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CHAPTER 2

Professionalism and Professional Responsibilities

Learning Objectives

1. Explain what it means to be a professional and how these traits apply to auditors.
2. Explain the structure of the AICPA *Code of Professional Conduct*.
3. Apply the conceptual framework approach to ethical decision making for members in public practice.
4. Evaluate the ethical behavior needed to comply with rules of conduct on integrity and objectivity.
5. Evaluate the ethical behavior needed to comply with rules of conduct on independence.
6. Evaluate the ethical behavior needed to comply with rules of conduct on general standards.
7. Evaluate the ethical behavior needed to comply with other rules of conduct for members in public practice.
8. Evaluate an auditor's legal liability under common law.
9. Evaluate an auditor's legal liability under statutory law.

ANSWERS TO MULTIPLE-CHOICE QUESTIONS

1. B

LO 1, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

2. D

LO 2, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

3. A

LO 3, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

4. D

LO 4, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

5. A

LO 5, BT: E, Difficulty: Moderate, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

6. C

LO 5, BT: E, Difficulty: Moderate, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

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7. D

LO 5, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

8. C

LO 5, BT: C, Difficulty: Moderate, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

9. D

LO 6, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Ethics

10. B

LO 7, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: Ethics, AICPA PC: Professional Behavior

11. D

LO 8, BT: C, Difficulty: Easy, TOT: 2 min., AACSB: None, AICPA PC: Professional Behavior

12. C

LO 8, BT: AP, Difficulty: Moderate, TOT: 2 min., AACSB: None AICPA PC: Professional Behavior

13. B

LO 9, BT: C, Difficulty: Moderate, TOT: 2 min., AACSB: None, AICPA PC: Professional Behavior

14. A

LO 9, BT: C, Difficulty: Moderate, TOT: 2 min., AACSB: None, AICPA PC: Professional Behavior

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ANSWERS TO REVIEW QUESTIONS

R2.1 An Auditor's concern for the public interest comes from the practitioner's work and the recognition by practitioners of an obligation to society. Upon becoming licensed as a CPA, individuals also agree to accept the responsibility to follow professional standards (e.g., accounting and auditing standards), and a code of professional conduct (usually written into state rules or law). It is also important for auditors to be independent of management when serving the public interest. The public expects auditors to provide reasonable assurance that financial statements are free of material misstatement.
LO 1, BT: C, Difficulty: Easy, TOT: 10 min., AACSB: Ethics*, AICPA PC: Ethics*

R2.2 The question is answered in the table below:

	Architecture	Public Accounting
Recognized by a specialized body of knowledge	Knowledge of building codes and how to build structures	Auditing or Tax knowledge
A formal education process	To become a licensed architect a candidate must graduate from an accredited architecture program (or its equivalent)	To become a CPA a candidate must complete150 semester hours of education including requirements in accounting and business
Standards governing admission to the profession	To become a licensed architect, a candidate must complete an education requirement, pass a professional exam, and complete an experience requirement	To become a licensed CPA a candidate must complete the state's education requirement, pass the CPA exam, and complete an experience requirement
Adherence to a code of ethics	Architects must follow the Code of Ethics and Professional Conduct of the American Institute of Architects	CPAs must follow the Code of Ethics of the state where they are licensed. AICPA members must also follow the AICPA *Code of Professional Conduct*.
Recognized status indicated by a license	State governments (through state boards of architect examiner) grant a license to practice architecture	State governments (through state boards of accountancy) grant a CPA license to practice public accounting

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A public interest in the work that practitioners perform	The public interest in the work of architects relates to building safety	The public interest in the auditor's work related to the public's reliance on the auditor's opinion about the fair presentation of financial information. Tax accountants have a duty to the public regarding compliance with tax laws.
Recognition by practitioners of an obligation to society	Architects recognize an obligation to follow building codes and at times put the public safety ahead of the wishes of their clients	Accountants have an obligation to ensure that fair presentation in financial statements supersedes their obligation to their clients. The same is true for compliance with tax laws.

LO 1, BT: S, Difficulty: Challenging, TOT: 20 min., AACSB: Ethics, AICPA PC: Ethics

R2.3 The AICPA's *Code of Professional Conduct* (the Code) provides guidance to all members of the AICPA with respect to performance of their responsibilities. The Code consists of principles, rules, interpretations, and other guidance for AICPA members.

Part 1 of the Code includes rules for members in public practice (usually CPA's) in CPA firms,

Part II of the Code includes ethical rules for members in business (such as a CFO, a controller, or an accountant working in industry or government), and

Part III includes ethical rules for other members (e.g., non-CPA members of the AICPA).
LO 2, BT: C, Difficulty: Easy, TOT: 5 min., AACSB: Ethics, AICPA PC: Ethics

R2.4 In this instance, the CPA's best friend is the CFO of a new audit client. This causes two significant threats. First, a familiarity threat may exist due to a long relationship (the CPA's best friend from college). A CPA may become too sympathetic to the client's interests or too accepting of the client's work or product. Second, a possible advocacy threat may exist due to the fact that the CPA may promote the client's position to the point that his or her objectivity or independence is compromised.

The threats are significant and a safeguard exists if the CPA is not a partner in the office where the professional engagement takes place or in a position to influence the outcome of the engagement.

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The safeguard would be for the CPA not to be involved in the prospective client's audit engagement or if the non-partner CPA is involved, the work of the CPA must be reviewed by a partner in the CPA firm. This could reduce the threat to an acceptable level.
LO 2, 3, BT: E, Difficulty: Moderate, TOT: 15 min., AACSB: Ethics, *AICPA PC: Ethics, Decision Making*

R2.5 A self-interest threat exists because the new client's audit fees will represent 25% of the audit firms 'revenues. In this case the threat exists from the large portion of the firm's revenues to be derived from the audit of the prospective client. The reliance on such a large portion of the firm's revenues may cause undue pressure from the prospective client regarding their audit (or loss of the client's audit).

The self-interest threat is significant, but likely can be safeguarded. The tone at the top of the firm needs to emphasis integrity and objectivity in the audit work, and not subordinating judgment to that of the client. The audit engagement should be reviewed by a second partner not associated with the engagement prior to issuing the audit report. If the CPA is a sole practitioner, the CPA should have the work reviewed by another firm prior to issuing an opinion.
LO 2, 3, BT: C, Difficulty: Moderate, TOT: 10 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

R2.6 The integrity and objectivity rule involves the performance of any professional service, wherein 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.

A CPA should not have a conflict of interest if a CPA or CPA firm provides professional service related to a particular matter involving two or more clients whose interests, with respect to that matter, are in conflict. This could be two clients (e.g., husband and wife) at the same time, who are in a legal dispute (e.g., divorce) with each other. A safeguard may be to use separate engagement teams who are provided clear policies and procedures on maintaining confidentiality,

Further, a CPA should not knowingly misrepresent material facts, such as knowingly overstating earnings, as this could cause a material misstatement in the company's financial statement.

A CPA should not give an unqualified or an unmodified opinion on financial statements that the CPA believes have a material misstatement.

A CPA in public practice should not subordinate his or her judgment to the judgment of others in the firm, such as going along with the opinion of another member of the audit team without doing independent research on a matter that is the CPA's responsibility. A CPA in public practice should research the issue and present an alternative position if the CPA believes their firm is reaching the wrong decision.
LO 4, BT: C, Difficulty: Easy, TOT: 10 min., AACSB: Ethics, AICPA PC: Ethics

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R2.7 Yes, it is appropriate as a CPA firm must manage the appearance of independence. A CPA or an immediate family member, having an ownership interest in an attest client, are examples of the types of activities that impair the appearance of independence for a CPA firm. Therefore, it is important for a CPA firm to ask questions of an employee about his or her investments or the investments of his or her spouse (or immediate family member) to avoid the independence in appearance for the firm and its clients.

Section 1.200 of the Code specifies a number of circumstances that can impair the appearance of independence to guide CPAs in observable aspects of ethical conduct that is targeted to situations where CPAs may appear to have a conflict of interest. As a result, a CPA must think both about how his or her own activities could cause a threat to independence, as well as the activities of his or her spouse or other family members that could threaten independence. Refer to Illustration 2.5 for definitions of a covered member and activities that impair independence.

LO 5, BT: AN, Difficulty: Easy, TOT: 10 min., AACSB: Ethics, AICPA: PC: Ethics

R2.8 When a professional employee of a CPA firm leaves the firm and is subsequently employed by a firm's attest client, independence can be impaired inasmuch as the professional employee may have continuing relationships, such as payout of the pension plan, with the CPA firm. Also, if the employee goes to work for an attest client, that employee may be familiar with the audit plan and/or staff working on the engagement, and there is a familiarity and undue influence risk that the former employee could influence the engagement. When a member of the attest engagement team or an individual in a position to influence the attest engagement intends to discuss potential employment from an attest client, independence will be impaired with respect to the client unless the CPA promptly reports such consideration or offer to an appropriate person in the firm, and removes himself or herself from the engagement until the employment offer is rejected or employment with the audit client is no longer being sought.

LO 3, 5, BT: AP, Difficulty: Moderate, TOT: 10 min., AACSB: Ethics, AICPA PC: Ethics

R2.9 The SEC and PCAOB rules related to auditor independence rules for public companies are stricter than the AICPA rules that apply to non-public entity audits. The following table lists a few instances and provides examples of how they are different.

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Independence Issue	Example
Bookkeeping and financial statement preparation	The Sarbanes Oxley Act (SOX) of 2002 prohibits CPA firms from doing any bookkeeping or financial statement preparation services for a public company attest client. The AICPA rules allow CPAs to do some bookkeeping and to prepare financial statements for a non-public audit client as long as they comply with the rules on non-attest services (ET 1.1295.000)
Internal Audit Outsourcing	The Sarbanes Oxley Act (SOX) of 2002 prohibits CPA firms from performing internal audit services for a public company attest client. The AICPA rules allow CPAs to do perform internal audit services for a non-public audit client as long as they comply with the rules on non-attest services (ET 1.1295.000)
Financial Information System Design	The Sarbanes-Oxley Act of 2002 prohibits CPA firms from performing financial information system design and implementation services for a public company attest client. The AICPA rules allow CPAs to help a client with financial information system design in an advisory capacity as long as the client makes final decisions. Implementation is more difficult for a CPA as it requires performing management functions that would impair independence. The key rules are the rules on non-attest services (ET 1.1295.000)

LO 5, BT: AP, Difficulty: Moderate, TOT: 15 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

R2.10 The AICPA *Code of Professional Conduct* lists the following 4 four aspects:

1. *Professional competence* states that a CPA may undertake only those professional services that the member or members firm can reasonably expect to be completed with professional competence. An example of this standard exists when a CPA does not have sufficient competence to complete the engagement. For example, if an member who performs only audit services is approached by a client to perform tax services, the member should refer the engagement to another CPA with the appropriate qualifications. Alternatively, the CPA would have to develop the competence needed to perform the tax engagement before the work starts.

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2. The *due care* standard expects CPAs to exercise the professional care that would be expected of other CPAs performing the same work. For example, in the audit engagement, this would include following Generally Accepted Auditing Standards (GAAS).

3. The *planning and supervision* standard states all engagements should be adequately planned and supervised. If a CPA is working on a review of financial statements, or a tax engagement, both engagements need to be adequately planned and supervised.

4. In the performance of any professional services, CPAs should obtain *sufficient, relevant information*. The level of information relates to the services performed, and a CPA performing an audit engagement will need sufficient, competent evidence. A CPA preparing a tax return will need information that is appropriate sufficient and relevant to perform the engagement.

LO 6, BT: AP, Difficulty: Moderate, TOT: 15 min., AACSB: Ethics, AICPA PC: Ethics

R2.11 Henry Owens and the firm do not need to be independent to prepare tax returns or compiled financial statements. Henry and his firm are not in violation of the Code of Professional Conduct by taking on the contingent fee engagement to prepare a claim for damages from BP, based on ET 1.510 on Contingent Fees and ET 1.520 on Commissions and Referral Fees. However, when the firm prepares quarterly compiled financial statements it needs to state that the firm is not independent of the client.

LO 7, BT: E, Difficulty: Challenging, TOT: 15 min., AACSB: Ethics, AICPA PC: Ethics and Decision Making

R2.12 A third party may be defined as an individual, who is not the client, but who used the client's audited financial statements in his or her decision making. In general, the plaintiff must prove the following when suing an auditor:

- The auditor owed a duty of care to the plaintiff. The level of care owed to the plaintiff depends on state laws regarding privity. For example, under the Restatement of Torts standard the auditor owes a duty of care to any foreseen users of financial statements.
- The auditor breached the duty by failing to act with due care (negligence). For example, an auditor would be negligent by failing to follow Generally Accepted Auditing Standards (GAAS).
- The auditor's negligence was the proximate cause of the plaintiff's damage. For example, the plaintiff must show that they relied on the audited financial statements and that reliance was the proximate cause of the plaintiff's losses.
- The plaintiff had actual damages. The plaintiff must show that the auditor's failure to follow GAAS resulted in damages (e.g., loss of an investment based on the financial statements).

LO 8, BT: AP, Difficulty: Moderate, TOT: 15 min., AACSB: None, AICPA: None

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R2.13 Because John Rodriguez purchased bonds in the primary market (e.g. a new issue of securities) the Securities Act of 1933 applies. John only needs to prove:

1. That he acquired the securities described in the registration statement,
2. That he incurred a loss, and
3. The financial statements included in the registration statement were materially false or misleading,

LO 9 BT: A, Difficulty: Moderate, TOT: 10 min., AACSB: None, AICPA: None

R2.14 Because Mary Chen's purchase of Fly By Night Airlines shares was in the secondary market the Securities Act of 1934 applies. As a result, under rule 10b-5 Mary must prove:

1. The financial statements contain a material, factual misrepresentation or omission,
2. The plaintiff incurred a loss,
3. The plaintiff relied on the financial statements,
4. Damages were suffered as a result of the reliance on the financial statements, and
5. *Scienter,* that the auditor either had actual knowledge of the falsity of the representation, or had a reckless disregard for the truth or falsity of the representation.

LO 9 BT: A, Difficulty: Moderate, TOT: 15 min., AACSB: None, AICPA: None

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SOLUTIONS TO ANALYSIS PROBLEMS

AP2.1

Step 1. Identify the Threat: This situation regarding substantial doubt may be an Undue Influence threat.

Step 2: Evaluate the Significance of the Threat: The going concern issue appears to be material to the users of the financial statements.

Step 3: Identify and Apply Safeguards: An audit firm must make its own independent judgment and not be swayed by the opinion of a former member of the CPA firm. The CPA firm should not subordinate judgment but instead the firm should act with integrity and objectivity. An Engagement Quality Central Reviewer (EQCR) should review the basis for a judgment about a "going concern" opinion, or a second partner review should be conducted, or a review should be completed by some other CPA who does not work at the CPA firm (in the case of a sole practitioner).

Step 4: Evaluate the Effectiveness of the Safeguards: If the firm acts in a way that it forms its own independent judgements about the going concern issue, the safeguards are effective.

Step 5: Document Threats and Safeguards Applied. The firm needs to document the discussion above in its working papers.

LO 2,3. BT: AP Difficulty: Basic, TOT: 15 min., AACSB: Ethics, AICPA PC: Ethics

AP2.2

a) Independence involves both Independence in Fact (A CPA should be independent from the client in terms of state of mind and acting with integrity and objectivity) and Independence in Appearance (A CPA should not have a direct investment in an audit client, or another financial interest that would appear to a reasonable third party to impair independence).

b) Carrying a note or an account receivable for audit fees that are past due creates a self-interest threat and impairs the firm's independence. (ET 1.230.010)

c) Independence is impaired. The CPA cannot be an officer of the company during the period under audit. In both situations (1) or (2), the CPA is an officer of the companyduring the period of professional engagement which begins when the engagement letter is signed or the beginning of the year under audit, whichever comes first; and ends when the audit report is signed. Because the firm is not independent, it must resign the audit and not issue an audit opinion on the financial statements.

LO5. BT: AP, Difficulty: Moderate, TOT: 20 min., AACSB: Ethics, AICPA PC: Ethics

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AP2.3

a. Under AICPA rules (ET 1.295) CPAs may perform bookkeeping and accounting services and remain independent if the following four conditions are met:

- The CPA must not have any other relationships, such as a financial interest that would impair his or her independence.
- The client must accept full responsibility for the financial statements.
- The CPA must not assume the role either of an employee or management in the client's operations (e.g., the CPA should not initiate transactions or sign checks).
- The CPA must conform to professional standards in performing the attest engagement.

b. If WTI is a public company, the SEC rules prohibit CPAs from performing bookkeeping and accounting services for SEC registrants. The Jones and Jones firm is not independent if WTI is a public company. The client (WTI) must prepare its own financial statements.

c. Under AICPA rules, Jones and Jones can perform business valuation services and consulting services for non-public companies. These client services are acceptable for a private company so long as the CPA is not involved in implementing his or her advice. If the Jones and Jones firm is to remain independent, they must not assume management responsibility and the client must take full responsibility for key assumptions and any final decisions based on a consulting engagement. Jones and Jones must act strictly in an advisory capacity.

d. Under the SEC rules, CPAs are prohibited from performing appraisal or valuation services, providing fairness opinions, or contribution-in-kind reports for SEC audit clients. Valuation services are not acceptable for a CPA to perform for a public company. This prohibited service is listed on page 2-21.

LO 5. BT: AP, Difficulty: Challenging, TOT: 30 min., AACSB: Ethics, AICPA PC: Ethics

AP2.4

a. Rule of Conduct	**b. Effect of Rule**
1. ET 1.200 - Independence	Indeterminate. The information needed to assess the applicability of Interpretations ET 1.260.010 and ET 1.260.020 is not stated.
2. ET 1.310 – Compliance with Standards	No violation. GASB principles are recognized as authoritative pronouncements for governmental entities.
3. ET 1.400 – Acts Discreditable	Violation. This is considered to be an act discreditable to the profession.

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4. ET 1.200 – Independence.	No violation. Retirement payments to individuals formerly engaged in the practice of public accounting are specifically permitted, absent certain conditions.
5. ET 1.200 – Independence.	Violation. The prohibition against direct financial interest applies to the period of the professional engagement (at the beginning of the year under audit through the time of expressing an opinion).
6. ET 1.300 - General Standards.	Violation. A member shall undertake only engagements that member or member's firm can reasonably expect to complete with professional competence.
7. ET 1.510 - Contingent Fees.	No violation. A member's fee may vary depending on the complexity of the engagement.
8. ET 1.600 – Advertising and Other Forms of Solicitation.	No violation. The rule can no longer be used to prevent members from using advertising that includes self-laudatory claims.
9. ET 1.200 - Independence.	Violation. Interpretation 1.277.010 states that a member cannot be an officer of the client during the time period covered by the financial statements.
10. ET 1.700 - Confidential Client Information	Indeterminate. No information is given as to whether the client approved disclosure of the information.
11. ET 1.100 - Integrity and Objectivity	Violation. A member should not perform a professional service when he or she has a conflict of interest.
12. ET 1.600 - Advertising and Other Forms of Solicitation.	No violation. The rule can no longer be used to prevent members from using advertising that includes testimonials.

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13. ET 1.310 - Compliance with Standards.	No violation. The Accounting and Review Services Committee is the body designated to promulgate standards for review services for nonpublic entities.
14. ET 1.200 - Independence	Violation. Interpretation 1.295 states a member's independence is impaired by serving in the capacity of making management decisions for a bank client.
15. ET 1.520 - Commissions and Referral Fees.	Indeterminate. A member is allowed to pay a commission to another CPA or another third party to obtain a client provided disclosure is made to the client.

LO 4,5,6 & 7. BT:E, Difficulty: Moderate, TOT: 35 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

AP2.5

1. A member of the AICPA may practice public accounting in any form of organization permitted by state law or regulation as long as the characteristics of the organization conform to a resolution adopted by the Council of the AICPA. CPAs must own the majority (greater than 50 percent) of the financial interests in an attest firm. Non-CPA owners must be actively engaged in providing services to the firm's clients as their principal occupation. Bradley's 50% ownership and provision of insurance services rather than professional accounting services, violates this characteristic.

2. A member in the practice of public accounting may have a financial interest in a commercial corporation which performs, for the public, services of a type performed by public accountants and whose characteristics do not conform to resolutions of the Council, provided such interest is not material to the corporation's net worth, and the member's interest in and relation to the corporation is solely that of an investor. Certainly, Gilbert's 50% interest is material to Financial Services, Inc., and Gilbert's status is not that of an investor. In this respect, Gilbert is in violation of Interpretation 1.800.

3. Expressing an unqualified opinion on Grandtime's financial statements, which did not disclose a material lien on the building asset, is a violation of both Rule 1.310 (Compliance with Standards) and Rule 1.320 (Accounting Principles). Rule 1.310 includes auditing standards promulgated by the Auditing Standards Board. These standards include the requirement that a member shall not permit his or her name to be associated with financial statements unless the member has complied with Generally Accepted Auditing Standards (GAAS). The third standard of reporting states that informative disclosures are to be regarded as reasonably adequate unless

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otherwise stated in the report. Since there was no disclosure of the building lien in the financial statements, Gilbert should have qualified his opinion.

ET 1.320 requires that a member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles (GAAP) if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles. GAAP requires disclosure of assets pledged as security for loans.

4. Having Bradley inform the insurance company of the prior lien on Grandtime's building is a violation of ET 1.700 of the Code, which enjoins a member from violating the confidential relationship between himself and his client without consent of the client. The lien should have been disclosed in Gilbert's report on Grandtime's statements, but it may not be disclosed by him independently to a third party unless the client agrees to such disclosure.

   However, ET 1.700 should not be interpreted to preclude a CPA from correcting a previous error. In this case, Gilbert's expressing an opinion that the financial statements were prepared in accordance with generally accepted accounting principles when, in fact, they were not, is a violation. Gilbert should have first exhausted all means to persuade Grandtime to correct the error by recalling the original financial statements and reissuing them in corrected form with a new auditor's report.

LO 4,5,6,& 7. BT:E, Difficulty: Challenging, TOT: 35 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

AP2.6

1. This situation relates to ET 1.200 - Independence. The situation would be acceptable providing that Herb does not assume the role of an employee and the client is sufficiently knowledgeable of the company's activities and financial condition and the applicable accounting principles so the client can reasonably accept responsibility for the work. For SEC purposes, responsibility for maintenance of the accounting records must be performed by accounting personnel employed by the client. Therefore, if Ethical was an SEC client, Herb could not perform this work.

2. This situation relates to responsibilities to clients, ET 1.700 - Confidential Client Information. Herb has violated professional ethics because ET 1.700 states "A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client." This does not apply to a validly issued subpoena or summons enforceable by order of a court.

3. This situation relates to ET 1.200 - Independence. If an employee or partner accepts more than a token gift from a client, even with the knowledge of the member's firm,

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the appearance of independence may be lacking. Good advice would be to never accept anything from a client at a price less than what other independent buyers pay.

4. This situation relates to ET 1.200 -Independence. Interpretation 1.200 states a member, or a firm of which the member is a partner or shareholder, shall not express an opinion on financial statements of an enterprise unless the member and the member's firm are independent with respect to such enterprise. Independence will be considered to be impaired if a member or a member's firm had any loan to or from an enterprise except as permitted in ET 1.1260. The exceptions pertain to certain collateralized loans, loans against insurance policies, and credit card and cash advances on checking accounts which meet certain balance requirements. The exceptions do not include unsecured loans, thus this is a violation.

5. This situation relates to ET 1.200 - Independence. Interpretation. ET 1.240 states that independence will be considered to be impaired if a member, or a firm of which he or she is a partner, had or was committed to acquire any direct or material indirect financial interest in the enterprise. Cash and Green would not have a problem performing an independent audit because Herb is not a managerial employee of the office doing the audit. With respect to the audit of Leverage Corp, Herb is not considered to be a covered member.

LO 4,5,6,& 7. BT:E, Difficulty: Challenging, TOT: 35 min., AACSB: Ethics, AICPA PC: Ethics, Decision Making

AP 2.7 The facts reveal negligence on Field's part in that the firm did not follow its own audit program nor did it make a proper investigation into the many irregularities and suspicious circumstances. Compliance with GAAP is of some evidentiary value to Field if it in fact complied with the principles set forth therein. However, the courts do not invariably accept GAAP as the conclusive test to disprove negligence. Furthermore, even if assuming GAAP were followed literally, GAAS certainly were not under the facts stated.

Field will undoubtedly rely upon the privity defense to avoid liability to Slade, a third party to the Field-Tyler contract. However, most jurisdictions recognize the standing of a third-party beneficiary to sue. Therefore, Slade would assert such status. In a majority of jurisdictions Slade would be regarded as a third-party beneficiary if it is within a known and intended class of beneficiaries. Other jurisdictions have gone even further in recognizing a duty is owed to those whom the CPA should reasonably foresee as recipients of the financial statements for authorized business purposes. There are insufficient facts to determine whether Field knew that Tyler intended to use the audited financial statements to secure credit from Slade. Therefore, it is not possible to determine whether the privity defense will bar recovery.

Fraud does not require that the party suing be in privity of contract with the defendant. However, the most significant problem in proceeding based upon fraud is that fraud requires a knowledge of falsity (*scienter*) or a recognized substitute therefor. Based upon

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the facts, Field did not actually know of management's fraud. However, it may be guilty of conduct which may be deemed to be a reckless disregard for the truth. The courts also resort to the constructive fraud theory where the facts are compelling, i.e., a shutting of one's eyes to the obvious. Sometimes, the conduct is labeled gross negligence, and an inference of fraud may be drawn from this by the trier of fact.
LO 8. BT:E, Difficulty: Challenging, TOT: 35 min., AACSB: None, AICPA: None

AP2.8 City is likely to prevail against Winston based on constructive fraud. To establish a cause of action for constructive fraud, City must prove that:

- Winston made a materially false statement of fact.
- Winston lacked a reasonable ground for belief that the statement was true. Constructive fraud may be inferred from evidence of gross negligence or recklessness.
- Winston intended another to rely on the false statement.
- City justifiably relied on the false statement.
- Such reliance resulted in damages or injury.

Under the facts of this case, Winston is likely to be liable to City based on constructive fraud. Winston made a materially false statement of fact by rendering an unqualified opinion on Bell's financial statements. Winston lacked a reasonable ground for belief that the financial statements were fairly presented by recklessly departing from the standards of due care in that Winston failed to investigate other embezzlements, despite having knowledge of at least one embezzlement, and Winston did not notify Bell's management of the matter. Winston intended that others would rely on the audited financial statements. City justifiably relied on the audited financial statements in deciding to loan Astor $600,000 and damages resulted as evidenced by Astor's default on the City loan.

City is not likely to prevail against Winston based on negligence. In order to establish a cause of action for negligence against Winston, City must prove that:

- Winston owed a legal duty to protect City.
- Winston breached that legal duty by failing to perform the audit with the due care or competence expected of members of the profession.
- City suffered actual losses or damages.
- Winston's failure to exercise due care proximately caused City to suffer damages.

The facts of this case establish that Winston was negligent by not detecting the overstatement of accounts receivable because of its inadvertent failure to follow its audit program. However, Winston will not be liable to City for negligence because Winston owed no duty to City. This is the case because Winston was not in privity of contract with City, and the financial statements were neither audited by Winston for the primary benefit of City, nor was City within a known and intended class of third party beneficiaries who were to receive the audited financial statements.
LO 8. BT:E, Difficulty: Challenging, TOT: 20 min., AACSB: None, AICPA: None

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AP2.9

1. True. The offering was filed with the SEC and was a public offering.

2. True. This is the essence of the 1933 Act. The effect of The Securities Act of 1933 is to give to third parties who purchase registered securities similar rights against the auditor as are possessed by the client under law.

3. True. Accountants have no liability if they can show that their work was adequate to support their opinion. (This is the "due diligence" defense).

4. True. One defense available to the accountants is to demonstrate that the losses on loans were due to causes other than errors or omissions in the financial statements.

5. True. Any action must be filed within three years after the securities have been offered to the public and within one year after the discovery of the error or omission.

6. False. That is not the function of the SEC. The SEC does not pass judgment on the merit of securities, nor does it defend accountants.

7. False. The fact that the financial statements are management's responsibility is not a defense if the auditor knows of loans and collateral pledged that were not disclosed.

LO 9.. BT: AN, Difficulty: Moderate, TOT: 25 min., AACSB: None, AICPA: None

AP2.10

Part I

a. No. It is unlikely that Peters will prevail. The facts do not involve liability in the sale of registered securities or liability for reports filed with the SEC. Because the stock transaction involved interstate commerce, Peters 'claim may be based on Section 17 (the antifraud provision) of The Securities Act of 1933 and Rule 10b-5 under The Securities Exchange Act of 1934. In either case, he will have to show fraud on the part of Doe, or a manipulative device or scheme, in connection with the sale of a security under the 1933 Act or the purchase or sale of a security under the 1934 Act. If this can be shown, an implied civil damage remedy is available to Peters against Doe.

   Although Doe was negligent, the United States Supreme Court, in the *Hochfelder* case, held that a violation of Rule 10b-5 requires scienter, something greater than mere negligence. Unless the violation of GAAS involves intent, or gross negligence, Doe would not be held in violation of Rule 10b-5.

b. Likely. It is likely that Peters will prevail based upon his state's common law action. At common law, a key issue is whether Doe & Co. owed a duty of care to Peters. Under the Restatement of Torts doctrine Peters would be a foreseen third party as a

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shareholder in the company. Doe & Co. would be responsible for not carefully following GAAS.

Part II

Yes. Ira will likely prevail and recover damages from Baker. He will base his action on Section 11 of The Securities Act of 1933. Section 11 imposes liability on experts, including accountants, whose opinions appear in a registration statement. The experts are liable to all those who, in reliance on their opinions, purchase securities in a public offering under The Securities Act of 1933. Ira does not have to prove Baker was negligent in auditing Able. All he needs to allege and prove is that there is a materially false statement or omission of a material fact in the registration statement. The only defense that Baker may assert is that it exercised the degree of care that would be exercised by certified public accountants in similar circumstances. This is commonly referred to as the "due diligence" defense. Negligence by Baker is therefore a violation of Section II and makes Baker liable to Ira for his damages.

LO 8,9. BT: E, Difficulty: Challenging, TOT: 25 min., AACSB: None, AICPA: None

AP2.11 Crea will not be liable to the purchasers of the common stock. Although an offering of securities made pursuant to Regulation D is exempt from the registration requirements of The Securities Act of 1933, the antifraud provisions of the federal securities acts continue to apply. In order to establish a cause of action under Section 10(b) and Rule 10b-5 of The Securities Act of 1934, the purchasers generally must show that:

- Crea made a material misrepresentation or omission in connection with the purchase or sale of a security;
- Crea acted with some element of *scienter* (intentional or willful conduct);
- Crea's wrongful conduct was material;
- the purchasers relied on Crea's wrongful conduct; and that,
- there was a sufficient causal connection between the purchaser's loss and Crea's wrongful conduct.

Under the facts of this case, Crea's inadvertent failure to exercise due care, which resulted in Crea not detecting the president's embezzlement, will not be sufficient to satisfy the *scienter* element because such conduct amounts merely to negligence. Therefore, Crea will not be liable for damages under Section 10(b) and Rule 10b-5 of The Securities Act of 1934.

Crea is likely to be held liable to Safe Bank based on Crea's negligence despite the fact that Safe is not in privity of contract with Crea. In general, a CPA will not be liable for negligence to creditors if the auditor's report was primarily for the benefit of the client or for use in the development of the client's business, and only incidentally or collaterally for the use of those to whom the client might show the financial statements. However, a CPA is generally liable for ordinary negligence to third parties if the audit report is for the identified third party's primary benefit.

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In order to establish Crea's negligence, Safe must show that:

- Crea had a legal duty to protect Safe from unreasonable risk;
- Crea failed to perform the audit with the due care or competence expected of members of its profession;
- there was a causal relationship between Safe's loss and Crea's failure to exercise due care;
- actual damage or loss resulting from Crea's failure to exercise due care.

On the facts of this case, Crea will be liable based on negligence since the audited financial statement reports were for the primary benefit of Safe, an identified third party, and Crea failed to exercise due care in detecting the president's embezzlement, which resulted in Safe's loss (Dark's default in repaying the loan to Safe).

LO 8,9. BT: E, Difficulty: Challenging, TOT: 25 min., AACSB: None, AICPA: None

AP2.12 Johnson and Wiley do not have an independence problem based on Independence Interpretation 1.220.040. Johnson and Wiley CPAs did not perform prohibited attest services for the year ended December 31, 2025. During the calendar year ended December 31, 2024, prohibited services were performed by Fritz and Rufner, but Fritz and Rufner was not associated with Johnson and Wiley, CPAs. Fritz and Rufner discontinued performing prohibited non-attest services as of December 1, 2024. Johnson and Wiley CPAs acquired Fritz and Rufner as of January 1, 2025. As a result, no prohibited services were performed by Johnson and Wiley, the members of the former firm Fritz and Rufner, during the period covered by the 2025 financial statements.

LO 2,3,4,5. BT: E, Difficulty: Challenging, TOT: 25 min., AACSB: Ethics, AICPA: Ethics, Decision Making

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Audit Decision Case

C2-1

a. There are three ethical issues that need to be addressed:
    i. Does Thornson & Danforth need to be independent to complete an annual tax return for King Companies, Inc?
    ii. If James sells his ownership in the King Companies, Inc. on November 30, 2024, is Thornson & Danforth independent for the audit of King Companies, Inc. for the year ended December 31, 2025?
    iii. Is there a familiarity threat and is the threat adequately safeguarded?
b. Gather appropriate information: Following is a summary of relevant information related to this case. The information is organized around the three issues identified above.
    i. Independence and tax returns:
        i. King Companies, Inc. is a private company and not subject to SEC rules.
        ii. Independence is required for attest services (e.g., audits or reviews of financial statements, or other attest engagements).
        iii. Preparing a tax return is a non-attest engagement and subject to rules regarding non-attest services (ET 1.295)
    ii. Independence and having a direct investment in an attest client.
        i. Having a direct financial interest in an attest client is a self-interest threat that cannot be safeguarded. (ET 1.240.010.01)
        ii. A CPA cannot have a direct financial interest in an attest client during the period of the professional engagement. (ET 1.240.010.01)
        iii. James cannot hold a direct investment during the period of the professional engagement. The period of the professional engagement begins when Thornson & Danforth sign an engagement letter or January 1, 2025, whichever comes first, and ends when the audit report is signed.
    iii. Familiarity Threat
        i. Because James Danforth previously owned stock in King Companies, Inc., it might appear to an independent third party that a familiarity threat exists (ET 1.000.010.12).
        ii. A familiarity threat can be safeguarded.
c. Analyze information and evaluate alternatives.
    i. Independence and tax returns.
        i. The case is not clear about whether James Danforth performs any management responsibilities at King Companies, Inc.
        ii. Danforth must address the activities that impair independence summarized in Illustration 2.8.
    ii. Independence and having a direct investment in an attest client.
        i. It is important that James not sign an engagement letter prior to selling his ownership interest.

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ii. James sold his ownership interest in November of 2024, prior to the beginning of the period under audit (January 1, 2025).

iii. Familiarity Threat.

i. A familiarity threat might exist.

ii. An adequate safeguard to preserve the audit firm's independence would be having Danforth's partner (Thornson or another partner) review and concur with material audit decisions prior to issuing the audit report.

d. Draw a conclusion

i. Independence and tax returns.

i. As long as Danforth does not perform any management activities, Danforth can prepare the tax return for King Companies, Inc. and remain independent. A tax service is a nonattest service. As long as the CPA complies with section (ET 1.295) of the AICPA *Code of Professional Conduct*

ii. Independence and having a direct investment in an attest client.

i. As long as the engagement letter is signed in December 2024 or later, Danforth does not have a direct investment in King Companies, Inc. during the period of the professional engagement. Hence, the firm will be independent with respect to the audit of the financial statements for the period ended December 31, 2025. The key issue is a CPA cannot have a direct financial interest in an attest client during the period of the professional engagement. (ET 1.240.010.01)

iii. Familiarity Threat

i. The familiarity threat can be safeguarded, and the audit firm's independence preserved, by having a concurring partner review and concur with material audit decisions prior to issuing the audit report, will safeguard the familiarity threat. This situation is covered by the Conceptual Framework for Independence (ET 1.210.010)

LO 2,3,4,5. BT: E, Difficulty: Challenging, TOT: 40 min., AACSB: Ethics, AICPA: Ethics, Decision Making

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Cloud 9

Following is an evaluation of each of the items that might have a potential impact on independence for Cloud 9.

Issue	Evaluation
Jo Wadley and David Collier (Cloud 9's CFO) both serve on the board of directors of the local chapter of Special Olympics.	There may be a familiarity threat because Jo Wadley and David Collier serve together on the same board. However, the familiarity threat can be addressed by an independent review of the engagement by the firm's engagement quality control reviewer to determine that the audit team used an appropriate level of professional skepticism. Independence is not impaired by this relationship.
A tax senior in another office has a sister who consults with Cloud 9 on shoe design. Cloud 9 is her biggest client.	The sister who consults with Cloud 9 is a close relative of a member of W&S Partners. However, the tax senior is not likely a covered member. Further, the rules related to close relatives say that the relative should not hold a key position with Cloud 9. A consultant on shoe design would not be a key position. Independence is not impaired.
Fifteen employees of W&S Partners, ranging from partners to entry level staff, own shares in retailers that sell Cloud 9 shoes and apparel.	While 15 employees own stock in retailers who sell Cloud 9 shoes and apparel, they do not own stock in Cloud 9. Independence is not impaired.
A survey shows that 23 percent of professional staff working for W&S Partners have purchased Cloud 9 shoes in the past.	The fact that employees purchase Cloud 9 shoes does not impair independence. Generally, purchasing a client's products does not impair independence.

LO 2,3,4,5. BT: E, Difficulty: Moderate, TOT: 43 min., AACSB: Ethics, AICPA: Ethics, Decision Making

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