

Auditing and Assurance Services, 15e, Global Edition (Arens)
Chapter 5 Ethics and the Audit Profession

Learning Objective 5-1

1) Ethics are:

- A) needed in the professions, but is not needed for society in general.
- B) a set of moral principles or values.
- C) not formed by life experiences.
- D) always incorporated in laws.

Answer: B

Terms: Ethical Principles

Diff: Easy

Objective: LO 5-1

AACSB: Ethical understanding and reasoning abilities

2) _____ means that a person acts according to conscience, regardless of the situation.

- A) Caring
- B) Fairness
- C) Integrity
- D) Respect

Answer: C

Terms: Ethical principles and integrity

Diff: Moderate

Objective: LO 5-1

AACSB: Ethical understanding and reasoning abilities

3) One of the main reasons people act unethically is that they choose to act selfishly.

- A) True
- B) False

Answer: A

Terms: Ethical Principles

Diff: Easy

Objective: LO 5-1

AACSB: Ethical understanding and reasoning abilities

Learning Objective 5-2

1) A six-step approach is often used to resolve an ethical dilemma. The first step in this process is to:

- A) identify the alternative actions available.
- B) identify the ethical issues from the facts.
- C) determine who will be affected by the outcome of the dilemma.
- D) obtain the relevant facts.

Answer: D

Terms: Ethical dilemma

Diff: Moderate

Objective: LO 5-2

AACSB: Ethical understanding and reasoning abilities

2) Describe an ethical dilemma that an auditor or an accountant might face in his or her business career, then illustrate how the auditor or accountant might use the six-step approach presented in the text to resolve that dilemma. Be specific.

Answer: An ethical dilemma is a situation a person faces in which a decision must be made about an appropriate behavior. Although students' answers will vary depending on the dilemma, their answer should list the following six steps, along with a discussion of how each step relates to their particular dilemma:

1. *Obtain the relevant facts.* Students should list the key facts from their dilemma.
2. *Identify the ethical issues from the facts.* Students should identify the key ethical issue(s) in their dilemma.
3. *Determine who is affected by the outcome of the dilemma and how each person or group is affected.* Students should identify who is involved and how each person is affected by the dilemma.
4. *Identify the alternatives available to the person who must resolve the dilemma.* Students should list the alternatives available to the auditor or accountant.
5. *Identify the likely consequence of each alternative.* Students should identify both the short- and long-term effects of each alternative.
6. *Decide the appropriate action.*

Terms: Ethical dilemma

Diff: Challenging

Objective: LO 5-2

AACSB: Ethical understanding and reasoning abilities

3) A rationalization method that can easily result in unethical behavior is the argument that "everybody does it."

- A) True
- B) False

Answer: A

Terms: Ethical Principles

Diff: Easy

Objective: LO 5-2

AACSB: Ethical understanding and reasoning abilities

Learning Objective 5-3

1) The underlying reason for a code of professional conduct for any profession is:

- A) the need for public confidence in the quality of service of the profession.
- B) it provides a safeguard to keep unscrupulous people out.
- C) it is required by federal legislation.
- D) it allows licensing agencies to have a yardstick to measure deficient behavior.

Answer: A

Terms: Reason for code of professional conduct

Diff: Easy

Objective: LO 5-3

AACSB: Reflective thinking skills

2) Which of the following statements is true when the CPA has been engaged to perform an audit of financial statements?

- A) The CPA firm is engaged and paid by the client; therefore, the firm has primary responsibility to be an advocate for the client.
- B) The CPA firm is engaged and paid by the client, but the primary beneficiaries of the audit are those who rely on the financial statements.
- C) Should a situation arise where there is no convincing authoritative standard available, and there is a choice of actions which could impact a client's financial statements, the CPA is free to endorse the choice which is in the investors' interests.
- D) The CPA firm has primary responsibility to the FASB.

Answer: B

Terms: CPA engaged to perform audit of financial statements

Diff: Moderate

Objective: LO 5-3

AACSB: Reflective thinking skills

3) Explain why there is a special need for ethical conduct in the auditing profession.

Answer: The reason for an expectation of a high level of professional conduct by any profession is the need for public confidence in the quality of service by the profession, regardless of the individual providing it. It is not practical for most customers to evaluate the quality of the performance of professional services because of their complexity. Therefore, since the users (e.g., the general public) of services provided by an auditor generally cannot evaluate the quality of the auditor's performance, it is critical to the auditing profession that the public have a high degree of confidence in the quality of the services provided by the auditor. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and ethical conduct by all its members. If users of auditing services were to lack confidence in the quality of those services, then the value of CPA firms' audits would be diminished, as would the demand for audits. It is essential that the users regard CPA firms as competent and unbiased.

Terms: Need for ethical conduct in auditing profession

Diff: Easy

Objective: LO 5-3

AACSB: Ethical understanding and reasoning abilities

Learning Objective 5-4

1) Which of the following is(are) true concerning the Ethical Principles of the *Code of Professional Conduct*?

- I. They identify ideal conduct.
 - II. They are general ideals and are not enforceable.
- A) I only
 - B) II only
 - C) I and II
 - D) Neither I nor II

Answer: C

Terms: Ethical principles of the Code of Professional Conduct

Diff: Easy

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

2) Which of the following is **not** one of the four parts of the AICPA's Code of Professional Conduct?

- A) Principles
- B) Rules of Conduct
- C) Interpretations
- D) Definitions

Answer: D

Terms: AICPA Code of Professional Conduct

Diff: Easy

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

3) One of the AICPA's Ethical Principles deals with the public interest. It states that members should accept the obligation to act in a way that will:

A)

Honor the public trust	Serve the client's interest
Yes	Yes

B)

Honor the public trust	Serve the client's interest
No	No

C)

Honor the public trust	Serve the client's interest
Yes	No

D)

Honor the public trust	Serve the client's interest
No	Yes

Answer: C

Terms: Ethical Principles; Public interest; Obligations

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

4) According to the Principles section of the Code of Professional Conduct, all members:

A) should be independent in fact and in appearance at all times.

B) in public practice should be independent in fact and in appearance at all times.

C) in public practice should be independent in fact and in appearance when providing auditing and other attestations services.

D) in public practice should be independent in fact and in appearance when providing auditing, tax, and other attestation services.

Answer: C

Terms: Principles section of the Code of Professional Conduct

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

5) Which of the following statements best describes the enforceability of the Interpretations of the Rules of Conduct?

- A) The Interpretations are not enforceable.
- B) The Interpretations are enforceable.
- C) The Interpretations may be enforceable if they have been reviewed and approved by the AICPA's Division of Professional Ethics.
- D) The Interpretations are not enforceable, but a practitioner must justify departure from them.

Answer: D

Terms: Enforceability of Interpretations of the Rules of Conduct

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

6) Of the four parts of the AICPA's Code of Professional Conduct, which part is enforceable?

- A) Ethical Rulings
- B) Rules of Conduct
- C) Principles
- D) Interpretations

Answer: B

Terms: AICPA Code of Professional Conduct; Enforceable

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

7) Ethical Rulings are:

- I. explanations relating to broad hypothetical circumstances.
- II. not enforceable, but one must justify departure.
- III. explanations relating to specific factual circumstances.

- A) I and II
- B) I and III
- C) II and III
- D) I, II, and III

Answer: C

Terms: Ethical Rulings

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

8) The AICPA's Code of Professional Conduct requires independence for all:

- A) attestation engagements.
- B) services performed by accountants in public practice.
- C) accounting and auditing services performed.
- D) professional work performed by CPAs.

Answer: A

Terms: Independence

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

9) When a member observes the profession's technical and ethical standards and strives to continually improve her competence and quality of services, she is exercising:

- A) due care.
- B) integrity.
- C) independence.
- D) objectivity.

Answer: A

Terms: Independence

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

10) Four of the six Ethical Principles in the AICPA's *Code of Professional Conduct* are equally applicable to all members of the AICPA. Which of the following principles applies only to members in public practice?

- A) Scope and Nature of Services
- B) Integrity
- C) Due Care
- D) The Public Interest

Answer: A

Terms: Ethical Principles apply only to members in public practice

Diff: Challenging

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

11) The Code of Professional Conduct is established by the membership of the AICPA, and the Interpretations of the Rules of Conduct are prepared by the:

- A) Financial Accounting Standards Board.
- B) Securities and Exchange Commission.
- C) CPA licensing agencies within each state.
- D) Professional Ethics Executive Committee of the AICPA.

Answer: D

Terms: Code of Professional Conduct; Interpretations of Rules of Conduct

Diff: Challenging

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

12) Identify and describe each of the four parts to the AICPA's *Code of Professional Conduct*. Also discuss which parts are officially enforceable and which are not.

Answer: The four parts to the *Code* are:

- *Principles*. These establish ideal standards of ethical conduct stated in philosophical terms. They are not officially enforceable.
- *Rules of conduct*. These are the minimum standards of ethical conduct stated as explicit rules that must be followed by every CPA in the practice of public accounting. They are officially enforceable.
- *Interpretations*. Interpretations of rules are intended to clarify the rules of conduct when there are questions from practitioners about a specific rule. They are not officially enforceable, but a practitioner must justify any departure.
- *Ethical rulings*. These are explanations by the executive committee of the professional ethics division of specific factual circumstances. They are not enforceable, but a practitioner must justify any departure.

Terms: Four parts of AICPA Code of Professional Conduct

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

13) Briefly describe the advantages and disadvantages of a code of conduct based on general statements of ideal conduct as opposed to specific rules that define unacceptable behavior.

Answer:

	<u>Advantages</u>	<u>Disadvantages</u>
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General statements	Emphasis on positive activities encouraging a high level of performance.	Difficult to enforce.
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Specific rules	Enforceability of minimum behavior and performance standards.	Tendency for rules to be regarded as maximum rather than minimum standards.
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Terms: Code of conduct general statements vs. specific rules

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

14) What are the six Ethical Principles stated in the *Code of Professional Conduct*? Briefly discuss each principle. Are these principles enforceable?

Answer: The six Ethical Principles of the *Code of Professional Conduct* are:

1. *Responsibilities*. Members should exercise sensitive professional and moral judgments.
2. *The Public Interest*. Members should demonstrate commitment to professionalism by serving the public interest and honoring the public trust.
3. *Integrity*. Members should perform all professional responsibilities with the highest sense of integrity.
4. *Objectivity and Independence*. Members should maintain objectivity and remain free of conflicts of interest. A member in public practice should be independent in both fact and appearance when providing auditing and other attestation services.
5. *Due Care*. Members should observe the profession's technical and ethical standards, strive continually to improve competence and quality of services, and discharge professional responsibilities to the best of their ability.
6. *Scope and Nature of Services*. A member in public practice should observe the principles of the *Code of Professional Conduct* in determining the scope and nature of services to be provided.

The Ethical Principles are not enforceable.

Terms: Ethical Principles

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

15) An advantage of specific rules in the *Code of Professional Conduct* is the enforceability of minimum behavior and performance standards.

A) True

B) False

Answer: A

Terms: Code of Professional Conduct

Diff: Easy

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

16) The AICPA *Code of Professional Conduct* permits the auditor to perform a wide variety of non-audit services for audit clients.

A) True

B) False

Answer: B

Terms: Code of Professional Conduct

Diff: Easy

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

17) An advantage of the principles of professional conduct in the *Code of Professional Conduct* is that they are more easily enforced than are the specific rules of conduct.

A) True

B) False

Answer: B

Terms: Code of Professional Conduct

Diff: Easy

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

18) In the *AICPA Code of Professional Conduct*, ethical rulings are less specific than rules of conduct.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Ethical rulings

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

19) Interpretations of rules of conduct in the *Code of Professional Conduct* are not officially enforceable and practitioners need not justify departure from them.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Interpretation of rules

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

20) In the *AICPA Code of Professional Conduct*, interpretations of rules are more specific than ethical rulings.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Ethical rulings; Interpretations of rules

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

21) In the *AICPA Code of Professional Conduct*, the second principle of professional conduct, entitled "The Public Interest," applies only to members of the AICPA in public practice and not to members who work as accountants in business, government, or education.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Public Interest principle

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

22) In the *AICPA Code of Professional Conduct*, the sixth principle of professional conduct, entitled "Scope and Nature of Services," applies to members of the AICPA who work in public practice, business, government, or education.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Scope and nature of services principle

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

23) The *Conceptual Framework for AICPA Independence Standards* can be used when making decisions on ethical matters not explicitly addressed in the Code.

A) True

B) False

Answer: A

Terms: AICPA Code of Professional Conduct

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

24) Each state also has rules of conduct that are required for licensing by the state.

A) True

B) False

Answer: A

Terms: AICPA Code of Professional Conduct

Diff: Moderate

Objective: LO 5-4

AACSB: Ethical understanding and reasoning abilities

Learning Objective 5-5

1) For which of the following professional services must CPAs be independent?

- A) Management advisory services
- B) Audits of financial statements
- C) Preparation of tax returns
- D) All three of the above

Answer: B

Terms: Independence

Diff: Easy

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

2) "Independence" in auditing means:

- A) maintaining an indirect financial interest.
- B) not being financially dependent on a client.
- C) taking an unbiased viewpoint.
- D) being an advocate for a client.

Answer: C

Terms: Independence

Diff: Easy

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

3) When CPAs are able to maintain their actual independence, it is referred to as independence in:

- A) conduct.
- B) appearance.
- C) fact.
- D) total.

Answer: C

Terms: Independence

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

4) The Sarbanes-Oxley Act _____ a CPA firm from doing both bookkeeping and auditing services for the same public company client.

- A) encourages
- B) prohibits
- C) allows
- D) allows on a case-by-case basis

Answer: B

Terms: Sarbanes-Oxley; non-audit services

Diff: Easy

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

5) The Sarbanes-Oxley Act requires which employees of an accounting firm to rotate off the engagement every five years?

A)

In-Charge Auditor	Lead audit partner
Yes	Yes

B)

In-Charge Auditor	Lead audit partner
No	No

C)

In-Charge Auditor	Lead audit partner
Yes	No

D)

In-Charge Auditor	Lead audit partner
No	Yes

Answer: D

Terms: Sarbanes-Oxley Act; Partner rotation

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

Topic: SOX

6) Which of the following statements is true with respect to audit committees?

A) Audit committee members should consist of members of the company's management.

B) All members of the audit committee must be financial experts.

C) The audit committee of a public company is responsible for hiring the auditor.

D) Audit committees must have a minimum of ten members.

Answer: C

Terms: Audit committee

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

7) The provisions of the Sarbanes-Oxley Act of 2002 are most likely to allow which of the following non-audit services for audit clients?

A) Appraisal or valuation services (e.g., pension, post-employment benefit liabilities)

B) Financial information systems design and implementation

C) Internal audit outsourcing

D) Tax consulting

Answer: D

Terms: Sarbanes-Oxley Act of 2002; Allowed non-audit services

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

8) Which of the following services are allowed by the SEC whenever a CPA also audits the company?

- A) Internal audit outsourcing
- B) Legal services unrelated to the audit
- C) Appraisal or valuation services
- D) Services related to assessing the effectiveness of internal control over financial reporting

Answer: D

Terms: Services allowed by SEC when CPA audits company

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

9) Which of the following services is **not** prohibited by the SEC whenever a CPA also audits the company?

- A) Actuarial services
- B) Assisting the company in preparing certain SEC registration statements (e.g., 10-Q, 10-K)
- C) Investment banker services
- D) Bookkeeping services

Answer: B

Terms: Services allowed by SEC when CPA audits company

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

10) The members of a client's "audit committee" should be:

- A) members of management.
- B) directors who are not a part of company management.
- C) non-directors and non-managers.
- D) directors and managers.

Answer: B

Terms: Members of audit committee

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

11) The Sarbanes-Oxley Act requires a cooling off period of _____ before a member of an audit team can work for a client in a key management position?

- A) One year
- B) Eighteen months
- C) Three years
- D) Five years

Answer: A

Terms: Sarbanes-Oxley Act; Cooling off period

Diff: Easy

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

Topic: SOX

12) In determining independence with respect to any audit engagement, the ultimate decision as to whether or not the auditor is independent must be made by the:

- A) auditor.
- B) client.
- C) audit committee.
- D) public.

Answer: A

Terms: Auditor independence

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

13) A CPA firm should decline an offer to perform consulting services engagement if:

- A) the proposed engagement is not accounting-related.
- B) recommendations made by the CPA firm are to be subject to review by the client.
- C) acceptance would require the CPA firm to make management decisions for an audit client.
- D) any of the above is true.

Answer: C

Terms: CPA firm should decline to perform consulting services

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

14) Companies are required to disclose in their proxy statement or annual filings with the SEC the total amount of audit and non-audit fees paid to the audit firm for the two most recent years. Which of the following is **not** one of the categories of fees that must be disclosed?

- A) Tax fees
- B) Consulting fees
- C) Audit-related fees
- D) All other fees

Answer: B

Terms: Annual SEC filings; Audit and non-audit fees

Diff: Challenging

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

15) Interpretations of the *AICPA Code of Professional Conduct* are dominated by the concept of:

- A) independence.
- B) compliance with standards.
- C) accounting.
- D) acts discreditable to the profession.

Answer: A

Terms: Interpretations of AICPA Code of Professional Conduct dominated by

Diff: Challenging

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

16) A public company may obtain internal audit services from their financial statement auditor if it is approved by the company's audit committee.

A) True

B) False

Answer: B

Terms: Public company; Non-audit services purchased

Diff: Easy

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

Topic: SOX

17) The audit committee of a private company need not approve all non-audit services provided by the company's financial statement auditor.

A) True

B) False

Answer: A

Terms: Private company; Non-audit services purchased

Diff: Moderate

Objective: LO 5-5

AACSB: Ethical understanding and reasoning abilities

18) For a public company, the Sarbanes-Oxley Act requires audit committee approval of all non-audit services prior to their performance by the company's external auditor.

A) True

B) False

Answer: A

Terms: Sarbanes-Oxley Act; Audit committee

Diff: Moderate

Objective: LO 5-5

AACSB: Reflective thinking skills

Topic: SOX

Learning Objective 5-6

1) Interpretations of Independence Rule 101 prohibit covered members from owning any stock or other direct investment in audit clients. Covered members would include which of the following?

A)

All partners in the engagement office even if they have no engagement responsibility	Individuals on the attest engagement	The firm and its employee benefit plans
Yes	Yes	Yes

B)

All partners in the engagement office even if they have no engagement responsibility	Individuals on the attest engagement	The firm and its employee benefit plans
Yes	No	No

C)

All partners in the engagement office even if they have no engagement responsibility	Individuals on the attest engagement	The firm and its employee benefit plans
No	Yes	Yes

D)

All partners in the engagement office even if they have no engagement responsibility	Individuals on the attest engagement	The firm and its employee benefit plans
No	No	No

Answer: A

Terms: Independence Rule 101; Direct investment; Covered members

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

2) In some situations, the interpretations of the Rules of Conduct permit former partners to have relationships with a client of the firm without affecting the firm's independence. Which of the following situations would cause a loss of independence?

- A) The former partner works in the maintenance department of an audit client of his former firm.
- B) The former partner's grandson works in the warehouse of an audit client of his former firm.
- C) The former partner was held out as an associate of the firm.
- D) The former partner purchased 5% of the stock of an audit client of his former firm.

Answer: C

Terms: Independence ramifications on auditor and CPA firm

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

3) The financial interests of a CPA's family members can affect the CPA's independence. Which of the following parties would **not** be included as a "direct financial interest" of the CPA?

- A) Spouse
- B) Dependent child
- C) Relative supported by the CPA
- D) Sibling living in the same city as the CPA

Answer: D

Terms: Independence; Direct financial interest

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

4) Interpretations of the rules regarding independence allow an auditor to serve as:

- A) a director or officer of an audit client.
- B) an underwriter for the sale of a client's securities.
- C) a trustee of a client's pension fund.
- D) an honorary director for a not-for-profit charitable or religious organization.

Answer: D

Terms: Independence

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

5) Independence is required of a CPA when performing:

- A) external audits.
- B) all attestation services.
- C) all attestation and tax services.
- D) all professional services.

Answer: B

Terms: Independence

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

6) CPAs may provide bookkeeping services to their private company audit clients, but there are a number of conditions that must be met if the auditor is to maintain independence. Which of the following conditions is **not** necessary?

- A) The CPA must not assume a management role or function.
- B) The client must hire an external CPA to approve all of the journal entries prepared by the auditor.
- C) The auditor must comply with GAAS when auditing work prepared by his/her firm.
- D) The client must accept responsibility for the financial statements.

Answer: B

Terms: Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

7) An example of an "indirect ownership interest in a client" would be ownership of a client's stock by a member's:

- A) dependent child.
- B) spouse.
- C) non-dependent grandfather.
- D) All of the above are examples of indirect ownership.

Answer: C

Terms: Indirect ownership interest in a client

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

8) When determining whether independence is impaired because of an ownership interest in a client company, materiality will affect ownership:

- A) in all circumstances.
- B) only for direct ownership.
- C) only for indirect ownership.
- D) under no circumstances.

Answer: C

Terms: Independence; Materiality

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 9) A direct financial interest violates independence in which of the following circumstances?
- A) When close relatives such as nondependent children, brothers, and sisters have a significant financial interest in the client
 - B) When close relatives such as nondependent children, brothers, and sisters have any financial interest in the client
 - C) When the CPA owns shares in a mutual fund that has an ownership interest in the client
 - D) When close relatives such as brother, sister, or in-laws are employed by the client

Answer: A

Terms: Direct financial interest, independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

10) A CPA sole practitioner purchased stock in a client corporation and placed it in a trust as an educational fund for the CPA's minor child. The trust securities were not material to the CPA but were material to the child's personal net worth. Would the independence of the CPA be considered to be impaired with respect to the client?

- A) Yes, because the stock is a direct financial interest
- B) Yes, because the stock is an indirect financial interest that is material to the CPA's child
- C) No, because the CPA does not have a direct financial interest in the client
- D) No, because the CPA does not have a material indirect financial interest in the client

Answer: A

Terms: Financial interest and independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

11) Julie and Lisa are sisters. Julie is a CPA auditing the company where Lisa works. Julie's independence is impaired if:

- A) Lisa is the controller.
- B) Lisa owns 25% of the company.
- C) Lisa is the marketing manager.
- D) all of the above.

Answer: A

Terms: Financial interest and independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

12) Oehlers, CPA, is a staff auditor participating in the engagement of Capital Trust, Inc. Which of the following circumstances impairs Oehlers independence?

- A) Oehlers' sister is an internal auditor employed by Capital Trust.
- B) Oehlers' friend, and employee of another local accounting firm, prepares the tax return of Capital Trust's CEO.
- C) Oehlers and Capital Trust's 401K plan own stock with the same corporation.
- D) During the period of professional engagement, Capital Trust and Oehlers discussed business over lunch at a first-class restaurant.

Answer: A

Terms: Financial interest and independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

13) An auditor's independence is considered impaired if the auditor has:

- A) an immaterial, indirect financial interest in a client.
- B) an outstanding \$8,000 balance on a credit card issued by a client.
- C) an automobile loan from a client bank, collateralized by the automobile.
- D) a joint, closely held business investment with the client that is material to the auditor's net worth.

Answer: D

Terms: Financial interest and independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

14) According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?

- A) The auditor's checking account, which is fully insured by a federal agency, is held at a client financial institution.
- B) The auditor is also an attorney who advises the client as its general counsel.
- C) An employee of the auditor serves as treasurer of a charitable organization that is a client.
- D) The client owes the auditor fees for two consecutive annual audits.

Answer: A

Terms: Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

15) Which of the following loans would be prohibited between a CPA firm or its members and an audit client?

- A) Automobile loans
- B) Loans fully collateralized by cash deposits at the same financial institution
- C) New home mortgage loans
- D) Unpaid credit card balances not exceeding \$10,000 in total

Answer: C

Terms: Independence; Loan exceptions

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

16) Under the AICPA independence rules, the auditor:

- A) is prohibited from performing a company's audit and installing and designing the client's new information system.
- B) does not need to document the understanding and willingness of the client to perform all management functions associated with the nonaudit service.
- C) is prohibited from doing any bookkeeping services for the client if performing the audit.
- D) must follow the more restrictive SEC independence rules when dealing with a public company.

Answer: D

Terms: Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

17) The Code of Conduct rule on independence indicates that materiality must be considered when:

A)

Evaluating direct investments made by the CPA	Evaluating indirect ownership investments
Yes	Yes

B)

Evaluating direct investments made by the CPA	Evaluating indirect ownership investments
No	No

C)

Evaluating direct investments made by the CPA	Evaluating indirect ownership investments
Yes	No

D)

Evaluating direct investments made by the CPA	Evaluating indirect ownership investments
No	Yes

Answer: D

Terms: Independence; Direct and indirect ownership investments

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

18) Which of the following instances would impair a CPA's independence when they have been retained as the auditor?

I. A charitable organization where the CPA serves as treasurer

II. A municipality where the CPA owns \$250,000 of the \$25 million outstanding bonds of the municipality

III. A company that the CPA's investment club owns a 10% investment interest

A) I and II

B) I and III

C) II and III

D) I, II, and III

Answer: D

Terms: Impair independence

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 19) Under the AICPA independence rules, independence can be considered impaired when:
- A) billed fees remain unpaid for professional services for more than ninety days.
 - B) a client in bankruptcy has unpaid fees for more than one year.
 - C) there is litigation by the client related to the auditor's tax or other nonaudit services.
 - D) when there is a lawsuit by the client claiming deficiencies in the previous year's audit.

Answer: D

Terms: Independence ramifications on auditor and CPA firm

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 20) Which of the following is **least** likely to impair a **CPA firm's** independence with respect to an audit client in the Oklahoma City office of a national CPA firm?

- A) A partner in the Oklahoma City office owns an immaterial amount of stock in the client.
- B) A partner in the Jersey City office owns 25% of the client's stock.
- C) A partner in the Oklahoma City office, who does not work on the audit engagement, previously served as controller for the audit client.
- D) A partner in the Chicago office previously served as vice president of finance for the audit client.

Answer: D

Terms: Independence

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 21) A CPA's financial interests in nonclients may have an effect on independence if the nonclients are investors in or investees of the client. Which situation would **not** impair a CPA's independence?

- A) The client has an immaterial investment in a nonclient investee in which the CPA has an immaterial investment.
- B) The CPA has a material indirect financial interest in a nonclient in which the client has a material investment.
- C) The client investor has a nonmaterial investment in the nonclient investee in which the CPA has a material investment.
- D) The CPA has a joint closely held investment with the client in a nonclient that is material to the client as well as the CPA.

Answer: A

Terms: Impair CPA independence

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 22) Which of the following statements is true? The CPA firm will lose its independence if:
- A) a staff auditor providing audit services to the client acquires stock in that client.
 - B) a staff tax preparer who provides 15 hours of non-audit services to the client acquires stock in that client.
 - C) an audit manager in an office different than the office providing audit services has a direct, immaterial financial interest in the audit client.
 - D) a covered member has an indirect, immaterial financial interest in an audit client.

Answer: A

Terms: Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 23) Interpretations to the Rules of Conduct permit a CPA firm to do both bookkeeping and auditing for the same private company client if three criteria are met. Which of the following is **not** one of those criteria?

- A) The client must accept full responsibility for the financial statements.
- B) The client is required to file an annual report, including audited financial statements, with the Securities and Exchange Commission.
- C) The CPA must not assume the role of employee or of manager.
- D) The CPA must follow applicable auditing standards.

Answer: B

Terms: Services allowed by SEC when CPA audits company

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

- 24) Which of the following circumstances impairs an auditor's independence?

- I. Litigation by a client against an audit firm claiming a deficiency in the previous audit
 - II. Litigation by a client against an audit firm related to tax services
 - III. Litigation by an audit firm against a client claiming management fraud or deceit
- A) I and II
 - B) I and III
 - C) II and III
 - D) I, II, and III

Answer: B

Terms: Impair auditor independence

Diff: Challenging

Objective: LO 5-6

AACSB: Reflective thinking skills

25) Which of the following circumstances impairs an auditor's independence?

- I. Litigation by a client against an audit firm claiming a deficiency in the previous audit
- II. Litigation by a client against an audit firm related to tax services
- III. Litigation by an audit firm against a client claiming management fraud or deceit

A) I and II

B) I and III

C) II and III

D) I, II, and III

Answer: B

Terms: Impair auditor independence

Diff: Challenging

Objective: LO 5-6

AACSB: Reflective thinking skills

26) Each of the following situations involves a possible violation of the rule on independence. For each situation, (1) decide whether the *Code of Professional Conduct* has been violated, and (2) briefly explain how the situation violates (or does not violate) the *Code of Professional Conduct*.

a. Harry Brown is a partner in the Topeka office of Hedley & Co., CPAs. Harry's brother is employed in an audit-sensitive position by Jensen Appliances, a publicly held company in Kansas. Jensen Appliances is one of Hedley & Co.'s audit clients. Neither Harry nor personnel from the Topeka office is involved in the audit of Jensen.

Violation? Yes No

Explanation:

b. John Woods is an audit manager with Calden & Co., CPAs, a one-office CPA firm. John owns 100 shares of common stock in one of the firm's audit clients, but he does not provide any audit or non-audit services to the company.

Violation? Yes No

Explanation:

c. The accounting firm of Fine & Herman, CPAs, provides bookkeeping and tax services for Henderson Corporation, a privately held company. Fine & Herman also performs the annual audit of Henderson Corporation.

Violation? Yes No

Explanation:

d. Bob Shelton CPA, is the auditor of Cafe Ecko. A couple of weeks ago, Cafe Ecko's management commenced litigation against Bob, alleging he was negligent in last year's audit.

Violation? Yes No

Explanation:

e. Hamilton Appliance has not paid Karen Linwood, CPA, her audit fee for the past two years. Karen is starting work on the current year's audit of Hamilton.

Violation? Yes No

Explanation:

Answer:

a. No violation. Although partners in a CPA firm are not allowed to have close relatives employed in a position of significant influence by a client, it is acceptable to have a close relative employed in an audit-sensitive position (with no significant influence), as long as the partner does not participate in the engagement and is not in an office that participates on the engagement.

b. No violation. John is not a covered member with respect to the audit client as he has no responsibility for the engagement and is not in a position to influence the engagement.

c. No violation. The AICPA does not prohibit CPA firms from providing bookkeeping, tax, and audit services to the same non-public client.

d. Violation. When there is a lawsuit or intent to start a lawsuit between a CPA and an audit client's management related to audit services, independence is impaired.

e. Violation. Independence is impaired if fees remain unpaid for services provided more than one year prior to the date of the report.

Terms: Violation of rule on independence; AICPA Code of Professional Conduct

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

27) Don Crosby, a partner in a national CPA firm, has just learned that his self sufficient daughter has accepted a position as the CFO of Sunglasses, Inc., a current client within the office with which he is employed. Explain the independence ramifications on 1) Don's independence, 2) his office, and 3) the firm's independence.

Answer:

1. Don's non-dependent daughter is considered a close relative. Because she has a key position for the client, Don's independence is impaired.

2. Because Don is considered a covered member any office in which he is employed cannot be independent.

3. The firm will not be considered independent. However, the firm can maintain its independence if they either move:

a. Don to an office that does not participate on the engagement or

b. the audit engagement to an office in which Don is not employed.

Terms: Independence ramifications on auditor and CPA firm

Diff: Challenging

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

28) Rule 101, Independence, prohibits a CPA from performing both audit services and bookkeeping services for the same public company in the same year.

A) True

B) False

Answer: A

Terms: Rule 101, Independence

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

29) Under Rule 101, Independence, independence is considered to be impaired if fees remain unpaid for professional services provided more than six months before the date of the current year's report.

A) True

B) False

Answer: B

Terms: Rule 101, Independence

Diff: Easy

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

30) Auditors are allowed to have an indirect financial interest in an audit client, such as ownership of stock in a client's company by the auditor's brother, as long as the amount of the financial interest is immaterial to the brother.

A) True

B) False

Answer: A

Terms: Indirect financial interest; Immaterial

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

31) Rule 101, Independence, applies to members of the AICPA when performing any professional service.

A) True

B) False

Answer: B

Terms: Rule 101, Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

32) Rule 101, Independence, applies to covered members in a position to influence an attest engagement.

A) True

B) False

Answer: A

Terms: Rule 101, Independence

Diff: Moderate

Objective: LO 5-6

AACSB: Ethical understanding and reasoning abilities

Learning Objective 5-7

1) The CPA must not subordinate his or her professional judgment to that of others in any:

- A) engagement.
- B) audit engagement.
- C) engagement excluding tax services.
- D) engagement where the opinion of a specialist is used.

Answer: A

Terms: CPA subordinate professional judgment

Diff: Easy

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

2) Which of the following would be a violation of the rule requiring "objectivity" by the CPA?

- I. The auditor accepts management's opinion regarding the collection of accounts receivable without an independent evaluation.
 - II. In preparing a client's tax return, the CPA encourages a client to take a deduction for which there is no support.
- A) I only
 - B) II only
 - C) I and II
 - D) Neither I nor II

Answer: C

Terms: Violation of rule requiring CPA objectivity

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

3) Several months after an unqualified audit report was issued, the auditor discovers the financial statements were materially misstated. The client's CEO agrees that there are misstatements, but refuses to correct them. She claims that "confidentiality" prevents the CPA from informing anyone. Which of the following statements is correct?

- A) The CEO is correct and the auditor must maintain confidentiality.
- B) The CEO is incorrect, but since the audit report has been issued, it is too late to correct the report.
- C) The CEO is correct, but to be ethically correct, the auditor should violate the confidentiality rule and disclose the error.
- D) The CEO is incorrect, and the auditor has an obligation to issue a revised audit report, even if the CEO will not correct the financial statements.

Answer: D

Terms: Confidentiality on audit

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

- 4) A CPA firm may charge a contingent fee for:
- A) an audit.
 - B) consulting services for a client for which they do not perform any attestation services.
 - C) the preparation of an original tax return for a client for which they do not perform any attestation services.
 - D) the preparation of an amended tax return.

Answer: B

Terms: Contingent fees

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

- 5) A member in public practice shall neither receive from, nor pay to, a client a commission when the member or member's firm also performs certain services for that client. Are commissions allowed if the CPA performs:

A)

A compilation that will be used by a third party	An audit of prospective financial information
Yes	Yes

B)

A compilation that will be used by a third party	An audit of prospective financial information
No	No

C)

A compilation that will be used by a third party	An audit of prospective financial information
Yes	No

D)

A compilation that will be used by a third party	An audit of prospective financial information
No	Yes

Answer: B

Terms: Commissions

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

6) The AICPA's Code of Professional Conduct states that a CPA should maintain integrity and objectivity. The term "objectivity" in the Code refers to a CPA's ability to:

- A) choose independently between alternate accounting principles and auditing standards.
- B) distinguish between accounting practices that are acceptable and those that are not.
- C) be unyielding in all matters dealing with auditing procedures.
- D) maintain an impartial attitude on matters that come under the CPA's review.

Answer: D

Terms: AICPA Code of Professional Conduct; Objectivity

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

7) Which of the following is required for a firm to designate itself "Member of the American Institute of Certified Public Accountants" on its letterhead?

- A) At least one of the partners must be a member of the AICPA.
- B) All partners must be members of the AICPA.
- C) The partners whose names appear in the firm name must be members of the AICPA.
- D) A majority of the partners must be members of the AICPA.

Answer: B

Terms: Members of the AICPA requirements

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

8) CPAs are prohibited from which of the following forms of advertising?

- A) Self-laudatory advertising
- B) Celebrity endorsement advertising
- C) Use of trade names, such as "Awesome Auditors"
- D) Use of phrases, such as "Guaranteed largest tax refunds in town!"

Answer: D

Terms: Prohibited forms of advertising

Diff: Challenging

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

9) Which of the following would be considered a violation of the AICPA Code of Conduct?

- A) The CPA makes the audit files available to the client's bank without the permission of the client.
- B) The CPA firm charges a contingent fee for nonattestation services to a client for whom he does not perform any attestation services.
- C) The CPA firm takes a prospective client to lunch to discuss auditing services.
- D) A CPA firm uses the name San Diego Tax Specialists.

Answer: A

Terms: Code of ethics

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

10) Rule 301 of the AICPA's Code of Professional Conduct requires CPAs to maintain the confidentiality of client information. This rule would be violated if a CPA disclosed information without a client's consent as a result of a:

- A) subpoena or summons.
- B) peer review.
- C) complaint filed with the trial board of the Institute.
- D) request by a client's largest stockholder.

Answer: D

Terms: Confidentiality

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

11) Which one of the following statements is false?

- A) Confidentiality is broken when an auditor is presented with a subpoena concerning an audit client.
- B) Information that a CPA obtains from a client is generally not privileged.
- C) When a CPA firm conducts an AICPA-authorized peer review of the quality controls of another CPA firm, permission of the client is not needed to examine audit documentation.
- D) A CPA firm which observes substandard audit documentation of another firm during a peer review can initiate a complaint to the AICPA.

Answer: A

Terms: Confidentiality

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

12) A CPA firm:

- A) can sell securities to a client for whom they perform an attestation service.
- B) can receive a commission for a client that they are engaged to perform an attestation service for.
- C) cannot receive a referral fee for recommending the services of another CPA.
- D) can receive a commission from a nonattestation client as long as the situation is disclosed.

Answer: D

Terms: Rule 503, Commissions and Referral Fees

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

13) Which of the following represents all of the ways a CPA firm can be organized under Rule 505?

- A) Proprietorships and partnerships
- B) Proprietorships, partnerships, and professional corporations
- C) Proprietorships, general partnerships, general corporations, professional corporations, limited liability companies, and limited liability partnerships if permitted by state law
- D) Single proprietorships, partnerships, professional corporations if permitted by state law, or regular corporations

Answer: C

Terms: Rule 505, AICPA Code of Professional Conduct; CPA firm form of organization

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

14) In which of the following circumstances would a CPA be ethically bound to refrain from disclosing any confidential client information?

- A) The CPA is issued a summons enforceable by a court order which orders the CPA to present confidential information.
- B) A major stockholder of a client company seeks accounting information from the CPA after management declined to disclose the requested information.
- C) Confidential client information is made available as part of a quality review of the CPA's practice by a peer review team authorized by the AICPA.
- D) An inquiry by a disciplinary body of a state CPA society requests confidential client information.

Answer: B

Terms: Confidential client information

Diff: Moderate

Objective: LO 5-7

AACSB: Ethical understanding and reasoning abilities

15) Which of the following fee arrangements is **not** a violation of the AICPA's Code of Professional Conduct?

- A) Basing fees as an expert witness on the amount awarded to the plaintiff, even though the CPA performs a compilation for client use
- B) Basing consulting fees on a percentage of a bond issue, even though the CPA performs a review of the client's financial statements
- C) Basing fees for a tax service on the amount of the refund that the client will receive
- D) Basing consulting fees on a percentage of a bond issue, even though the CPA performs an audit of the client's financial statements

Answer: A

Terms: Fee arrangements not a violation of AICPA Code of Professional Conduct

Diff: Challenging

Objective: LO 5-7

AACSB: Reflective thinking skills

16) Which of the following is **not** defined as an act discreditable in either the Rules or the Interpretations of the AICPA's Code of Professional Conduct?

- A) The CPA firm's partner in charge failed to file his tax return for the past year.
- B) The CPA firm discriminates in its hiring practices based on the age of the applicant.
- C) The CPA retains the client's books and records to enforce past-due payment of the CPA's bill, even after the client has demanded they be returned.
- D) The CPA firm's partner-in-charge was a passenger in a car driven by his wife. On the way home from the firm's Christmas party, she was charged with "driving while intoxicated."

Answer: D

Terms: Act discreditable

Diff: Challenging

Objective: LO 5-7

AACSB: Reflective thinking skills

17) Freedom from _____ means the absence of relationships that might interfere with objectivity or integrity.

- A) independence.
- B) acts discreditable.
- C) impartiality.
- D) conflicts of interest.

Answer: D

Terms: Conflicts of interest

Diff: Moderate

Objective: LO 5-7

AACSB: Analytic skills

18) Rule 201 - General Standards requires members to comply with certain standards and interpretations. Which of the following is **not** a standard specifically addressed in Rule 201?

- A) Professional integrity
- B) Due professional care
- C) Planning and supervision
- D) Sufficient relevant data

Answer: A

Terms: Rule 201, General Standards

Diff: Challenging

Objective: LO 5-7

AACSB: Reflective thinking skills

19) Which of the following activities is allowed for a CPA firm's attestation clients?

- A) Contingent fees fixed by a court
- B) Commissions for referring a review client to an insurance agency for insurance coverage
- C) Preparation of tax returns for which fees are based upon client refunds
- D) Each of the above is allowed.

Answer: A

Terms: Activities allowed for CPA firm's attestation clients

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

20) Discuss Rule 301–Confidential Client Information, including the four exceptions to the rule.

Answer: Rule 301 prohibits a member from disclosing any confidential client information without the specific consent from the client. However, there are four conditions when client permission is not required:

- Obligations related to technical standards; i.e., when Rule 202 or Rule 203 requires the disclosure.
- In response to a valid subpoena or summons and compliance with laws and regulations.
- A peer review is being conducted under AICPA, state CPA Society, or State Board of Accountancy authorization.
- The CPA is initiating or responding to an inquiry from a recognized investigative body or the professional ethics division.

Terms: Rule 301, Confidential Client Information and exceptions

Diff: Challenging

Objective: LO 5-7

AACSB: Reflective thinking skills

21) The following situations involve a possible violation of the AICPA's *Code of Professional Conduct*. For each situation, (1) determine the applicable rule from the *Code*, (2) decide whether or not the *Code* has been violated, and (3) briefly explain how the situation violates (or does not violate) the *Code*.

a. In 2013, Freeman and Johnson, both CPAs, decided to form a CPA practice. In 2015, Freeman and Johnson approached Bill Delaney, a physician and medical expert, and asked him to assist them with their growing medical consulting practice. Delaney agreed, but only after he was given an ownership interest in the firm. Delaney does not intend to quit his private medical practice.

Rule: _____ Violation? Yes No
Explanation:

b. Brian DePalie has a successful dentistry practice in Charleston. Brian has recommended one of his patients to Katie Walton, CPA. To show gratitude for the referral, Katie has agreed to pay Brian a token gift of \$50. Katie discloses the payment arrangement to her new clients.

Rule: _____ Violation? Yes No
Explanation:

c. The accounting firm of Bayer & Peng, CPAs, is negotiating a fee with a new audit client. They agree the client will pay \$50,000 if Bayer & Peng issues a clean, unqualified opinion, \$40,000 if a qualified opinion is issued, and only \$20,000 if an adverse opinion is issued.

Rule: _____ Violation? Yes No
Explanation:

d. Don Smith, CPA, is a member of the engagement team that performs the audit of Shaw Corporation. Don's five-year-old daughter, Precious, received ten shares of Shaw Corporation's common stock for her fifth birthday. The stock was a gift from Precious's grandmother.

Rule: _____ Violation? Yes No
Explanation:

e. Jennifer Harris, CPA, is a partner in the CPA firm that audits Alltech, Inc., a closely held corporation. Jennifer's sister-in-law is the chief financial officer at Alltech, Inc.

Rule: _____ Violation? Yes No
Explanation:
Answer:

a. Violation of the rule on Form of Organization and Name (Rule 505). Non-CPA ownership of firms is allowable, however, non-CPA owners must actively provide services to the firm's clients as their principal occupation.

b. No violation of the Commissions and Referral Fees rule (Rule 503). A CPA may pay a referral fee to a non-CPA as long as the payment is disclosed to the client.

c. Violation of the Contingent Fees rule (Rule 302). This is a contingent fee agreement and is prohibited by Rule 302.

d. Violation of the Independence rule (Rule 101). Don is a covered member for purposes of Rule 101. Because his daughter is a dependent, her ownership interest in Shaw is treated as a direct financial interest of her father.

e. No violation of the Independence rule (Rule 101). According to the *Code* a close relative is defined as a parent, sibling, or nondependent child. Thus, a sister-in-law is not considered to be a close relative.

Terms: Violations of Rules of AICPA Code of Professional Conduct

Diff: Challenging

Objective: LO 5-5, LO 5-6 and LO 5-7

AACSB: Analytic skills

22) The following situations involve a possible violation of the AICPA's *Code of Professional Conduct*. For each situation, (1) determine the applicable rule from the *Code*, (2) decide whether or not the *Code* has been violated, and (3) briefly explain how the situation violates (or does not violate) the *Code*.

a. Howard Cunningham & Co., CPAs, designates its firm as "Members of the American Institute of Certified Public Accountants." All of the partners of the firm are CPAs. However, one of the partners has recently chosen to allow her membership to lapse because of personal reasons.

Rule: _____ Violation? Yes No

Explanation:

b. Brad Long, CPA, was traveling from Orlando to Miami, Florida when he was pulled over by a police officer on suspicion of driving under the influence. He was convicted in court of driving while under the influence of alcohol. Because of past convictions, Brad was sentenced to 5 years in prison.

Rule: _____ Violation? Yes No

Explanation:

c. Kelley Brent, CPA, is a partner in a one-office CPA firm that audits Dane, Inc., a closely held corporation. Kelley's sister was recently appointed as the chief financial officer for Dane, Inc.

Rule: _____ Violation? Yes No

Explanation:

d. Sarah Martin, CPA, is a senior auditor in the San Francisco office of Cooper & Howell, CPAs. Sarah's father is employed as the controller of Line Electronics, a public company in Detroit, Michigan. Line Electronics is one of the firm's audit clients. Neither Sarah nor the San Francisco office is involved in the audit of Line Electronics.

Rule: _____ Violation? Yes No

Explanation:

e. On August 20, 20x6, Hank Anderson, CPA and partner, was offered and accepted the engagement to audit the annual financial statements of Jernigan Corporation for the year ended December 31, 20x6. Preliminary work began on the audit on September 15, 20x6 and the engagement ended on March 7, 20x7. Jernigan is regulated by the SEC. Hank served as controller of Jernigan Corporation from December 1, 20x2, until April 10, 20x6, at which time he terminated his employment with Jernigan.

Rule: _____ Violation? Yes No

Explanation:

Answer:

a. Violation of the Form of Organization and Name rule (Rule 505). A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless *all* of its owners are members of the Institute.

b. Violation of the Acts Discreditable rule (Rule 501). Felonies are considered acts discreditable.

c. Violation of the Independence rule (Rule 101). According to the *Code*, Kelly's sister is a "close relative" and she occupies a key position at an audit client. Because Kelly is a partner in the office that provides the audit services to Dane, the firm is not independent.

d. No violation of the Independence rule (Rule 101). While Sarah's father occupies a key position with an audit client of the firm, there is no independence violation as long as Sarah is not a member of the engagement team. The firm may provide the audit services.

e. Violation of the Independence rule (Rule 101). Since Hank had an employment relationship with the client during part of the period covered by the financial statements, his independence is impaired.

Terms: Violations of Rules of AICPA Code of Professional Conduct

Diff: Challenging

Objective: LO 5-5, LO 5-6 and LO 5-7

AACSB: Analytic skills

23) The scenarios below all involve a possible violation of the AICPA's *Cod of Professional Conduct*.

1. Using the list below, indicate which of the *Code of Conduct* Rules applies to the scenario.

- a. 101: Independence
- b. 102: Integrity and Objectivity
- c. 302: Contingent Fees
- d. 501: Acts Discreditable
- e. 503: Commissions and Referral Fees
- f. 505: Form of Organization and Name

2. State if the scenario is a violation of the *Code*.

Scenario:

1. Margaret Henry is a partner in the Tupelo office of Jenkins & Thorn, CPAs. Margaret's father is the controller at Markrich Sporting Supplies, Inc., a publicly held company in Tupelo. Markrich is one of Jenkins & Thorn's audit clients. Margaret is not involved in the audit of Markrich.

2. Jason Alexander is an audit manager with Reese & Co., CPAs. Jason owns 100 share of common stock in one of the firm's audit clients, but he does not provide any audit or non-audit services to the company.

3. The accounting firm of Fine & Herman, CPAs, provides bookkeeping and tax services for Henderson Corporation, a privately held company. Mr. Herman also performs the annual audit of Henderson Corporation.

4. Elaine Cooper CPA, is the auditor of Paula's Pizza. Toward the end of the audit, Paula gave Elaine her estimate of receivable collectability and Elaine accepted it without any testing.

5. Charley Ray, CPA, is a member of the engagement team that performs the audit of Desiree Corporation. Charley's five-year-old daughter, Becky, received ten shares of Desiree common stock for her fifth birthday in a trust fund established by Becky's grandmother.

6. Freeman and Johnson formed a successful CPA practice ten years ago. In the current year, they approached Adam Sawtooth, a surgeon and medical expert, and asked him to assist them with their growing medical consulting practice. Sawtooth agreed, but only after he was given an ownership interest in the firm. Sawtooth does intend to reduce his private practice hours and spend 40% of his working hours devoted to the Freeman & Johnson practice.

7. Sally Preen has a successful computer network consulting business. Sally has recommended one of her clients to Sam Walton, CPA. To show gratitude for the referral, Sam has agreed to pay Sally a token gift of \$50. Sam has not disclosed the payment arrangement to his ne clients.

8. The accounting firm of Smith & Black, CPAs, is negotiating a fee with a new audit client where the client will pay \$50,000 if the client obtains the line of credit needed for working capital purposes. Otherwise, the fee will be \$40,000.

9. Brad Barns, CPA, was traveling from Las Vegas to the Grand Canyon when he was pulled

over by a police officer for suspicion of driving under the influence. He was convicted in court of driving under the influence of alcohol and received six months probation.

10. Manuel Lopez, CPA, is a senior in a small, local, CPA firm that audits Childress, Inc., a closely held corporation. Manuel's sister was recently appointed as the controller for Childress, Inc.

Answer:

Part 1: 1. a 6. f
 2. a 7. e
 3. a 8. c
 4. b 9. d
 5. a 10. a

Part 2: 1. Yes 6. Yes
 2. No 7. Yes
 3. No 8. Yes
 4. Yes 9. No
 5. Yes 10. Yes

Terms: AICPA Code of Professional Conduct; Ethical rulings; Interpretations of rules

Diff: Challenging

Objective: LO 5-5, LO 5-6 and LO 5-7

AACSB: Ethical understanding and reasoning abilities

24) Imprisonment for a period of six months or longer will result in automatic expulsion from the AICPA.

A) True

B) False

Answer: B

Terms: Imprisonment; Expulsion

Diff: Easy

Objective: LO 5-7

AACSB: Reflective thinking skills

25) Rule 505, Form of Organization and Name, prohibits CPA firms from practicing as limited liability partnerships.

A) True

B) False

Answer: B

Terms: Rule 505, Form of Organization and Name

Diff: Easy

Objective: LO 5-7

AACSB: Reflective thinking skills

26) Under Rule 505, Form of Organization and Name, a CPA firm may use any name as long as it is not misleading.

A) True

B) False

Answer: A

Terms: Rule 505, Form of Organization and Name

Diff: Easy

Objective: LO 5-7

AACSB: Reflective thinking skills

27) A CPA firm may practice public accounting only in a form of organization permitted by federal law or regulation.

A) True

B) False

Answer: B

Terms: Form of Organization

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

28) Under Rule 301, Confidential Client Information, permission is not required from the client to use the audit documentation relating to that client during an AICPA-authorized peer review program with another CPA firm.

A) True

B) False

Answer: A

Terms: Rule 301, Confidential Client Information

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

29) Information obtained by a CPA from a client is legally privileged in federal court.

A) True

B) False

Answer: B

Terms: Legally privileged information

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

30) Rule 502, Advertising and Other Forms of Solicitation, prohibits members of the AICPA in public practice from performing comparative advertising.

A) True

B) False

Answer: B

Terms: Rule 502, Advertising and Other Forms of Solicitation

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

31) Under Rule 505, Form of Organization and Name, a CPA firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless a majority of its owners are members of the Institute.

A) True

B) False

Answer: B

Terms: Rule 505, Form of Organization and Name

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

32) Under the AICPA's Code of Professional Conduct, CPAs are prohibited from offering audit clients a discount for referring a prospective client even if they are disclosed.

A) True

B) False

Answer: B

Terms: AICPA Code of Professional Conduct; Offer audit clients a discount

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

33) All owners of a CPA firm must be CPAs who are qualified to practice.

A) True

B) False

Answer: B

Terms: CPA qualified to practice

Diff: Moderate

Objective: LO 5-7

AACSB: Reflective thinking skills

Learning Objective 5-8

1) If the board of accountancy in the state in which a CPA firm is licensed has rules that are different than the AICPA's rules, the CPA firm must follow:

- A) whichever rules are less restrictive.
- B) whichever rules are more restrictive.
- C) the rules of the AICPA.
- D) the rules of the state's board of accountancy.

Answer: B

Terms: State rules which differ from AICPA rules

Diff: Moderate

Objective: LO 5-8

AACSB: Reflective thinking skills

2) Describe the methods used by the AICPA and State Boards of Accountancy to enforce the rules of conduct.

Answer: The AICPA uses two levels of disciplinary action. For less serious, and probably unintentional violations of Rules of Conduct, the division limits the discipline to a requirement of remedial or corrective action. For more serious violations, the level of disciplinary action goes before the Joint Trial Board. The violator may be suspended or expelled from membership in the AICPA.

Violation of a State Boards' rules of conduct is punishable by loss of the violator's CPA certificate and license to practice.

Terms: Methods to enforce the rules conduct

Diff: Moderate

Objective: LO 5-8

AACSB: Reflective thinking skills

3) Expulsion from the AICPA for failing to follow the rules of conduct is, by itself, sufficient to prevent a CPA from practicing public accounting.

A) True

B) False

Answer: B

Terms: Expulsion from AICPA for failing to follow rules of conduct

Diff: Moderate

Objective: LO 5-8

AACSB: Reflective thinking skills