Chapter Six

The Rules of the Code of Conduct

After presenting the principles, the AICPA Professional Code of Conduct examines the rules that govern those principles. The code states, "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."[1] These rules are formally applicable only to members of the AICPA and people under members' control. If members violate the rules, they are subject to disciplining by the AICPA. Thus, it is necessary to review these rules to understand the AICPA's expectations regarding accountants' behavior.

The code breaks down the rules into five sections, as follows:

- Section 100 – Independence, Integrity, and Objectivity
- Section 200 – General Standards Accounting Principles
- Section 300 – Responsibilities to Clients
- Section 400 – Responsibilities to Colleagues
- Section 500 – Other Responsibilities and Practices

In most cases, the rule in each of the five sections is followed by interpretations of that rule, which address the acceptability of specific types of activities. Finally, under each of the sections, there are numerous specific ethics rulings. Over the years, as it has evolved, there have been many deletions and revisions to the code.

This chapter examines the rules of the AICPA code.[2]

[1] AICPA Code of Professional Conduct, Section 91.01.
[2] To examine the rules of the AICPA in full, go to www.aicpa.org.

Accounting Ethics, Second Edition. Ronald Duska, Brenda Shay Duska, and Julie Ragatz.

I Section 100 – Independence, Integrity, and Objectivity

Rule 101 – Independence

This rule, which governs independence, reads, "A member in public practice shall be independent in the performance of professional services as required by standards promulgated by bodies designated by Council."[3]

Under the interpretation of Rule 101, the code specifies what bodies a member should consult:

> 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.[4]

There is not time to examine all of these different standards. Therefore, we will focus on what Section 100 says about independence. In general, what does independence require?

The interpretation in the code does not specify what constitutes independence. Rather, it cites the threats to independence. Independence is considered to be impaired if the following transactions, interests, or relationships occur:

A During the period of a 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. …
   (3) Had a joint, closely held investment that was material to the covered member.

[3,4] AICPA Code of Professional Conduct, Section 101.01.

(4) ... had any loan to or from the client, any officer or director of the client, or any individual owning 10 percent or more the client's outstanding equity securities or other ownership interests.

B During the period of the professional engagement, a partner or professional employee of the firm, his of 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.[5]

Not only can any of the above entanglements compromise an accountant's independence, but they can also jeopardize the accountant's integrity and objectivity by creating a real or perceived conflict of interest, a subject covered in the next rule.

Rule 102 – Integrity and objectivity

Rule 102 is a powerful governing rule in accounting ethics: "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."[6]

We have already discussed integrity at length in the previous chapter on code principles. But what about objectivity? Code principles impose the obligation on the accountant to be impartial, intellectually honest, and free of conflicts of interest. Objectivity, then, is the ability to stand back as a third-party observer, to set aside personal interests and appraise an issue on its own merits. Intellectual honesty requires looking at a situation from all possible perspectives.

Ethical theory gives us various ways to achieve objectivity – for example, Kant's universalizability principle, which asks, What if everyone did this? But the most common way in ethics to attain objectivity is to invoke the Golden

[5] AICPA Code of Professional Conduct, Section 101.01, Section 101.02.
[6] AICPA Code of Professional Conduct, Section 101.01, Section 102.01.

Rule: Do unto others as you would have them do unto you. Asking how you would like others to treat you enables you to abandon the doer's perspective of the action and adopt the receiver's perspective. By going outside of yourself to consider an issue, you become a detached, disinterested observer – that is, you become impartial and objective.

Misrepresentation

Rule 102-1 proscribes deliberate, knowing misrepresentations of facts. This is simply an appeal to the accountant's honesty. Misrepresentation is lying, and lying, as we discussed earlier in this book, is unethical. Although the code applies only to AICPA members, the spirit of this rule applies to all accountants. Thus, it prohibits auditors from misrepresenting a financial statement, tax accountants from misrepresenting income or assets, and management accountants from misrepresenting inventories. The accounting professional must be truthful; to misrepresent is to use the person to whom the misrepresentation is given merely as a means to the misrepresenter's end.

Conflicts of interest

Rule 102-2 describes a conflict of interest as a situation in which certain relationships impair objectivity. It is not advisable, for example, for doctors to diagnose their loved ones, or for business colleagues to become romantically involved with subordinates whose work they need to evaluate. Judges must recuse themselves if they have an interest in a case. Similar recommendations hold for accountants:

> 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 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."[7]

An important element of this interpretation is that it goes beyond the mere existence of a conflict of interest. It even includes the *appearance* of a conflict, a distinction that has become highly contentious. Some think the mere appearance of a conflict is not enough to disqualify an accountant from performing an audit. Others insist that even the appearance of a conflict undermines the trust that the general public must have in the integrity of the accountant's work. The code interpretation agrees with

[7]AICPA Code of Professional Conduct, Section 101.01, Section 102.03.

this line of thought, directing members to avoid any situation that can be *viewed* by the client or other parties as impairing the member's objectivity.

As far back as the 1970s, the AICPA's Commission on Auditor's Responsibilities, usually known as the Cohen Report after its chairman, stated, "It is obvious the auditing firms' aspirations to maximize the number of well-paying clients provides them considerable interest in their clients' financial success."[8] The SEC's Theodore Levitt, more than a quarter of a century later, asserted, "It is not enough that the accountant in an engagement act independently ... For investors to have confidence in the quality of the audit, the public must perceive the accountant as independent."[9]

The code seems to concur with Levitt, although it may not appear so at first glance. Initially, the interpretation makes allowances for apparent conflicts of interest under circumscribed conditions: "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."[10]

The code warns, however, that disclosure and consent cannot eliminate independence impairments in all cases: "Certain professional engagements, such as audits, reviews, and other attest services, require independence. Independence impairments according to rule 101, its interpretations, and rulings cannot be eliminated by such disclosure and consent."[11]

The code presents several scenarios that could impair – or be seen to impair – 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 the member has a financial interest.

[8]The Commission on Auditors' Responsibilities, "Report, Conclusion and Recommendations", New York, 1978, p. 2.
[9]Stephen Cohn, "Auditing and Ethical Sensitivity," Brooklyn College, City University of New York.
[10,11]AICPA Code of Professional Conduct, Section 102.03.

- 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 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).[12]

Obligations to external accountants

Rule 102-3 enumerates the obligations of a member to his or her employer's external accountant, requiring members to "be candid and not knowingly misrepresent facts or knowingly fail to disclose material facts."[13] Hence, if there are irregularities, an accountant's obligation is to make them known.

Subordination of judgment

In Rule 102-4, the code prohibits members from subordinating their judgment to their supervisors'. It takes courage and self-control to disagree with a supervisor. Nevertheless, it is unethical to represent a company's financial situation in the way a supervisor wishes if the accountant's best judgment indicates that the representation is inaccurate or misleading. The accountant must use research and consultation to determine whether the supervisor's approach is acceptable under generally accepted auditing or accounting practices.

If a member and his or her supervisor have a dispute regarding the preparation of financial documents, the member should take the following steps:

> 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:

[12] AICPA Code of Professional Conduct, Section 102.03.
[13] AICPA Code of Professional Conduct, Section 102.04.

(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.[14]

Thus, the rule against subordination of judgment places a heavy responsibility on an accountant. If the member and his or supervisor cannot resolve their disagreement, even after taking the appropriate steps, the member may have to terminate his or her relationship with the supervisor.

Let's now move on to Section 200.

II Section 200 – General Standards Accounting Principles

Rule 201 – General standards

The first rule in Section 200, which reiterates the prescriptions under the principle of due care states, "A member shall comply with the following standards

[14] AICPA Code of Professional Conduct, Section 102.05.

and with any interpretations thereof by bodies designated by Council."[15] The rule lists four standards, 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.[16]

Rule 202 – Compliance with standards

Rule 202 reads, "A member who performs auditing, review, compilation, management consulting, tax, or other professional services shall comply with standards promulgated by bodies designated by Council."[17]

Several bodies determine technical standards. The Financial Accounting Standards Board (FASB) is designated to establish financial accounting principles for federal government entities. The Governmental Accounting Standards Board (GASB) is authorized to establish financial accounting and reporting standards for activities and transactions of state and local governmental entities. The AICPA, in accord with the Sarbanes–Oxley Act of 2002, recognizes the Public Company Accounting Oversight Board (PCAOB) as the body to set standards relating to the preparation and issuance of audit reports for entities within its jurisdiction. As of May 2008, and subject to review in 3 to five 5 years, the AICPA designated the International Accounting Standards Board (IASB) to establish professional standards for international financial accounting and reporting principles.

The AICPA, under Rule 201, names several committees and boards to promulgate technical standards: The Accounting and Review Services Committee is "designated to issue enforceable standards in connection with the unaudited financial statements or other unaudited financial information of a nonpublic company."[18] The Auditing Standards Board establishes standards for disclo-

[15] AICPA Code of Professional Conduct, Section 201.01.
[16] AICPA Code of Professional Conduct, Section 102.03.
[17] AICPA Code of Professional Conduct, Section 202.01.
[18] For complete information about the ARSC, go to www.aicpa.org.

sure of financial information not included in the PCAOB purview. The Management Consulting Services Executive Committee oversees rules governing consulting services. The Tax Executive Committee promulgates professional practice standards regarding to tax services. Finally, the Forensic and Valuation Services Executive Committee sets standards to govern those areas.[19]

Rule 203 – Accounting principles

The final rule in Section 200 deals with the use of generally accepted accounting principles (GAAP). The first part of the rule reads as follows:

> 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 (GAAP) 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.*[20]

Thus, the rule enjoins a member from certifying that financial statements or data are in accord with GAAP if there is a departure from those principles that has a material effect on the statements or data. The rule then qualifies that prohibition with the following provision:

> 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."[21]

An accountant should follow GAAP, therefore, unless there is a reason to depart from those rules, and if so, the accountant must be prepared to justify the departure. Currently, there is a heated debate over whether GAAP affords

[19] ARSC, Appendix A: "Council Resolution Designating Bodies to Promulgate Technical Standards," as amended January 12, 1988; revised April 1992, October 1999, May 2004, October 2007, and May 2008.
[20,21] AICPA Code of Professional Conduct, Section 203.01.

sufficient tools to determine the worth of large corporations and whether techniques such as "pro forma" accounting and other valuation methods provide adequate information about a company's financial condition. There is a loud call to FASB for needed reform in these areas. (We will return to this issue later in the book.)

III Section 300 – Responsibilities to Clients

This brings us to the rules devoted to the accountant's responsibilities to clients. Section 300 focuses on the specific areas of confidentiality and contingent fees.

Rule 301 – Confidential client information

This rule is straightforward: "A member in public practice shall not disclose any confidential client information without the specific consent of the client."[22] Although the rule does not specify what is deemed confidential, such information would logically include income figures, debts, and information that is not part of the public record and that a third party has no legitimate claim to know.

An accountant can be relieved of the obligation of confidentiality in certain circumstances. The accountant must comply, for example, to a "validly issued and enforceable subpoena or summons," and must not "prohibit review of a member's professional practice."[23]

Rule 302 – Contingent fees

Rule 302, which is rather complex, concerns contingent fees. The rule prohibits members from accepting fees contingent upon audits or reviews of financial statements, or compilations of statements to be used by a third party that do not disclose a lack of independence. Hence, accountants who engage in "opinion shopping," or guarantee that their auditing will make the company look good – no matter how subtly they market these activities – are in violation of Rule 302. The rule also prohibits preparing original or amended tax returns for a contingent fee.

The code defines a contingent fee as follows: "[A] a contingent fee is a fee established for the performance of any service pursuant to an arrangement

[22,23] AICPA Code of Professional Conduct, Section 301.01.

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."[24] Fees fixed by public authorities are not considered contingent in this area.

IV Section 400 – Responsibilities to Colleagues

The next section of the code is reserved for the accountant's responsibilities to colleagues. Whereas other professional codes exhort fellow professionals to encourage, aid, and mentor each other, and they delineate the responsibilities of self-policing, the AICPA code is currently silent in these areas. According to William Keenan, technical manager of the AICPA's professional ethics committee, "There is nothing in existence at present to be included in Section 400. I believe the section was reserved for addressing possible future rules and interpretations dealing with responsibilities to colleagues, but there is nothing in the offing at present and nothing to my knowledge that has been issued in the past in exposure draft form to the membership."[25]

Although Section 400 remains empty, there are obviously times when accountants must evaluate their responsibilities to their colleagues – how to handle situations in which other accountants commit illegal or unethical actions in pursuing their work, for example. Accountants must also consider their responsibilities to other professionals in multidisciplinary financial planning groups in which they participate. Throughout the course of this book, we will deal with specific issues as they arise.

V Section 500 – Other Responsibilities and Practices

The final section of the code details the accountant's other responsibilities and practices.

Rule 501 – Acts discreditable

Rule 501 says succinctly, "A member shall not commit an act discreditable to the profession."[26]

[24] AICPA Code of Professional Conduct, Section 302.01.
[25] E-mail communication to author, March 25, 2001.
[26] AICPA Code of Professional Conduct, Section 501.01.

The interpretation of this rule discusses when and to what extent requests for records by clients and former clients should be honored. In brief, the client is entitled to receive client-provided records, client records prepared by the member, or supporting records. The accountant can "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; ... [p]rovide the requested records in any format usable by the client; and [m]ake and retain copies of any records returned or provided to the client."[27] The accountant is not obligated to return any working papers, which are the accountant's property.

The rule then lists the following types of discreditable acts:[28]

- discrimination and harassment in employment practices
- failure to follow standards and/or procedures or other requirements in government audits
- negligence in the preparation of financial statements or records
- failure to follow requirements or governmental bodies, commissions, or other regulatory agencies
- solicitation or disclosure of CPA examination questions or answers
- failure to file a tax return or pay tax liability
- 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

Rule 501 also notes that if state laws and regulations impose obligations that are greater than the provisions in this interpretation, the accountant must comply with those laws and regulations.

Rule 502 – Advertising and other forms of solicitation

Rule 502 forbids a member in public practice "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."[29] According to the code, prohibited activities are 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.

[27] AICPA Code of Professional Conduct, Section 501.02.
[28] AICPA Code of Professional Conduct, Sections 501.03–501.09.
[29] AICPA Code of Professional Conduct, Section 502.01.

(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.[30]

Rule 503 – Commissions and referral fees

The first section of Rule 503 prohibits commissions, as follows:

> 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.[31]

This section creates problems for accountants who undertake financial or estate planning for their clients. Given that an accountant is familiar with the client's financial affairs, it is argued, it is prudent for the accountant to perform financial or estate planning services, provided, of course, that the accountant is trained in and has the competence to offer such services. Because these services often involve brokering products for a commission, it only seems fair that the accountant be entitled to the commission on selling those products. In the section on standards of disclosure for permitted commissions, the code recognizes the potential conflict of interest that commission-based sales can generate:

> 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.[32]

Rule 503 also addresses referral fees:

> Any member who accepts a referral fee for recommending or referring any service of a CPA to any person or entity or who pays a referral fee to obtain a client shall disclose such acceptance or payment to the client.[33]

[30] AICPA Code of Professional Conduct, Section 502.03.
[31–33] AICPA Code of Professional Conduct, Section 503.01.

In short, if an accountant is receiving commissions or referral fees, he or she is obliged to disclose that fact to the client.

Rule 505 – Form of organization

The general precepts of the final rule of the code (Rule 504 has been deleted) are simple:

> 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.[34]

There are, however, two applications of this rule that are complicated: applications to members who own a separate business and applications to alternative practices. For members who, either individually or collectively, own a separate business, all the principles and rules in the AICPA code apply to the member. Whether they apply to the firm itself in terms of referrals depends on the composition of the firm.

With regard to alternative practices, the code requires, as follows:

> … 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.
>
> 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:

[34] AICPA Code of Professional Conduct, Section 505.01.

> (a) Compliance with all aspects of applicable state law or regulation
> (b) Enrollment in an AICPA-approved practice monitoring program
> (c) Compliance with the independence rules prescribed by Rule 101, Independence …
> (d) Compliance with applicable standards promulgated by Council-designated bodies … 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.[35]

To summarize, the rules of the code break down into five sections: (1) Independence, Integrity, and Objectivity, (2) General Standards Accounting Principles, (3) Responsibilities to Clients, (4) Responsibilities to Colleagues, and (5) Other Responsibilities and Practices. The rules are informed by the general principles of honesty, integrity and independence.

Upcoming chapters examine how the accountant fulfills his or her responsibilities in the various fields of accounting – auditing, financial or management accounting, and tax accounting. Chapter 7 looks at the auditing function.

[35] AICPA Code of Professional Conduct, Section 505.04.