cancellation, forfeiture, or suspension of a license by operation of law or by order or decision of the board or a court of law, or the voluntary surrender of a license by a licensee shall not deprive the board of jurisdiction to commence or proceed with any investigation of or action or disciplinary proceeding against the licensee, or to render a decision suspending or revoking the license.

False Statements in Application; Exam Cheating.
Section 5110.

(a) After notice and an opportunity for a hearing, the board may deny an application to take the licensing examination, deny admission to current and future licensing examinations, void examination grades, and deny an application for a license or registration to any individual who has committed any of the following acts:

(1) Made any false, fraudulent, or materially misleading statement or a material omission in any application for a license, examination, or registration.

(2) Cheated or subverted or attempted to subvert any licensing examination.

(3) Aided, abetted, or conspired with any other person to violate paragraph (1) or (2).

(4) Any act that if committed by an applicant for licensure would be grounds for denial of a license or registration under Section 480 or if committed by a licensee or a registrant would be grounds for discipline under Section 5100.

(5) Any act committed outside of this state that would be a violation of this article if committed within this state.

(b) Neither the withdrawal of an application for examination, licensure, or registration, nor the expulsion or voluntary departure from an examination shall deprive the board of its authority to deny an application for, or admittance to, current or future licensing examinations, or to commence or continue a proceeding based on a violation of this article.

(c) Nothing in this article shall be construed to limit the authority of the board to refuse admittance to or to remove from the licensing examination, any person suspected of cheating or failing to comply with examination procedures or requirements.
(d) The term “licensing examination” includes the Uniform Certified Public Accountant examination, ethics examination, and any other professional or vocational licensing examination offered or administered by, or through, the board or other agencies within or outside of this state, for professional or vocational licensing purposes.

(e) The board may take any of the actions described in subdivision (a) based upon any determination, decision, ruling, or finding made by any state or other governmental entity, foreign or domestic, that any individual has committed any of the actions described in paragraphs (1) to (5), inclusive, of subdivision (a).

(f) The provisions of this section are in addition to any other remedies that may be available under other provisions of law including, but not limited to, those set forth in Sections 123, 480, and 496.

Cheating Defined
Section 5111. Cheating on, or subverting or attempting to subvert any licensing examination includes, but is not limited to, engaging in, soliciting, or procuring any of the following:

(a) Any communication between one or more examinees and any person, other than a proctor or examination official, while the examination is in progress.

(b) Any communication between one or more examinees and any other person at any time concerning the content of the examination including, but not limited to, any examination question or answer, unless the examination has been publicly released by the examining authority or jurisdiction.

(c) The taking of all or a part of the examination by a person other than the applicant.

(d) Possession or use at any time during the examination or while the examinee is on the examination premises of any device, material, or document that is not expressly authorized for use by examinees during the examination including, but not limited to, notes, crib sheets, textbooks, and electronic devices.

(e) Failure to follow any examination instruction or rule related to examination security.

(f) Providing false, fraudulent, or materially misleading information concerning education, experience, or other qualifications as part of, or in support of, any application for admission to any professional or vocational examination.

Procedure; Limitation on Actions
Section 5112.

(a) The board may deny an application to take the licensing examination, deny admittance to current and future licensing examinations, and void examination grades on the grounds set forth in Section 5110 using either of the following procedures:

(1) Notifying the individual in writing of all of the following:

(A) The action the board has taken.

(B) The reasons the action was taken.

(C) The earliest date on which the individual may reapply for admittance to the licensing examination.

(D) The individual’s right to a hearing under the provisions of Chapter 5 (commencing with Section 11500) of Division 3 of Title 2 of the Government Code if a written request for a hearing is made within 60 days from the date of the board’s notice. If the individual does not request a hearing, the board’s action shall become final at the expiration of this 60-day period.

(2) Filing and serving a statement of issues in accordance with Section 11504 of the Government Code.

(b) The board shall issue the notice of action under paragraph (1) of subdivision (a) or file and serve the statement of issues under paragraph (2) of subdivision (a) within five years of the last day of the examination with respect to which the alleged prohibited act was committed or within three years of the discovery of the commission of the alleged prohibited act, whichever occurs later.

Readmission to the Examination
Section 5113. An individual who has been denied admission to the licensing examination under Section 5110 may petition the board for admission to the Certified Public Accountant examination not less than one year after the effective date of the decision issued by the board following a hearing held pursuant to the provisions of Chapter 5 (commencing with Section 11500) of Division 3 of Title 2 of the Government Code or, if there was no hearing, may petition the board not less than one year after the decision or action pursuant to the notice of action becomes final as provided in subparagraph (D) of paragraph (1) of subdivision (a) of Section 5112, unless the decision or notice of action issued by the board specifies a different time frame within which this petition may be filed. However, in no event shall the time frame specified by the board be more than three years from the effective date of the board’s decision or from the date that the board’s action pursuant to the notice of action becomes final.
Petitions for Reinstatement or Reduction of Penalty
Section 5115.

(a) A person whose license has been revoked or surrendered may petition the board for reinstatement or reduction of penalty after a period of not less than one year has elapsed from the effective date of the decision or from the date of the denial of a similar petition, unless a longer period, not to exceed three years, is specified by the board in any decision revoking the license, accepting the surrender of the license, or denying reinstatement of the license.

(b) A person whose license has not been revoked or surrendered but who has been disciplined by imposition of a suspension or otherwise disciplined may petition the board for reinstatement or reduction of penalty after a period of not less than one year has elapsed from the effective date of the decision.

(c) The board shall give notice to the Attorney General of the filing of the petition and the Attorney General and the petitioner shall be afforded an opportunity to present either oral or written argument before the board itself. The board itself shall rule on the petition, and the decision shall include the reasons therefor and any terms and conditions that the board reasonably deems appropriate to impose as a condition of reinstatement or reduction of penalty, including, but not limited to, restrictions on the petitioner’s scope of professional practice.

Article 6.5: Administrative Penalties

Administrative Penalties: General Provisions
Section 5116.

(a) The board, after appropriate notice and an opportunity for hearing, may order any licensee or applicant for licensure or examination to pay an administrative penalty as provided in this article as part of any disciplinary proceeding or other proceeding provided for in this chapter.

(b) The board may assess administrative penalties under one or more provisions of this article. However, the total administrative penalty to be paid by the licensee shall not exceed the amount of the highest administrative penalty authorized by this article.

(c) The board shall adopt regulations to establish criteria for assessing administrative penalties based upon factors, including, but not limited to, actual and potential consumer harm, nature and severity of the violation, the role of the person in the violation, the person’s ability to pay the administrative penalty, and the level of administrative penalty necessary to deter future violations of this chapter.

(d) Administrative penalties assessed under this article shall be in addition to any other penalties or sanctions imposed on the licensee or other person, including, but not limited to, license revocation, license suspension, denial of the application for licensure, denial of the petition for reinstatement, or denial of admission to the licensing examination. Payment of these administrative penalties may be included as a condition of probation when probation is ordered.

(e) All administrative penalties collected under this article shall be deposited in the Accountancy Fund.

Administrative Penalties: All Accountancy Act Violations
Section 5116.1. In accordance with Section 5116 and applicable regulations, except as provided in Section 5116.2, any licensee who violates any provision of this chapter may be assessed an administrative penalty of not more than five thousand dollars ($5,000) for the first violation and not more than ten thousand dollars ($10,000) for each subsequent violation.

Administrative Penalties: Specified Accountancy Act Violations
Section 5116.2. In accordance with Section 5116 and applicable regulations, any licensee who violates subdivision (a), (c), (i), (j) or (k) of Section 5100 may be assessed an administrative penalty of not more than one million dollars ($1,000,000) for the first violation and not more than five million dollars ($5,000,000) for any subsequent violation, except that a licensee who is a natural person may be assessed an administrative penalty of not more than fifty thousand dollars ($50,000) for the first violation and not more than one hundred thousand dollars ($100,000) for any subsequent violation.

Administrative Penalties: Subversion of the Examination
Section 5116.3. In accordance with Section 5116 and applicable regulations, any person who is found to have cheated or subverted or attempted to subvert or cheat on any licensing examination or who conspired with or aided or abetted any other person to cheat, subvert or attempt to subvert any examination may be assessed an administrative penalty of not more than five thousand dollars ($5,000) for the first violation and not more than ten thousand dollars ($10,000) for each subsequent violation.

Procedure for Administrative Penalties
Section 5116.4.

(a) The board’s executive officer may request assessment of an administrative penalty in any disciplinary or other proceeding provided in this chapter or in any notice to an applicant pursuant to Section 5112.
(b) The administrative penalty pursuant to subdivision (a) shall become final unless contested within the time period provided for the filing of a notice of appeal, for the filing of a notice of defense, or for requesting a hearing in the proceeding.

(c) Nothing in this article shall prevent an administrative penalty from being included in a final contested or default decision of the board or in a notice issued pursuant to Section 5112 once the time period for requesting a hearing has expired.

Judgment Ordering Payment of Administrative Penalty
Section 5116.5. The board may obtain a judgment in any court of competent jurisdiction ordering the payment of any final administrative penalty assessed by the board pursuant to this article upon the filing of a certified copy of the board’s final decision or notice issued pursuant to Section 5112.

Definition of “License”
Section 5116.6. Anywhere the term “licensee” is used in the article it shall include certified public accountants, public accountants, partnerships, corporations, holders of practice privileges, other persons licensed, registered, or otherwise authorized to practice public accountancy under this chapter, and persons who are in violation of any provision of Article 5.1 (commencing with Section 5096).

ARTICLE 7: Prohibitions and Offenses Against the Chapter Generally

Violations as Misdemeanor
Section 5120. Any person who violates Article 3 (commencing with Section 5050) is guilty of a misdemeanor, punishable by imprisonment for not more than six months, or by a fine of not more than one thousand dollars ($1,000), or both. Whenever the board has reason to believe that any person is liable to punishment under this article, the board or with its approval the administrative committee, may certify the facts to the appropriate enforcement officer of the city or county where the alleged violation had taken place and the officer may cause appropriate proceedings to be brought.

Evidence of Violation
Section 5121. The display or uttering by a person of a card, sign, advertisement or other printed, engraved or written instrument or device, bearing a person’s name in conjunction with the words “certified public accountant” or any abbreviation thereof or the words “public accountant” or any abbreviation thereof shall be prima facie evidence in any prosecution, proceeding or hearing brought under this article that the person whose name is so displayed caused or procured the display or uttering of such card, sign, advertisement or other printed, engraved or written instrument or device. Any such display or uttering shall be prima facie evidence that the person whose name is so displayed holds himself or herself out as a certified public accountant, or a public accountant holding a permit to practice public accountancy in this State under the provisions of this chapter. In any prosecution or hearing under this chapter, evidence of the commission of a single act prohibited by this chapter shall be sufficient to justify a conviction without evidence of a general course of conduct.

Injunctions
Section 5122. Whenever in the judgment of the board, or with its approval the administrative committee, any person has engaged, or is about to engage, in any acts or practices which constitute, or will constitute, an offense against this chapter, the board may make application to the appropriate court for an order enjoining the acts or practices, and upon showing by the board that the person has engaged, or is about to engage, in any such acts or practices, an injunction, restraining order, or other order that may be appropriate shall be granted by the court.

Accountancy Rules and Regulations

ARTICLE 1: General

Section 1. Definition of “Accountancy Act”
“Accountancy Act” as used in these regulations means Division 3, Chapter 1, of the Business and Professions Code.

Section 2. Confusing Titles
The following are titles or designations likely to be confused with the titles Certified Public Accountant and Public Accountant within the meaning of Section 5058 of the Business and Professions Code:

(a) “Accountant,” “auditor,” “accounting,” or auditing,” when used either singly or collectively or in conjunction with other titles.

(b) Any other titles or designations which imply that the individual is engaged in the practice of public accountancy.

Section 2.4. Definitions of Attest Services and Attest Reports
Attest services as used in Section 5095 of the Business and Professions Code and attest report as used in Section 5096.5 of the Business and Professions Code 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.

Section 2.5. Definition of “Audits”
Making audits—as a part of bookkeeping operations,”
as used in Section 5052 of the Business and Professions Code, refers to the evaluation of financial and operational data solely for review by management and not intended for distribution to outside parties, and does not include those activities set forth in Sections 5051(c) and (d) of the Business and Professions Code.

Section 3. Notification of Change of Address

(a) Address Notification—Individual Licensees:

(1) Each licensee shall notify the board of any change in his or her address of record within 30 days after the change. The address of record is public information. If the address of record is a post office box or mail drop, the change of address notification shall include the street address of either the licensee’s primary place of employment or his or her residence.

(2) For purposes of this section, “licensee” includes any holder of an active, inactive, suspended, or expired certified public accountant license or public accountant license issued by the board which is not canceled or revoked.

(3) All notification required under this subsection shall be in writing and shall be signed by the licensee.

(b) Notification of Change of Address—Licensed Firm:

(1) Each licensed firm shall notify the board of any change in its address of record within 30 days after the change. The address of record is public information. If the address of record is a post office box or mail drop, the change of address notification shall include the street address of the firm’s principal office.

(2) For purposes of this section, “licensed firm” includes any partnership or professional corporation licensed by the board to practice public accountancy even if the license is suspended or expired, provided the license is not canceled or revoked.

(3) All notifications required under this subsection shall be in writing and shall be signed by a licensed partner or licensed shareholder of the firm.

Section 4. Safe Harbor Language.

A person who is not licensed by the California Board of Accountancy, and who prepares a financial report in a form substantially the same as that set forth in subsection (a) or (b) below, shall not be deemed to be engaged in the practice of public accountancy as defined in Section 5051 of the Business and Professions Code.

(a) “I [we] have prepared the accompanying financial statements of [name of entity] as of [time period] for the [period] then ended. This presentation is limited to preparing in the form of financial statements information that is the representation of management [owners]. I [we] have not audited, reviewed, or compiled the accompanying financial statements. I [we] do not express an opinion or any other form of assurance on them. I [We] am [are] not required to be licensed by the California Board of Accountancy for the preparation of these financial statements.”

(b) “We [I] have prepared the accompanying statement of assets, liabilities and equity for [name of company] as of [month-day-year], together with the related statements of revenue, expense, [and cash flow] for the year [or month] then ended on the income tax basis of accounting. The preparation of financial statements on the income tax basis of accounting is limited to presenting information that is the representation of management [the owners]. We [I] have not audited nor reviewed the accompanying statements. Accordingly, we [I] do not express an opinion or any other form of assurance on them.

Management has [The owners have] elected to omit substantially all of the disclosures ordinarily included in financial statements prepared on the income tax basis of accounting. If the omitted disclosures were included in the financial statements, they might influence the user’s conclusions about the company’s assets, liabilities, equity, revenues, expenses [and cash flow]. Accordingly, these financial statements are not designed for those who are not informed about such matters.”

We [I] am [are] not required to be licensed by the California Board of Accountancy for the preparation of these financial statements.”

Section 5. Observance of Rules

A licensee of the state Board of Accountancy engaged in the practice of public accountancy as defined in Section 5051 of the Business and Professions Code or engaged in an occupation in which the licensee renders services of the type performed by certified public accountants or public accountants or renders other professional services shall observe and is subject to rules and regulations of the State Board of Accountancy in the conduct of such activity. For purposes of Section 5, the term “activity” includes but is not limited to bookkeeping, financial planning, investment planning, tax services and management services.

ARTICLE 9: Rules of Professional Conduct

Section 50. Client Notification.

Every licensee engaged in the practice of public ac-
countancy 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 Accountant, 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.

Section 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.

Section 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.

Section 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.

Section 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.

(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.

Section 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.

Section 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.

Section 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 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 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.

Section 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.

Section 56. Commissions—Basic Disclosure Requirements

(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 of 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 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.

Section 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.

Section 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.

Section 56.3. Commissions – Definitions

For purposes of Section 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 license’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.

Section 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) of 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).

Section 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,
Section 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.

Section 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.

Section 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.

Section 61. The Reporting of Settlements, Arbitration Awards, and Judgments.
(a) To meet the reporting requirements of paragraph (b)(2) of Section 5063, licensees 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.

Section 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’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 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 acting in a judicial or regulatory capacity or there is a reasonable expectation of substantive review by a taxing authority.

Section 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.

Section 65. Independence

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

Section 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 under this section shall expire five years after the date of issuance unless renewed prior to its expiration.

Section 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.

Section 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
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Section 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.

Section 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.

Section 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 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 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.

Section 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.

Section 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 5083, 5092, 5093, and 5095 of the Accountancy Act and Sections 11.5, 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 reasonable 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.

ARTICLE 12: Continuing Education Rules

Section 80. Inactive License Status.

Upon application, a licensee may have his/her license placed in an inactive status.

(a) The holder or a license in an inactive status shall not engage in the practice of public accountancy as defined in Section 5051 of the Business and Professions Code. This section does not prohibit a holder of an inactive license from receiving a share of the net profits from a public accounting firm or other compensation from a public accounting firm, provided that the licensee does not otherwise engage in the practice of public accountancy.

(b) A license in an inactive status shall be renewed during the same time period in which a license in an active status is renewed. The renewal fee for a license in active status shall also apply for the renewal of a license in inactive status.

c) The continuing education requirements described in Section 87 are not applicable at the time of renewal for a licensee renewing a license in an inactive status.

(d) At the time of renewal, the holder of a license in an inactive status may convert his/her license to an active status by paying the renewal fee and complying with the continuing education requirements as described in Section 87. A minimum of 20 hours of continuing education shall be completed in the one-year period immediately preceding the time of renewal, 12 hours of which must be in subject areas described in Section 88(a)(1).

e) The holder of a license in an inactive status may convert to an active status prior to the next renewal by meeting the continuing education requirements as stated in Section 87.1.

Section 81. Continuing Education Requirements for Renewing an Expired License.

(a) As a condition for renewing a license in an active status, a licensee renewing an expired license shall adhere to the basic requirements described in Section
87 in the two-year period immediately preceding the date on which the licensee applies for license renewal. No carryover of continuing education is permitted from one license renewal period to another.

(b) For the purpose of this section, the following definitions shall apply:

(1) Date of license renewal shall mean the date the license application, including the applicable renewal and delinquency fee, is postmarked on the envelope.

(2) “Expired” license shall mean delinquent, lapsed or a late renewal that is postmarked after the licensee’s last or most recent license expiration date up to five years.

Section 87. Basic Requirements.

(a) 80 Hours. As a condition of renewing a license in an active status, a licensee shall complete at least 80 hours of qualifying continuing education as described in Section 88 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 after December 31, 2011, 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 subject areas as described in Section 88(a)(1).

(b) Ethics Continuing Education Requirement
A licensee renewing a license in an active status after December 31, 2009 shall complete four hours of the 80 hours of continuing education required pursuant to subsection (a) in course subject matter specified pertaining to the following: 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. 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 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) A licensee who must complete continuing education pursuant to subsections (c) and/or (d) of this section shall also complete an additional eight hours of continuing education specifically related to the detection and/or reporting of fraud in 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) or (d).

(f) New Licensees.

(1) A licensee receiving an initial license shall be required to complete 20 hours of continuing
education as described in Section 88, for each full six month interval in the initial license period as a condition of renewing a license in an active status.

(2) A licensee engaged in governmental auditing, as described in subsection (c), at any time during the initial license period shall complete six hours of governmental continuing education, as described in subsection (c), as part of each 20 hours of continuing education required for renewing the license in an active status. A licensee who meets the requirements of this subsection shall be deemed to have met the requirements of subsection (f)(3).

(3) A licensee who provides audit, review, compilation, or attestation services, as described in subsection (d), at any time during the initial license period shall complete six hours of accounting and auditing continuing education, as described in subsection (d), as part of each 20 hours of continuing education required for renewing the license in an active status.

(4) If the initial license period is less than six full months, there is no continuing education required for renewing the license in an active status.

(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.

Section 87.1. Conversion to Active Status Prior to Renewal.

(a) A licensee who has renewed his/her license in an inactive status may convert the license to an active status prior to the next license expiration date by (1) completing 80 hours of continuing education credit as described in Section 88, to include the Ethics Continuing Education Requirement described in Section 87(b), within the 24-month period prior to converting to active status, of which a minimum of 20 hours shall be completed in the one-year period immediately preceding conversion to an active status, with a minimum of 12 hours in subject areas described in subsection (a)(1) of Section 88; (2) completing the regulatory review course described in Section 87.8 if more than six years have elapsed since the licensee last completed the course; (3) applying to the Board in writing requesting to convert the license to an active status; and (4) completing any continuing education that is required pursuant to subsection (j) of Section 89. The licensee may not practice public accounting until the application for conversion of the license to an active status has been approved.

(b) A licensee who, during the 24 months prior to converting his/her license to an active status, planned, directed, or conducted substantial portions of field work, or reported on financial or compliance audits of a governmental agency shall complete 24 hours of continuing education in governmental accounting and auditing as described in Section 87(c) as part of the 80 hours of continuing education required to convert his/her license to an active status under subsection (a). A licensee who meets the requirements of this subsection shall be deemed to have met the requirements of subsection (c).

(c) A licensee who, during the 24 months prior to converting his/her license to an active status, planned, directed, or performed substantial portions of the work or reported on an audit, review, compilation, or attestation service shall complete 24 hours of continuing education in accounting and auditing as described in Section 87(d) as part of the 80 hours of continuing education required to his/her license to an active status under subsection (a).

(d) A licensee who must complete continuing education pursuant to subsections (b) and/or (c) of this section shall also complete an additional eight hours of continuing education specifically related to the detection and/or reporting of fraud in financial statements as described in Section 87(e). 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 (b) or (c).

(e) Once a license is converted to an active status, the licensee must complete 20 hours of continuing education as described in Section 88 for each full six month period from the date of license conversion to an active status to the next license expiration date in order to fulfill the continuing education requirement for license renewal. If the time period between the date of change to an active status and the next license expiration date is less than six full months, no additional continuing education is required for license renewal.

(f) Once a license is converted to an active status, a licensee who engages in financial or compliance auditing of a governmental agency at any time between the date of license conversion to an active status and the next license expiration date shall complete six hours of governmental continuing education as part of each 20 hours of continuing education required under subsection (e). 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 (g).

(g) Once a license is converted to an active status, a licensee who engages in audit, review, compilation, or attestation services at any time between the date of license conversion to an active status and the next 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 (e). Continuing education in the areas of accounting and auditing shall meet the requirements of Section 87(d).

Section 87.5. Additional Continuing Education Requirements

(a) Following an investigation or hearing conducted pursuant to Business and Professions Code Section 5020 the Board or its designee may order a licensee to:

(1) Complete one or more of the 80 hours of continuing education not to exceed 80 hours in addition to the 80 hours qualifying continuing education required by Section 87, subsection (a), prior to permit renewal, which will contribute to the licensee’s professional competence.

(2) Complete one or more of the 80 hours of qualifying continuing education required by Section 87, subsection (a), or one or more of the hours ordered pursuant to subsection (a)(1) of this section, in a designated course of study which will contribute to the licensee’s professional competence.

(3) Complete one or more of the 80 hours of qualifying continuing education required by Section 87, subsection (a), or one or more hours ordered pursuant to this section, by a specified date. Such date may be extended by the Board or its designee.

(b) Failure of a licensee to comply with an order by the Board or its designee made pursuant to this section constitutes cause for disciplinary action under Section 5100 of the Business and Professions Code.

Section 87.6. Records Review Continuing Education Requirements

(a) The Report Quality Monitoring Committee is a committee appointed by the Board. This committee’s functions include the review of financial reports selected under Section 89.1 to monitor and promote compliance with applicable accounting principles and reporting standards. The Report Quality Monitoring Committee may order a licensee to:

(1) Complete one or more of the 80 hours of qualifying continuing education required by Section 87(a) in a designated course of study which will contribute to the licensee’s professional competence.

(2) Complete one or more of the 80 hours of qualifying continuing education required by Section 87(a) or 87.6(a)(1) by a specified date. Such date may be extended by the committee.

(b) Failure of a licensee to comply with an order by the committee made pursuant to this section constitutes cause for disciplinary action under Section 5100 of the Business and Professions Code.

Section 87.7. Continuing Education in the Accountancy Act, Board Regulations, and Other Rules of Professional Conduct.

(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 Accountancy Act and the Board of Accountancy Regulations, application to current practice, and other rules of professional conduct. Such course shall be approved by the Board prior to the licensee receiving continuing education credit for the course and shall be a minimum of 8 hours. The eight hours shall be counted towards the 80 hours required pursuant to Section 87.

(b) The operative date for this regulation is based on the last two digits of the license number according to the following schedule: for license numbers ending with 01-33 the operative date is January 1, 1998, for license numbers ending with 34-66 the operative date is January 1, 2000, for license numbers ending with 67-00 the operative date is January 1, 2002.

(c) Course providers shall apply to the Board for approval of the course specified in Subsection (a), on Form CE-PCE-1 (9/96), Professional Conduct and Ethics Application for Course Approval. The term of approval shall be for a two (2) year period. The Board may cancel its approval during this two year period if the Board determines that the course fails to meet the criteria specified in this Subsection. Approval shall be based on the following criteria:

(1) The course shall be a formal educational program that meets the requirements set forth in Sections 88, 88.1, and 88.2.
(2) The course shall have written educational goals and specific learning objectives, as well as a syllabus which provides a general outline, instructional objectives and a summary of topics for the course. A copy of the educational goals, learning objectives and course syllabus shall be submitted by the provider with the approval application.

(3) The course shall provide participants with the current California Accountancy Act and California Board of Accountancy Regulations (or summary thereof).

(4) Any self-study course shall require a 90 percent passing score on a test given at the conclusion of the course. The test shall be submitted along with the course materials for approval.

(5) A certificate of completion which includes the provider approval number shall be issued to each licensee who has satisfactorily completed the course.

(6) The course content shall include the following:

(A) A review and update of the current California Accountancy Act and the Board of Accountancy Regulations.

(B) Information which will provide an understanding of how the Statutes, Regulations and cases relate to current practice situations.

(C) A review of nationally recognized Codes of Professional Conduct as they relate to professional responsibility.

(D) A discussion of recent relevant cases on ethics and professional responsibilities for the accounting profession.

(E) A bibliography of recent publications and cases on professional conduct and ethics for the accounting profession.

(d) Upon receiving approval from the Board, the provider of the Professional Conduct and Ethics course required in Subsection (a) may represent the course in promotional materials as being approved by the Board during the term of approval.

(e) On a random basis established by the Board or at the Board’s request or in response to complaints about a particular course, the Board may review the records of a provider to ensure compliance with the criteria specified in this Section. Within 15 days of receipt of written notification, the provider shall submit or make available to the Board all material deemed necessary by the Board to determine whether the course complies. The Board may cancel its approval for a course found not to be in compliance.

(f) Approved course providers may allow a secondary provider to present their course through a site license, contractual arrangement, or other type of agreement.

(g) For every course presentation, including any made by a secondary provider, organization or party, the original approved provider (primary provider) who entered into the approval agreement with the California Board of Accountancy shall:

(1) Retain a written outline of the course and completion records to reflect the actual participant attendance, or in the case of self-study courses, passing test scores of 90 percent or higher. The retention period shall be eight years.

(2) Ensure that all participants who complete the course receive a certificate of completion, including all information specified in Section 89(b). If a secondary provider presented the course, the certificate shall identify both the primary and secondary providers.

(3) Be responsible for the quality and content of the course by requiring and ensuring that the course be presented only by qualified instructors and/or discussion leaders, and that presentations always include all components and content areas represented in the approval application.

(4) Periodically update course content to reflect current laws, regulations, case law decisions and standards of practice.

(h) Licensees may claim continuing education credit earned from completing a Board-approved course designed in fulfillment of this section for the Ethics Continuing Education Requirement described in Section 87(b) and/or for the Regulatory Review Requirement described in Section 87.8 provided the course is completed prior to January 1, 2011 and reported to the Board prior to January 1, 2012.

(i) Board-approved course providers may continue to offer the course, described in section 87.7(a) until December 31, 2010 for licensees to receive continuing education credit in fulfillment of the Ethics Continuing Education Requirement described in Section 87(b) and/or for the Regulatory Review Requirement described in Section 87.8.

(j) After January 1, 2010, the Board will no longer approve courses specific to this requirement.

Section 87.8: Regulatory Review Course.

(a) In order to renew a license in an active status after
December 31, 2009, 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. A licensee, licensed prior to the implementation of Section 87.8, shall maintain their existing reporting date used for the professional conduct and ethics requirement to report the completion of the Regulatory Review course.

Section 87.9. Offering a Regulatory Review Course.

(a) Prior to offering a regulatory review course which can be claimed by a licensee to fulfill Section 87.8, course providers shall apply to the Board for approval of the course by completing Initial Application Package CE-RR-1 (07/09), Regulatory Review Application for Course Approval, which is hereby incorporated by reference. Approval shall be based on the following criteria:

(1) The course shall be a formal educational program that meets the requirements described in Sections 88, 88.1, and 88.2.

(2) The course shall provide participants with the current California Accountancy Act and California Board of Accountancy Regulations.

(3) A self-study course shall require a 90 percent passing score on a test given at the conclusion of the course. The test shall be submitted along with the course materials for approval.

(4) A self-study course is required to demonstrate an average completion time of two 50-minute continuing education hours by pre-testing the documentation from a minimum of four current and active certified public accountants simulating the manner in which the course will be completed and showing the length of time spent by each participant to complete the course. Pre-testing participants are required to be independent of the group that developed and/or are offering the course and provide feedback on the level of difficulty of the course.

(b) The term of the approval shall be for a two-year period. In order to maintain Board approval, providers shall submit Renewal Application Package CE-RR-2 (07/09), Regulatory Review Approval Continuance Application, which is hereby incorporated by reference, prior to the end of the two-year period.

(c) Upon receiving approval from the Board, the provider of the Regulatory Review course required under Section 87.8 may represent the course in promotional materials during the term of approval, as being approved by the Board.

(d) The Board may review the records of a provider to ensure compliance with the criteria specified in this Section. Within 15 days of receipt of written notification, the provider shall submit or make available all material requested by the Board. The Board may cancel its approval for a course found not to be in compliance.

(e) For every course presentation, the provider that enters into the approval agreement with the Board shall:

(1) Retain completion records to reflect the actual participant attendance, or in the case of a self-study course, passing test scores of 90 percent or higher. The retention period shall be eight years.
(2) Be responsible for the quality and content of the course by requiring and ensuring that the course include all components and content areas represented in the approval application.

(3) Update course content to reflect current laws, regulations, and enforcement violations.

(f) A provider whose course is denied approval or when a previous approval is canceled by Board staff may appeal such action to the Board. The appeal shall be filed within six months of the action being appealed or the mailing of written notification, whichever is later. The appeal shall contain the following information:

(1) The name and business address of the provider making the appeal.

(2) The action being appealed and the date of any written notification from the Board.

(3) A summary of the basis for the appeal, including any information which the provider believes was not given adequate consideration by staff.

(g) The Board will consider only appeals based on information previously considered by staff. If the provider wishes to submit for consideration additional evidence or information not previously submitted to staff, such additional information should be submitted directly to staff with the request that its previous action be reconsidered. An appeal based on evidence or information not previously submitted to staff will be referred by the Board to staff for further consideration.

Section 88. Programs Which Qualify.

(a) The overriding consideration in determining whether a specific program qualifies as acceptable continuing education is that it be a formal program of learning which contributes directly to the professional competence of a licensee in public practice. It is the obligation of each licensee to select a course of study, consistent with the requirements of this section and Sections 88.1 and 88.2, which will contribute directly to his or her professional competence.

(1) Licensees shall complete a minimum of 50 percent of the required continuing education hours in the following subject areas: accounting, auditing, fraud, taxation, consulting, financial planning, ethics as defined in Section 87(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.

(2) Licensees may claim no more than 50 percent of the required number of continuing education hours in the following subject areas: communication skills, word processing, sales, marketing, motivational techniques, negotiation skills, office management, practice management, and personnel management.

(3) 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.

(4) A formal program of learning is an instructional activity that meets the requirements of Sections 88.1 and 88.2 or a course for which academic credit is granted by a university, college, or other institution of learning accredited by a regional or national accrediting agency.

(b) The following types of live presentation programs are deemed to qualify as acceptable continuing education provided the standards outlined in Section 88(a), Section 88.1, and Section 88.2 are maintained.

(1) Professional development programs of national and state accounting organizations.

(2) Technical session at meetings of national and state accounting organizations and their chapters which are designed as formal educational programs.

(3) University or college courses:

(i) Credit courses–each semester hour credit shall equal 15 hours toward the requirement. Each quarter hour credit shall equal 10 hours.

(ii) Non credit courses–each classroom hour will equal one qualifying hour.

(4) Other formal educational programs provided the program meets the required standards.

(c) Group Internet-Based Programs (Webcast): Programs that enable a licensee to participate from a computer in an interactive course presented by a live instructor at a distant location are qualifying, provided the program is based upon materials specifically developed for instructional use and meets the requirements of Section 88(a), Section 88.1, and Section 88.2.

(d) Formal correspondence or other individual study programs are qualifying provided the program
meets the requirements of Section 88(a), Section 88.1, and Section 88.2, and the licensee receives a passing score. Self-study modules for national examinations that contribute to the professional competency of a licensee in public practice, such as the CERTIFIED FINANCIAL PLANNER™ Certification Examination or the Certified Management Accountant examination qualify as acceptable continuing education if the modules meet the above requirements.

(e) The credit as an instructor, discussion leader, or speaker will be allowed for any meeting or program provided that the session is one which would meet the continuing education requirements set forth in Section 88(a), Section 88.1, and Section 88.2. The credit allowed an instructor, discussion leader, or a speaker will be on the basis of actual presentation hours, plus up to two additional hours for actual preparation time for each hour taught. The maximum credit for such preparation and teaching will not exceed 50 percent of the renewal period requirement. For repeat presentations, an instructor shall receive no credit unless the instructor can demonstrate that the program content was substantially changed and that such change required significant additional study or research. Credit for licensees attending, not as instructors, discussion leader, or speakers, is limited to the actual meeting time.

(f) Credit may be allowed by the Board for the following activities:

(1) writing published articles and books provided the publisher is not under the control of the licensee, and the article and/or book would contribute to his/her professional competence.

(2) writing instructional materials for any continuing education program which meets the requirements of Section 88(a), Section 88.1, and Section 88.2.

(3) writing questions for the Uniform Certified Public Accountant Examination.

The maximum credit allowed under this subsection (subsection f) shall not exceed 25 percent of the renewal period requirement.

Section 88.1. Provider Requirements.

(a) Live Presentation

In order to qualify as acceptable continuing education under Section 88(b) the provider of the live presentation program must:

(1) Require attendance and retain for a period of six years a record of attendance that accurately assigns the appropriate number of contact hours for participants including those who arrive late or leave early.

(2) Retain for a period of six years written educational goals and specific learning objectives, as well as a syllabus, which provides a general outline, instructional objectives, and a summary of topics for the course. A copy of the educational goals, learning objectives, and course syllabus shall be made available to the California Board of Accountancy upon request.

(3) Issue a certificate of completion to each licensee upon satisfactory completion of the course and retain records of licensees receiving certificates of completion for a period of six years. The amount of credit reflected on the certificate of completion shall be calculated in accordance with Section 88.2(a). The certificate of completion must delineate the subject areas, as described in Section 88(a)(1) and (2), for which the licensee may claim credit.

(b) Group Internet-Based Program (Webcast)

In order to qualify as acceptable continuing education under Section 88(c), the provider of the Group Internet-Based Program (Webcast) must be in compliance with requirements below:

(1) Require and monitor attendance throughout the program by using attendance-monitoring devices such as polling, questions, or surveys. The program shall include a minimum of two monitoring events each half hour, at least one of which occurs at an irregular interval.

(2) Have a live instructor while the program is being presented and a feature allowing participants to send questions/comments directly to the instructor and receive answers during the program.

(3) Retain, for a period of six years, a record of attendance that accurately assigns the appropriate number of participation hours for participants.

(4) Retain for a period of six years written educational goals and specific learning objectives, as well as a syllabus, which provides a general outline, instructional objectives, and a summary of topics for the course. A copy of the educational goals, learning objectives, and course syllabus shall be made available to the California Board of Accountancy upon request.

(5) Issue a certificate of completion to each licensee upon satisfactory completion of the course. Satisfactory completion shall at a minimum require responding to at least 75 percent of the monitoring events described in Section 88.1(b)(1) during...
the period for which continuing education credit is being granted. Retain records of licensees receiving certificates of completion for a period of six years. The amount of credit shall be displayed on the certificate of completion and shall be calculated in accordance with Section 88.2(b). The certificate of completion must delineate the subject areas, as described in Section 88(a)(1) and (2), for which the licensee may claim credit.

(6) Have a written policy to address rescheduling and the granting of partial credit in the event of a technology failure, and make that policy available to the Board upon request.

(c) Self-Study

In order to qualify as acceptable continuing education under Section 88(c) the sponsor of the self-study course must:

(1) Retain for a period of six years written educational goals and specific learning objectives, as well as a syllabus, which provides a general outline, instructional objectives, and a summary of topics for the course. A copy of the educational goals, learning objectives, and course syllabus shall be made available to the California Board of Accountancy upon request.

(2) Issue a certificate of completion to each licensee upon satisfactory completion of the course and retain records of licensees receiving certificates of completion for a period of six years. The amount of credit shall be displayed on the certificate of completion and shall be calculated in accordance with Section 88.2(c). The certificate of completion must delineate the subject areas, as described in Section 88(a)(1) and (2), for which the licensee may claim credit.

Section 88.2. Program Measurements.

(a) Live Presentation

In order to qualify as acceptable continuing education under Section 88(b) a live presentation program must:

(1) Be measured in 50 minute class hours. A program must be at least one 50 minute class hour in length to be acceptable continuing education. For a program composed of several segments, in which individual segments are less than 50 minutes, the sum of the segments, in increments not less than 25 minutes, may be added together to equal a full 50 minute class hour. For a program that is longer than one 50 minute class hour, credit shall be granted for additional 25 minute segments (one-half of a 50 minute class hour). Only class hours or the equivalent (and not participant hours devoted to preparation or study time) will be used to measure the hours of continuing education.

(2) Any program designed pursuant to Section 87(b) must be a minimum of one 50- minute class hour. Should a course be comprised of multiple subject areas as described in Section 88(a)(1), those components specific to Section 87(b) must be a minimum of one 50-minute class hour.

(3) Meet the provider requirements for live presentation under Section 88.1(a).

(b) Group Internet-Based Program (Webcast)

In order to qualify as acceptable continuing education under Section 88(c), a Group Internet-Based Program (Webcast) must:

(1) Be measured by actual program length in 50-minute class hours. A program must be at least one 50-minute class hour in length to be acceptable continuing education. For a program composed of several segments, the sum of the segments, in increments not less than 25 minutes, may be added together to equal a full 50-minute class hour. For a program that is longer than one 50-minute class hour, credit shall be granted for additional 25-minute segments (one-half of a 50-minute class hour). Only class hours or the equivalent (and not participant hours devoted to preparation or study time) will be used to measure the hours of continuing education.

(2) Any program designed pursuant to Section 87(b) must be a minimum of one 50-minute class hour. Should a program be comprised of multiple subject areas as described in Section 88(a)(1), those components specific to Section 87(b) must be a minimum of one 50-minute class hour.

(3) Meet the provider requirement for Group Internet-Based Program (Webcast) under Section 88.1(b).

(c) Self-Study

In order to qualify as acceptable continuing education under Section 88(d), any self-study course whether in electronic or paper text format must:

(1) Grant continuing education credit equal to the average completion time if the self-study course is designed to use learning methodologies that simulate a classroom learning process by employing significant ongoing interactive feedback to the participant regarding his or her learning
progress. These courses clearly define lesson objectives and manage the participant through the learning process by (A) requiring frequent participant response to questions that test for understanding of the material presented, (B) provide evaluated feedback to incorrectly answered questions, and (C) reinforcement feedback to correctly answered questions. Evaluated feedback means a response specific to each incorrect answer to the study questions that explains why the particular answer is wrong, as each one is likely to be wrong for a different reason. Reinforcement feedback means a response to the correct answer of the study questions that restates and explains why the answer selected was correct.

(2) Any program designed pursuant to Section 87(b) must be a minimum of one class hour. Should a program be comprised of multiple subject areas as described in Section 88(a)(1), those components specific to Section 87(b) must be a minimum of one 50-minute class hour.

(3) Require a passing score on a test given at the conclusion of the course.

(4) Any self-study program or component designed pursuant to Section 87(b) shall require a 90 percent passing score on a test given at the conclusion of the course. Should a program be comprised of multiple subject areas as described in Section 88(a)(1), those components specific to Section 87(b) shall require a 90 percent passing score on a test given at the conclusion of the component specific to Section 87(b) or at the conclusion of the course.

(5) Meet the provider requirements for self-study under Section 88.1(c).

Section 89. Control and Reporting.

(a) Upon renewal, a licensee who is required, pursuant to Section 87, to obtain continuing education must provide a written statement, signed under penalty of perjury, certifying that the requisite number of continuing education hours has been obtained. The licensee shall disclose the following information concerning courses or programs claimed as qualifying continuing education:

(1) Course title or description

(2) Date of completion

(3) Name of school, firm or organization providing the course or program

(4) Method of study, i.e., whether course or program is self-study, live presentation or Group Internet-Based Program (Webcast)

(5) Numbers of hours earned.

(b) If credit is claimed for completing the eight hour professional conduct and ethics course specified in Section 87.7, a licensee shall obtain and retain for six years after renewal of his or her license, a certificate of completion or its equivalent disclosing the following information:

(1) Name of licensee

(2) Course title

(3) Board-issued approval number for the professional conduct and ethics course completed by the licensee

(4) School, firm or organization providing the course

(5) Date of completion.

(6) Verification by a program provider representative, such as a signature or seal.

(c) If continuing education credit for attending a continuing education course is claimed, the licensee shall obtain and retain for four years after renewal a certificate of completion or its equivalent disclosing the following information:

(1) Name of licensee in attendance

(2) School, firm or organization conducting course

(3) Location of course attended

(4) Title of course or description of content

(5) Dates of attendance except when the licensee attended a course for academic credit given by a college, university, or other institution of higher learning accredited by an association recognized by the Secretary of the United States Department of Education, in which case the applicant may provide evidence of a grade of pass or “credit” to satisfy this requirement.

(6) Number of hours of actual attendance except when the licensee attended a course for academic credit given by a college, university, or other institution of higher learning accredited by an association recognized by the Secretary of the United States Department of Education, in which case the applicant may provide evidence of a grade of pass or “credit” to satisfy this requirement.

(7) Verification by a program provider representative, such as a signature or seal.

(d) If continuing education credit is claimed for completing a self-study course, the licensee shall obtain and
retain for four years after renewal a certificate of completion or its equivalent disclosing the following information:

(i) The Board will solicit and verify such information on a test basis. If a licensee is found to have a deficiency, the licensee shall be so notified. Upon request, the licensee may be granted a reasonable period of time in which to correct the deficiency.

(j) A licensee who is determined by the Board at renewal not to have completed the required number of hours of qualifying continuing education shall be required to make up any deficiency. A licensee who is required to make up a deficiency shall be ineligible for active status license renewal or conversion to active status pursuant to Section 87.1 until such time as documentation to support the required hours of continuing education for license renewal has been submitted and approved by the Board.

Section 89.1. Reports.

(a) For purposes of monitoring and promoting compliance with applicable accounting principles and reporting standards, the Report Quality Monitoring Committee may require licensees, selected on the basis of a statistical sampling or upon referral from another committee of the Board, to supply copies of selected financial reports they have issued during the previous two years. This requirement applies to any licensee who had primary responsibility for, and authority to sign, at least one financial report that was issued during the previous two years. The financial report or reports to be submitted shall be selected by the responding licensee and shall reflect the highest level of service rendered by such licensee during the period.

For purposes of this regulation, financial report shall mean

(1) the licensee’s report issued as the result of an engagement covered by generally accepted auditing standards or government auditing standards (audit), or standards for accounting and review services (compilation or review), or attestation standards (attest engagements),

(2) accompanying financial statements or other client assertion,

(3) accompanying footnotes, and

(4) supplementary financial data, if any.

(b) Willful failure or refusal of a licensee to comply with the Board’s written request for a copy of financial report(s), within 30 calendar days of the licensee’s receipt of that request, constitutes a violation of Section 5100(g) of the Accountancy Act.
Section 90. Exceptions and Extensions.

(a) A renewal applicant may be granted either an extension of time to complete continuing education requirements or an exception from continuing education requirements. Extensions or exceptions may be granted by the Board for the following causes:

(1) Reasons of health, certified by a medical doctor, which prevent compliance by the licensee;

(2) Service of the licensee on extended active duty with the Armed Forces of the United States;

(3) Other good cause.

(b) No extension or exception shall be made solely because of age.

(c) Willful failure of a licensee to complete applicable continuing education within a specified extension of time shall constitute cause for disciplinary action pursuant to section 5100 (g) of the Accountancy Act.

(d) A renewal applicant who has met the requirement of Section 87(a) and becomes subject to continuing education pursuant to Section 87(c), (d), or (e) during the last 6 months of a two-year license renewal period shall be granted, upon request, an extension of time of up to 6 months in which to complete the continuing education required by Section 87 (c), (d), or (e). Continuing education completed pursuant to this extension shall be part of the 80 hours of continuing education required under Section 87(a) for the next two-year renewal period. However, it shall not be part of the 24 hours of continuing education required under Section 87(c) or (d) or the 8 hours of continuing education required under Section 87(e) for the next two-year renewal period.

Section 93. Unexpired Licenses

Permits issued under these rules expire at 12 midnight on the last day of the birth month of an odd numbered year if the licensee was born in an odd numbered year or of an even numbered year if the licensee was born in an even numbered year. Permit renewal is the responsibility of the licensee. To renew an unexpired permit, a certificate holder or registrant shall, before the time at which the permit would otherwise expire, apply for renewal on a form prescribed by the board, pay the renewal fee prescribed and give evidence to the board that the continuing education provisions of these regulations have been complied with. Renewal of an unexpired permit shall continue the permit in effect for the two-year renewal cycle ending in the licensee’s birth month unless otherwise provided for in these regulations or the California Accountancy Act.

Section 94. Failure to Comply

Failure to comply with these continuing education rules by a licensee engaged in public practice, as defined in Business and Professions Code Section 5051, constitutes cause for disciplinary action under Section 5100.

ARTICLE 12.5: Citations and Fines

Section 95. Citations

(a) The executive officer of the board, in lieu of filing an accusation seeking the suspension or revocation of any permit or certificate or the censure of the holder of any such permit or certificate pursuant to Section 5100, 5101 and 5156 of the Business and Professions Code, may issue a citation to any person as defined in Section 5035 of the Business and Professions Code who holds a permit or certificate from the board for a violation of any provision of the Accountancy Act or any regulation adopted by the board.

(b) In his or her discretion, the Board’s executive officer may issue a citation under this section to a licensee for a violation of a term or condition contained in a decision placing that licensee on probation.

Section 95.1. Citation Format

Each citation:

(a) shall be in writing;

(b) shall describe with particularity the nature of the violation, including specific reference to the provision of law determined to have been violated;

(c) may contain an assessment of an administrative fine, an order of correction or abatement fixing a reasonable period of time for correction or abatement of the violation, or both an administrative fine and an order of correction or abatement;

(d) shall be served in accordance with the provisions of Section 11505(c) of the Government Code;

(e) shall inform the cited person that if he or she desires a hearing to contest the finding of a violation, that hearing shall be requested by written notice to the board within 30 days of the issuance of the citation or assessment.

Section 95.2. Fines

The amount of the administrative fine assessed by the executive officer pursuant to this article shall not be less than $100 or more than $5,000 for each investigation.

Section 95.3 Citation Factors.

In assessing an administrative fine or issuing an order of correction or abatement, the executive officer of the board
shall give due consideration to the following factors:

(a) The gravity of the violation.
(b) The good or bad faith of the cited person or entity.
(c) The history of previous violations.
(d) Evidence that the violation was or was not willful.
(e) The extent to which the cited person or entity has cooperated with the board’s investigation.
(f) The extent to which the cited person or entity has mitigated or attempted to mitigate any damage or injury caused by the violation.

Section 95.4. Failure to Comply with Order

The failure of a licensee to comply with a citation containing an assessment of administrative fine, an order of correction or abatement or both an administrative fine and an order of correction or abatement after this citation is final and has been served in accordance with the provisions of Section 11505(c) of the Government Code shall constitute a ground for revocation or suspension of the license or permit.

Section 95.5. Appeals

Any person or entity served with a citation pursuant to this Article and Sections 125.9 and 148 of the Business and Professions Code may contest the citation by appealing to the board in writing within 30 calendar days of the issuance of the citation. The cited person or entity may contest any or all of the following aspects of the citation:

(a) The occurrence of a violation of the Accountancy Act or a regulation adopted by the board.
(b) The reasonableness of the order of correction or abatement.
(c) The period of time allowed for correction in the order of correction or abatement.
(d) The amount of the administrative fine. If the cited person or entity fails to notify the Board of his/her/its intent to contest the citation, the citation shall be deemed a final order of the Board and shall not be subject to administrative review.

If a cited person or entity notifies the Board that he/she/it intends to contest a citation, the Board shall afford an opportunity for a hearing. The Board shall thereafter issue a decision, based on findings of fact, affirming, modifying or vacating the citation or penalty or both, or directing other appropriate relief. The proceedings under this Section shall be conducted in accordance with the provisions of Chapter 5 (commencing with Section 11500) of Part 1 of Division 3 of Title 2 of the Government Code (the California Administrative Procedure Act). Failure of a cited person or entity who has appealed to the board to appear at the time and place of the hearing shall be deemed a withdrawal of his, her or its appeal, and the citation shall constitute a final order of the board and shall not be subject to administrative review.

Section 95.6. Unlicensed, Unregulated Practice

The executive officer of the board may issue citations, in accordance with Section 125.9 and 148 of the Business and Professions Code, against any person defined in Business and Professions Code Section 5035 who is acting in the capacity of a licensee under the jurisdiction of the Board. Each citation may contain an assessment of an administrative fine, an order of abatement fixing a reasonable period of time for abatement of the violation, or both an administrative fine and an order of abatement. Administrative fines shall be in a range from $100 to $5,000 for each investigation. Any sanction authorized for activity under this section shall be separate from and in addition to any other civil or criminal remedies.

ARTICLE 13: Denial, Suspension, and Revocation of Certificates, Permits, or Licenses

Section 98. Disciplinary Guidelines.

In reaching a decision on a disciplinary action under the Administrative Procedure Act (Government Code Section 11400 et seq.), the Board shall consider the disciplinary guidelines entitled “A Manual of Disciplinary Guidelines and Model Disciplinary Orders” (7th edition, 2011) which are hereby incorporated by reference. Deviation from these guidelines and orders, including the standard terms of probation, is appropriate where the Board in its sole discretion determines that the facts of the particular case warrant such a deviation—for example: the presence of mitigating factors; the age of the case; evidentiary problems.

Section 98.1. Mediation Guidelines.

The guidelines, entitled “California Board of Accountancy Mediation Guidelines” (July 17, 1998), which are hereby incorporated by reference, constitute the Board’s guidelines for determining whether an enforcement matter under Article 6 of the Accountancy Act is appropriate for referral to mediation and for the procedures and the form of the mediation process.

Section 99. Substantial Relationship Criteria

For the purposes of denial, suspension, or revocation of a certificate or permit pursuant to Division 1.5 (commencing with Section 475) of the Business and Professions Code, a crime or act shall be considered to be substantial-
ly related to the qualifications, functions or duties of a certified public accountant or public accountant if to a substantial degree it evidences present or potential unfitness of a certified public accountant or public accountant to perform the functions authorized by his or her certificate or permit in a manner consistent with the public health, safety, or welfare. Such crimes or acts shall include but not be limited to those involving the following:

(a) Dishonesty, fraud, or breach of fiduciary responsibility of any kind;
(b) Fraud or deceit in obtaining a certified public accountant’s certificate or a public accountant’s permit under Chapter 1, Division III of the Business and Professions Code;
(c) Gross negligence in the practice of a public accounting or in the performance of the bookkeeping operations described in Section 5052 of the code;
(d) Violation of any of the provisions of Chapter 1, Division III of the Business and Professions Code or willful violation of any rule or regulation of the board.

Section 99.1. Rehabilitation Criteria for Denials, Suspensions, Revocations, Restorations, Reduction of Penalty, Etc.

When considering the denial of a certificate or permit under Section 480 of the Business and Professions Code, the suspension or revocation of a certificate or permit or restoration of a revoked certificate under Section 11522 of the Government Code, the board, in evaluating the rehabilitation of the applicant and his present eligibility for a certificate or permit, will consider the following criteria:

(1) Nature and severity of the act(s) or offense(s).
(2) Criminal record and evidence of any act(s) committed subsequent to the act(s) or offense(s) under consideration which also could be considered as grounds for denial, suspension or revocation.
(3) The time that has elapsed since commission of the act(s) or offense(s) referred to in subdivision (1) or (2).
(4) The extent to which the applicant or licensee has complied with any terms of parole, probation, restitution, or any other sanctions lawfully imposed against the applicant or licensee.
(5) If applicable, evidence of expungement proceedings pursuant to Section 1203.4 of the Penal Code.
(6) Evidence, if any, of rehabilitation submitted by the applicant or licensee.
Chapter Questions

1. Albers, CPA, is a sole practitioner whose business consists of tax engagements, management consulting, write-up work, compilations and a few reviews. She does not perform audits of financial statements. Since she does an extensive amount of tax work, she prefers to use all of her CPE hours taking qualified tax update courses each year. Which of the following is correct?
   (a) Albers may use all of her CPE hours on tax courses, so long as she meets the required 80 hours.
   (b) If Albers takes only 80 hours of CPE, some of those hours must include topics other than tax.
   (c) Albers may use all of her 80 hours of CPE on qualified tax update courses if she is not required to take a California Regulatory Review course this renewal period.

2. Brown, CPA, has several wealthy tax clients who regularly confer with her about tax planning, estate planning and tax compliance issues. She is very familiar with these clients’ financial situations. Assuming none of the clients are attest clients and all required disclosures would be made by Brown, may she sell a list of these clients to Mr. Nasdaq, a registered investment adviser (RIA), if she notifies her clients in advance and explains how Mr. Nasdaq could be of service in helping them meet their financial needs?
   (a) Yes, commissions are allowed in California, provided the client is not an attest client.
   (b) No, because selling a list of clients is not allowed in California.
   (c) No, because commissions are not allowed in California.

3. A CPA firm was found to have knowingly prepared materially misleading financial statements, for the second time. What is the maximum administrative penalty the firm can receive for this second offense?
   (a) $ 50,000
   (b) $ 100,000
   (c) $ 1,000,000
   (d) $5,000,000

4. Mr. Hemp, CPA, has been convicted of illegal drug possession and use (a misdemeanor) and must pay a large fine. Because the amount of drugs involved was small and because he had no previous convictions, he was put on probation but did not have to serve any jail time. He is very embarrassed and ashamed of being caught and hopes the conviction will not affect his business. Must he notify the Board of Accountancy about his conviction?
   (a) No, because the conviction does not relate to the work normally performed by CPAs.
   (b) No, because the conviction was a misdemeanor, not a felony.
   (c) Yes.

5. Charlie, CPA was engaged as a professional practice reviewer (i.e., a peer reviewer) by Smith & Jones, CPAs. While reviewing Smith & Jones’ files, Charlie became aware that one of their public clients had a strong possibility of being acquired soon by a larger company, and that the present stockholders of the client were likely to be paid handsomely for their shares. After the conclusion of the practice review, may Charlie purchase some stock of Smith & Jones’ client?
   (a) This action would be prohibited by federal insider-trading laws, but is not addressed in the California Accountancy Act nor in the Accountancy Rules and Regulations.
   (b) This action would be prohibited by the California Accountancy Act.

6. Darrow is a CPA, but not a member of the AICPA or CalCPA. Is she bound by AICPA pronouncements?
   (a) Only members of the AICPA must follow AICPA pronouncements.
   (b) In many instances California licensees must adhere to AICPA pronouncements, whether or not they are members of the AICPA.
7. Evans, CPA, retired as a partner in a San Francisco CPA firm. She wished to continue practicing public accounting as a sole practitioner, but could not do so within a 100-mile radius of her former firm because she signed a non-competition agreement as part of her retirement contract. Therefore, she moved to San Diego to live and to begin a practice as a sole practitioner. How long does she have to communicate her new address and business affiliation to the Board?

(a) Evans need not notify the Board.
(b) Evans must notify the Board within one year of her move.
(c) Evans must notify the Board, in writing, within 30 days of her move.
(d) None of the above is correct.

8. Fuller, CPA, received a telephone call from an attorney who said he was looking for a CPA to act as an expert witness in one of his cases. The attorney then told Fuller some of the facts of the case and stated that the information was confidential. The attorney concluded the conversation by reminding Fuller that she had received confidential information and was thus precluded from working on the case for the opposing party. He hung up the telephone without engaging Fuller to work on the case. Which of the following responses are true?

(a) Fuller received confidential information and is therefore precluded from working on the case for the opposing party.
(b) Fuller may work on the case for the opposing party if she puts the attorney on notice that the information he is about to reveal is not confidential unless she is engaged to work on the case for him.

9. Green, CPA, has been approached by Dewy Cheetum, an attorney, to act as an expert witness on one of Mr. Cheetum’s cases. Mr. Cheetum’s fee will be 40% of his client’s award, should his client prevail. Mr. Cheetum wishes to pay Green 5% of his client’s award, if the client should prevail. May Green accept this fee arrangement?

(a) Yes, provided that neither Mr. Cheetum nor his client are attest clients of Green.
(b) No, because contingent fees are not allowed in California.
(c) No, because expert witness work may not be performed for a contingent fee.

10. Hill, CPA, wrote an article about ethics for CPAs acting as expert witnesses and the article was published in the Journal of Accountancy. How much time may Hill allocate to writing the article as part of her CPE requirement?

(a) Hill may not claim credit hours as part of her CPE requirement for writing an article.
(b) Hill may claim one-half the hours it actually took her to write the article.
(c) Hill may claim the actual number of hours it took her to write the article, up to 20 hours.

11. In March 2012, Iverson, CPA, had a $25,000 civil judgment entered against her for negligence in connection with her practice as a CPA. Since the judgment was less than $30,000, and since it was a civil, not criminal judgment, she believes that she is not under any obligation to notify the California Board of Accountancy about the judgment. Which of the following items are correct?

(a) Only judgments of $30,000 or more need to be reported, regardless of whether they are civil or criminal.
(b) Civil judgments over $30,000 and all criminal judgments must be reported.
(c) All judgments involving negligence must be reported, regardless of the amount.

12. Jones, et al., an Accountancy Corporation, is owned by ten CPAs licensed in California and three non-CPAs. All of the owners practice exclusively in California. Are the non-CPA owners responsible for the rules of professional conduct applicable to accountancy firms?

(a) No, because the rules of professional conduct apply only to CPAs.
(b) Yes, and the firm must certify that the non-licensee owners have been informed about the rules of professional conduct applicable to accountancy corporations.
(c) Yes, but the certification mentioned in answer B. is not required.
13. Keller, CPA, was so busy she forgot to complete all of her required CPE. When it became time to renew her license she realized that she was 30 hours short of the hours required, and she had not taken enough accounting and auditing hours, and it was the renewal period in which she was required to have her California Regulatory Review course, but she had not taken one in the last six years. What must Keller do?

(a) She must apply for a time extension. Until the extension arrives she may not practice public accounting.

(b) She should apply to have her license put on inactive status while she completes her CPE requirements. During that time she may not engage in the practice of public accounting.

(c) She has an automatic extension of 30 days to complete her CPE.

14. When Leung retired as managing partner of “Leung and Chang, CPAs,” she was entitled to a retirement annuity of $75,000 per year until she died. Is this arrangement allowed by the California Accountancy Act?

(a) Yes, it is allowed by the California Accountancy Act

(b) No, this arrangement would be a commission and would not be permitted.

15. Miller, CPA, received a phone call from Joe, a tax client, who just received a $500,000 distribution from the estate of his mother. Joe asked Miller for advice concerning what to do with the money. Miller reviewed with Joe various investment options, his risk tolerance, the tax consequences of several potential investments, and ultimately decided that Joe’s best course of action would be to consult with Mr. Nasdaq, a registered investment adviser (RIA). If Miller refers Joe to Mr. Nasdaq, may she accept a commission from Mr. Nasdaq, assuming all required disclosures are made to Joe?

(a) Yes, but these services may require that Miller be licensed by the California Department of Corporations or the SEC.

(b) No, since Joe is a tax client.

(c) No, because commissions are not allowed in California. Of 20 hours obtained each year of the renewal period beginning 1/1/2012 (Section 87). In addition, other require-ments may apply, depending on the nature of the licensee’s practice and length of time since the licensee last took a California regulatory review course.
Chapter Answers

1. (b) Licensees are required to fulfill 80 hours of CPE every renewal period (Section 87), including four hours of ethics CPE (Section 87(a)). In addition, other requirements may apply, depending on the nature of the licensee’s practice and depending on the length of time since the licensee last took a course in the California Accountancy Act and California Regulations.

Incorrect Responses:
(a) Because Albers’ practice includes compilations and reviews, she must take 24 hours of qualifying accounting and auditing CPE (Section 5027(d)). Because she is subject to the accounting and auditing CPE requirement, she is also required to take eight hours of fraud detection/reporting (Section 87(c)). Also, she must take four hours of ethics every renewal period (Section 87(a)). In addition, she must take two hours of Board-approved California Regulatory Review CPE every third renewal period (Section 87.7).
(c) Because Albers’ practice includes compilations and reviews, she must take 24 hours of qualifying accounting and auditing CPE (Section 5027(c)), and fraud detection/reporting (Section 5027(e)), and she must also take at least four hours of ethics every renewal period (Section 8027(a)).

2. (b) Licensees are not allowed to accept any fee or commission solely for the referral of a client to a third party (Section 5061(b)).

Incorrect Responses:
(a) Although commissions are allowed in certain circumstances, the requirement that the client not be an attest client is only one of several requirements (Section 5061).
(c) Commissions are allowed in California, provided all requirements are met (Section 5061).

3. (d) $1,000,000. According to Section 5116.2, firms violating Section 5110 (Unprofessional Conduct), subsections a, c, i, j, or k are subject to administrative penalties up to $1,000,000 for a first offense and $5,000,000 for subsequent offenses.

Incorrect Responses:
(a) $50,000 is the amount of administrative penalty for the first offense committed by a natural person.
(b) $100,000 is the amount of administrative penalty for subsequent offenses committed by natural persons.
(c) $1,000,000 is the amount of administrative penalty for the first offense committed by a firm.

4. (b) Section 5063 requires licensees to report all felony convictions. Since Mr. Hemp’s conviction was a misdemeanor, he does not have to report it.

Incorrect Responses:
(a) Mr. Hemp does not have to report his conviction because it was not a felony. Mr. Hemp would have had to report his conviction, even if it were a misdemeanor, if it had involved a crime related to the qualifications, functions, or duties of a CPA. (Section 5063(1)(B)).
(c) No, Mr. Hemp does not have to report his conviction because it did not relate to the qualifications, functions, or duties of a CPA and because it was not a felony.

5. (b) Insider trading would be considered “unprofessional conduct.” Section 5100 allows the California Board of Accountancy to revoke a CPA’s license for fiscal dishonesty or breach of fiduciary responsibility of any kind, among other things (Section 5100(i)).

Incorrect Responses:
(a) Although “insider trading” is not directly addressed in the California Accountancy Act or in the Accountancy Rules and Regulations, unprofessional conduct is addressed and prohibited (Section 5100).

6. (b) The California Accountancy Act and the Accountancy Rules and Regulations require licensees to adhere to professional standards (Sections 5062, 58, 65). In many situations the applicable professional standards are promulgated by the AICPA.

Incorrect Responses:
(a) Some pronouncements of the AICPA may be applicable only to AICPA members. However, California licensees must comply with professional standards (including GAAP and GAAS) (Section 58), independence standards (Section 65) and reporting standards (Section 5062).
7. (c) Licensees must notify the Board of any change in his/her address of record within 30 days after the change (Section 3(a)(1)). The notification must be in writing and signed by the licensee (Section 3(a)(3)).

Incorrect Responses:
(a) Yes, licensees must notify the board when they change their address of record (Section 3(a)(1)).
(b) Licensees have only 30 days in which to notify the Board (Section 3(a)(1)).
(d) Yes, item C. is correct.

8. (b) Confidential information does not include information obtained from a prospective client who does not subsequently become a client, where reasonable notice is given that the information will not be treated as confidential (Section 54 (a)).

Incorrect Response:
(a) Provided that certain conditions are met, the definition of confidential information allows for an exception (Section 54 (a)).

9. (c) Licensees may not perform an engagement as a testifying expert for a contingent fee (Section 62(a) (4)).

Incorrect Responses:
(a) Although Section 62 prohibits the receipt of contingent fees from attest clients, it also prohibits contingent fees for testifying as an expert witness.
(b) Contingent fees are allowed in California, so long as all the provisions of Section 62 are met.

10. (c) Authors may claim credit for articles published provided the publisher is not under the control of the licensee and the articles contribute to their professional competence (Section 88(f)(1)). The maximum credit allowed shall not exceed 25% of the renewal period requirement (20 hours) (Section 88(f)).

Incorrect Responses:
(a) Yes, Section 88(f) allows certain authors to claim credit for published books, articles, CPE programs and CPA exam questions.
(b) She may claim all the hours it took her to write the article, up to 25% of the renewal period requirement (Section 88(f)).

11. (c) After January 1, 1997 a licensee must report any criminal judgment involving theft, embezzlement, misappropriation of funds, breach of fiduciary responsibility, or preparation of false, fraudulent, or materially misleading financial statements (Section 5063(a)(1)). After January 1, 2003 a licensee must also report any judgment in a civil action alleging dishonesty, fraud, gross negligence, or negligence (Section 5063(c)(1)).

Incorrect Responses:
(a) The $30,000 rule applies to civil settlements or arbitration awards (Section 5063(b)(2)).
(b) The $30,000 rule applies to civil settlements or arbitration awards, and all felony convictions must be reported, as must conviction of any crime related to the qualifications, functions, or duties of a CPA (Section 5063).

12. (b) Section 51 requires all firms to certify that any nonlicensee owner with his or her principal place of business in California has been informed regarding the rules of professional conduct applicable to the firm.

Incorrect Responses:
(a) Although the rules of professional conduct apply to licensees, nonlicensee owners must be informed of those rules and a licensee owner or shareholder must sign the certification that the nonlicensee owners have been so informed (Section 51).
(c) Certification is required by Section 51.

13. (b) As a condition of active status license renewal, a licensee must complete the requirements of Section 87 and Section 87.7. A licensee who fails to complete those requirements should apply to have his/her licensee placed in an inactive status (Section 80).

Incorrect Responses:
(a) A renewal applicant may be granted either an extension of time to complete CPE requirements or an exception from them for reasons of health or service in the armed forces or other good cause (Section 90). Being busy and forgetful would not constitute good cause.
(c) No automatic extensions of time exist.

14. (a) Section 5061 (Commissions) does not prohibit retirement payments to individuals formerly engaged in the practice of public accounting or to their heirs or estates (Section 5061(g)).

Incorrect Responses:
(b) Whether or not this arrangement is considered a commission, it is allowed by Section 5061(g).
15. (a) A person engaged in the practice of public accountancy who is not performing attest services for a client and who makes the required disclosures may accept a commission for providing a client with the products or services of a third party in conjunction with professional services provided to the client by the licensee (Section 5061(b)). In this case the services provided are a review of Joe’s investment options, risk tolerance, and tax consequences of potential investments.

Incorrect Responses:

(b) Tax clients are not attest clients, and Miller is not performing a compilation or examination of prospective financial statements. Therefore, commissions are not prohibited because of other services provided by Miller (Section 5061(c)).

(c) Commissions are allowed in California, provided all the provisions of the following sections are met: 5061, 56, 56.1, 56.2, and 56.3.
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American Institute of Certified Public Accountants (AICPA)
www.aicpa.org
Professional Ethics: www.aicpa.org/members/div/ethics/index.htm

California Board of Accountancy (CBA)
www.dca.ca.gov/cba
Act: www.dca.ca.gov/cba/laws_and_rules/accountancy_act.shtml
Regulations: www.dca.ca.gov/cba/laws_and_rules/regs.shtml

Government Accountability Office (GAO)
www.gao.gov

International Federation of Accountants (IFA)
www.ifac.org
Ethics Code: www.ifac.org/ethics

Institute of Management Accountants (IMA)
www.imanet.org
Ethics Center: www.imanet.org/resources_and_publications/EthicsCenter.aspx

Internal Revenue Service (IRS)
www.irs.gov

National Association of State Boards of Accountancy (NASBA)
www.nasba.org
Model Code of Conduct: www.nasba.org/nasbaweb.nsf/srch (enter code of conduct)

Public Company Accounting Oversight Board (PCAOB)
www.pcaobus.org

Securities and Exchange Commission (SEC)
www.sec.gov
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