Ethics and the CPA

By

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January, 2021

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Ethics and the CPA

The word "ethics" is derived from the ancient Greek "ethos," meaning moral character. The related term, "mores," comes from the word "moral" and is derived from social guidelines. Ethics, however, is the implementation of what a group's value system defines as good or bad, and the behavior necessary to fulfill ideal states. When an individual's conduct is consistent with his/her group's values, then he/she has acted ethically. Being ethical is not just about acting out of one's own values. The values of a group to which the individual belongs define whether she has acted ethically. As such, ethics arise out of societal values.

Man versus machine can be compared in the midst of an ethical dilemma. The results reveal that robots, when placed in changing circumstances, can never be trained to act in an ethical manner. Even robots with artificial intelligence have no values.

Values and ethics are similar in that they complement each other. Because ethical behavior flows out of values, a person's ethical behavior is rewarded externally or by internal satisfaction, and the values of that person are confirmed. Such confirmation further solidifies values as a desired state, in turn further compounding the relative hierarchy of that particular value. Ethical behavior is then solidified as a given value's hierarchical position is confirmed or elevated.

Lawrence Kohlberg's research of values and ethics development proposes that values and ethics are developed from a person's interaction with the environment. He further proposes that people continually construct their own interpretations of values because their interaction with a changing environment results in changes over time. This is an important thing for CPA's to remember: As they are exposed to a work environment, they must be aware that they are bringing in their value system, while simultaneously exposing themselves to a different, perhaps conflicting, value system.

Values and ethics are dissimilar in that ethics represent behavior and values have to do with beliefs. Ethics are public while values are private; ethics are seen by others, while values are only perceived by others based upon a person's ethics. Values are the reason, while ethics are the effect. In this manner, values and ethics are very distinct from each other. A person's ethical behavior may actually be in conflict with his values, creating what psychologists call cognitive dissonance. While this incongruence results in discomfort to the individual, others witnessing unethical behavior may conclude that the behavior is reflective of the person's values.

Distinguishing between values and ethics is important for CPAs because merely trying to influence ethical behavior in others, without considering the importance of consistency between values and ethics, may produce results inconsistent with the cause. Eventually, values and ethics become aligned again, with values creating good or bad ethical behavior. Even when an individual's unethical behavior stops, one must be careful to realize that the underlying values of the person may or may not have changed. If the underlying values have not changed, then the unethical behavior is likely to repeat itself.

Because values change over time, and values provide the basis for ethical behavior, it is clear that achieving and sustaining ethical behavior can result only when consistency between values and ethics is developed. CPA's facing ethical dilemmas should be very aware of the important relationship between values and ethics, and strive for continual improvement (Thorp, 2005).

> ***Accountants are perhaps the most valuable employee fraud fighters because they possess the best understanding of how businesses operate and how transactions flow through the financial or "central nervous system" of the operation.***
>
> From Forensic and Investigative Accounting, p. 2.

The CPA as a Professional

In the aftermath of the scandals at the turn of the century, we do have to return to basic, simple ways of thinking. Remember, it has been said to "keep it simple." I contend we need to return to basic values in the way we think, in what we expect . . . and that means; as a CPA, you must show your ethics. As a CPA, it is incumbent on us as professionals to "show our ethics."

Being a professional means CPA's are engaged in the high standards of a profession; and that profession is being a CPA; and it carries very high standards. CPA's are professionals, which is why there are standards that require one to stay updated with the standards of the profession.

There is little doubt that the public has different expectations of behavior for a member of a profession, such as a doctor or lawyer, than they do for a nonprofessional, such as a sales or personnel manager. Why? The answer seems to have to do with the fact that a profession works with something of real value where trust in how competently they function or how responsibly they conduct themselves particularly important. Ultimately, the public's regard for a particular profession will govern the rights it enjoys: to practice, frequently with a monopoly on the services offered; to control entry to the profession; to earn a relatively high income; and to self-regulation or to be judged by one's peers rather than government officials. If a profession loses credibility in the eyes of the public, the consequences can be quite severe, and not only for the offending professional.

What makes a profession? In the final analysis, it is a combination of features, duties, and rights all framed within a set of common professional values – values that determine how decisions are made and actions are taken.

What Makes a Profession
Essential Features
• Extensive training
• Provision of important services to society
• Training and skills largely intellectual in character
Typical Features
• Generally licensed or certified
• Represented by organizations, associations, or institutes
• Autonomy
Foundations of Ethical Values
• Significantly delineated by and founded on ethical considerations rather than techniques or tools

The lack of credibility due to the financial scandals at the turn of the century was responsible for the introduction in 2002 of the Public Company Accounting Oversight Board (PCAOB) by the SEC in the United States, and the Canadian Public Accountability Board (CPAB) by the Canadian Institute of Chartered Accountants (CICA). The PCAOB oversees professional accountants who are able to practice before the SEC on large companies whose stock is traded on U.S. stock exchanges – which means that its oversight will affect the practice of large professional accounting firms worldwide – and the generally accepted accounting policies that are applied to those companies' accountants. After the Enron scandal and the passage of Sarbanes-Oxley (SOX) in 2002, CPA's doing audits of public companies must adhere to PCAOB Standards as set forth on page 26 of this class.

The services provided by a profession are so important to society that society is prepared to grant the profession the rights previously outlined, but it also watches closely to see the corresponding duties expected of the profession are discharged properly. In general terms, the duties expected of a profession are the maintenance of:

- *Competence* in the field of expertise;
- *Objectivity* in the offering of service;
- *Integrity* in client dealings;
- *Confidentiality* with regard to client matters;
- *Discipline* over members who do not discharge these duties according to the standards expected.

These duties are vital to the quality of service provided, a condition made more significant because of the fiduciary relationship a professional has with his or her clients. A fiduciary relationship exists when service provided is extremely important to the client, and where there is a significant difference in the level of expertise between the professional and the client such that the client has to trust or rely upon the judgment and expertise of the professional. The maintenance of the trust inherent in the fiduciary relationship is fundamental to the role of a professional – so fundamental that professionals have traditionally been expected to make personal sacrifices if the welfare of their client or the public is at stake.

Professionalism is essential by all CPA's. Each day when you go to work, you behave in a professional manner; it is the essence of what being a CPA means.

For the Good of the Organization

A way we all need to begin thinking is: ***for the good of the organization***. This philosophy is actually an obvious way of thinking but one that was often forgotten in the recent past. We have to balance our responsibilities and obligations. Obviously, as CPA's we have a responsibility to the profession. And as the SEC says, we have an obligation to the public interest. There are times when this may conflict with the responsibility to the organization or to the client. We have the professional responsibility to sort out our responsibilities. There are times when we have to put the interests of the organization over our own personal interests. Certainly, the organization one works for has a place in the hierarchy of responsibilities. An important premise is to put one's personal interests below the organization. Put your firm or organization above your own interest.

In the aftermath of greed, everyone needs to re-evaluate their priorities. First comes, the prioritization of the profession, according to SOX; then one's organization, then one's personal interest. That is the general hierarchy of rank for responsibilities as a CPA. Obviously, if all areas are balanced, it is much easier to avoid conflict. There may be times when conflicts occur. When a conflict of interest occurs and if it is material, the CPA must decide if he or she can remain objective in the performance of duties. If there is an obstacle that causes services to be impaired, it is incumbent on the professional to withdraw to avoid the conflict of interest. This can mean withdrawing from a project or engagement because the client's relative has an interest in one of your investments; or it can mean that you need to resign from the job due to a request to perform something believed to be wrong, such as managing the earnings to reach management's goals for the quarter. The professional is expected to do whatever is required under the circumstances.

The organization certainly has a place in the hierarchy. The organization's goals come before personal goals, and this may require some adjustment in our thinking. The organization is a "person" – an artificial person if a corporation; it can be sued; it has a place in the hierarchy. Remember as a CPA, first comes the profession; then the organization; then the client; then the person. Use this common-sense approach for success as a professional CPA.

The Public Interest

The public interest is defined as the collective well-being of the community of people and institutions the profession serves. The U.S. Senate, the Sarbanes-Oxley Act (SOX), and the SEC have made it clear that service to the public interest is paramount. The concept of loyal agency just to an employer has been refuted and is clearly out of step with the current expectations of the public. The conditions of a fiduciary relationship – the necessity to trust or rely on the judgment and expertise of a professional – are as applicable to professionals who serve within organizations as employees as to those who offer services directly to the public. The public considers the provision of services within organizations as indirectly for the public's benefit in any event.

In order to support the features for a profession, it is essential that the profession develop a set of values or fundamental principles to guide their members, and that each professional possess personal values that dovetail with these. Normally, desired personal values would include honesty, integrity, objectivity, discretion, courage to pursue one's convictions, and strength of character to resist tempting opportunities to serve themselves or others rather than the client. Without those values, the necessary trust required to support the fiduciary relationship cannot be maintained, so efforts are usually made by the profession to its members. Generally, criminal activity is considered cause for expulsion and failure to follow the standards of the profession that are expressed in its code of conduct can bring remedial measures, fines, suspension of rights, or expulsion.

As CPA's, the important lesson in ethics is to put the "public interest" ahead of self-interests. The following excerpt from the Journal of Accountancy says it very well.

THE LAST WORD

I WAS A 17-YEAR-OLD HIGH SCHOOL DROPOUT DURING VIETNAM; I joined the military to get an education. I started as a communications specialist, carrying a radio on my back, and then switched to the military police. I grew up protecting my family so it just made sense to me to protect others. That's how I see our role as CPAs, too—as helping and protecting people.

THE ARMY PAID FOR MY COLLEGE ON THE GI BILL. I intended to get a degree in computers, but the college had a requirement that all business majors take a year of accounting. The structure of accounting really appealed to me, so I changed to a dual major in MIS and accounting. I started out working for Arthur Andersen in its computer consulting division but I preferred to do accounting, so I struck out on my own in 1984. I have eight employees and 800 individual and corporate clients; I manage $25 million in client funds. My military background has absolutely helped me; a number of clients have told me they trust retired military.

WHILE I WAS IN THE ARMY I QUALIFIED IN FIVE AREAS: military police, finance, public relations, quartermaster and ordinance. Now I'm a full colonel in the Army National Guard. The more qualifications you have, the more likely you are to be called up. I've been called a number of times; if they call me again, I'll be proud to serve. I served during the riots in Watts, when the Pope came to visit, during Desert Storm. I fought wildfires in Arizona and spent a month in New Orleans after Hurricane Katrina. The military has allowed me to live a life I never would have experienced without them, and I believe it's my responsibility to pay our society back. I believe in serving our country.

I'M A LIFELONG LEARNER; I feel like the more I know, the more I can protect my clients. I'm a certified financial planner and a licensed paralegal; I hold Series 6 and 63 securities licenses and insurance licenses. I'm in law school right now, not so much because I want to practice law but because I just want to know more. I figure if I have to get 40 hours of CPE, why not do it toward something that is really going to benefit me and my clients? I also do a segment about finance and tax on the NBC morning news every Sunday. And I'm a national bodybuilder. I've won the Mister Arizona contest five times and the Armed Forces World Championship, and I came in second for Mister North America. I just appeared on Pay Per View's Night of Champions. I'm 51 years old and often compete against men in their 20s and 30s. They call me the Jack La Lanne of Phoenix.

A PROFESSOR OF MINE ONCE SAID the middle class is the middle class because they want to be; they come home from work and sit at home. I choose to keep myself busy. I learned in the military that giving yourself a goal pushes you to success. You can never be perfect—but you can always be better.

I SEE A DIRECT CORRELATION BETWEEN THE MILITARY AND ACCOUNTING. Both require excellence and discipline, integrity and professionalism. In both we are given the public trust, and the charge and responsibility to guard that trust.

—*As told to Cheryl Rosen*

ROBERT HOCKENSMITH, CPA
Colonel, U. S. Army National Guard
Phoenix, Arizona

Read this

Integrity

According to Mintz (p. 7), “Integrity is a fundamental trait of character that enables a CPA to withstand client and competitive pressures that might otherwise lead to the subordination of judgment.” A person of integrity will act out of moral principle, not expediency. That person will do what is right even if it means the loss of a client.

For example, assume that your tax client fails to inform you about an amount of earned income for the year and you confront the client on this issue. He tells you not to record it and reminds you there is no W-2 form or 1099 form to evidence the earnings. The client adds that you will not get to audit the company's books anymore if you do not adhere to his wishes.

If you are a person of integrity, you will not allow the client to dictate how the tax rules should be applied in the client's situation. You are the professional, know that tax law best, and have an ethical obligation to report taxes in accordance with the law. If you go along with the client and the Internal Revenue Service (IRS) investigates and sanctions you for failing to follow the IRS Tax Code, you could suffer irreparable harm to your reputation. The point is that a professional must never let loyalty cloud good judgment and ethical decision making.

Given that integrity is an essential characteristic for CPA's in the performance of professional services, it is important that the CPA have personal integrity as well. Integrity, indeed all of ethics, is not something one can turn on or off in one's professional or personal life. As the ancient Greeks pointed out, we learn how to be ethical by practice and exercising those virtues that enable us to lead a life of excellence.

The Josephson Institute of Ethics identifies Six Pillars of Character that provide a foundation to guide ethical decision making. These ethical values include trustworthiness, respect, responsibility, fairness, caring, and citizenship. The Josephson Institute believes that the Six Pillars act as a multilevel filter through which to process decisions. One in isolation is generally not enough – being trustworthy is not enough; we must also be caring.

The Six Pillars of Character
Trustworthiness
Respect
Responsibility
Fairness
Caring
Citizenship

From Mintz, p. 8.

Trust

Only recently have researchers begun to document what farsighted owners and managers have known for some time. The ethics of an organization are directly related to how leaders are perceived, to where there is sufficient trust for people to share ideas without fear of losing jobs or the respect of their coworkers and managers, and whether they believe that the organization is worthy of loyalty and hard work.

If employees have sufficient trust in their situation, they will participate wholeheartedly in restructuring sessions that involve downsizing, and may accept the necessity of shared work assignments or part-time work contracts with greater understanding. To maintain the trust necessary for such steps, an organization would have to be prepared to make trustable commitments to recall employees to full-time status when possible or to provide fair termination or contracting arrangements. Continuation of benefits could be one such way of maintaining trust with a contingent workforce.

Respect

All people should be treated with dignity. We do not have an ethical duty to hold all people in high esteem, but we should treat everyone with respect regardless of their circumstances in life. The Golden Rule encompasses respect for others through civility, courtesy, decency, dignity, tolerance, and acceptance.

Responsibility

A responsible person carefully reflects on alternative courses of action using ethical principles. A responsible person acts diligently and perseveres in carrying out moral action. We have the capacity to reason and a freedom to choose; we have the capacity to make responsible decisions.

Fairness

Fairness connotes treating others equally, impartially, and openly. In business, we might say that the fair allocation of scarce resources requires that those who have earned the right to a greater share of corporate resources as judged objectively by performance measures should receive a larger share than those whose performance has not met the standard. Fairness implies adherence to a balanced standard of justice without relevance to one’s own feelings.

The expectation of fair treatment is a right that individuals and groups can properly expect to receive. The concern for fair treatment has been evident in society's preoccupation with such issues as discrimination against women and other matters. Consequently, a decision will be considered unethical unless it is seen to be fair to all.

Fairness also implies objectivity in accounting and auditing. Accounting professionals should approach their roles as preparers of financial statements without bias or predisposition of how transactions should be reported and disclosed. First, the statements should be transparent (accurate, reliable, and reflect full disclosure). Second, the statements should be prepared in accordance with GAAP and not be misleading.

Caring

The essence of caring is empathy. Empathy is the ability to understand, be sensitive to, and care about the feelings of others. Caring and empathy support each other and enable a person to put himself in the position of another. This is essential to ethical decision making.

Citizenship

Citizenship is being a part of a community. The accounting profession is a community with values and standards of behavior. These standards are embodied in the various codes of conduct in the profession. CPA's should strive to live up to principles including honoring the public trust, acting with integrity in the performance of professional services, being independent of clients, making decisions objectively, and exercising due care in the performance of services. The American Institute of Certified Public Accountants (AICPA) Code of Professional Ethics guides the ethical behavior of CPA's and is the basis for discussing the professional obligations of CPA's to the public, clients, and employers.

If interested in implementing an integrity program, use principles from KPMG's The Ethical Compass – A Toolkit for Integrity in Business (Boehle, 2009). This toolkit includes best practices in internal ethics training and offers tips for success.

- **Organize management's structure to support ethical conduct.** The ethics and compliance components of an organization's governance structure must function independently from its operational components. This separation is essential to ensuring objectivity in the decisions related to ethics and compliance and guarding against potential conflicts. KPMG addressed this need by placing responsibility for all risk management matters with its deputy chairman, the number two person in the firm who is removed from the operations side of the business.

- **Ensure that ethical and compliance matters are brought to light at the firm's highest echelons.** In KPMG's case, two of the three most senior officers under the chairman are focused on risk management and ethic and compliance: the deputy chairman and the chief legal officer. The deputy chair oversees the Professional Practice Committee and the chief legal officer chairs the Legal and Compliance Committee. Additionally, KPMG's board of directors maintains a Professional Practice, Ethics and Compliance Committee that oversees the activities of management-level committees to ensure independent review of issues, policies, and practices.

- **Identify key influencers within the organization who can help an ethics program take root.** At KPMG, focus groups were used to determine that third-and fourth-year associates are critical in setting the ethical tone and promulgating leadership's ethics and compliance messages throughout the organization. This insight changed the way KPMG thought about the structure of its program and training. Accordingly, the firm developed new training to enable these associates to be more effective role models and resources on ethics and compliance issues for their immediate reports and peers.

- **Develop a Code of Conduct that is applicable to practical, everyday matters.** Because a Code of Conduct often serves as the starting point for an ethics program and related training, it is essential that it be clear to every person in the organization and that it take into account varying roles and responsibilities. In 2008, KPMG formed a content advisory panel to make its Code of Conduct more practical and to further demonstrate how the firm's principles and values apply in the everyday working environment.

- **Begin training on day one, and integrate it with other training programs.** KPMG requires every new hire to complete a series of training modules focused on the firm's Code of Conduct. Each training session is designed to bring the Code to life with role-playing exercises that capture what it means to conduct oneself in accordance with the Code.

- **Steep all facets of the hiring process in a culture of ethics.** KPMG uses every interview as an opportunity to set the tone and convey what it means to be part of KPMG by explaining its values, ethical commitments and the professionalism expected should one join the firm. These messages are reinforced during orientation and internship sessions.

- **Provide multiple channels for raising ethical concerns.** The first line of communication is to those closest to you, usually the person's performance manager or supervisor. In situations where an individual is not comfortable with a direct line of communication, a hotline or ombudsman could be contacted anonymously.

  Many frauds or wrongs are reported anonymously through hotlines. Hotlines often use a third party to report alleged wrongs that may be investigated internally or through an outside forensics accountant or other individual. The important point is to realize that hotlines are more effective in discovering frauds in an organization, yet hotlines are used only 20 percent of the time. To mitigate the likelihood for fraud in an organization, consider use of an anonymous reporting source, such as a hotline for the reporting of frauds.

- **Ensure consistent, transparent investigation and resolution of ethics violations.** An annual report from hotline processors should close the loop and ensure that resolution was made in a transparent manner.

Objectivity/Due Care

Whereas independence, integrity, and objectivity relate to the virtues of the individual CPA who performs professional services, the principle of due care addresses the quality of services performed by the CPA. In a study of enforcement actions against CPA's between 1987 and 1997, Beasley, Carcello, and Hermanson point out that in 80 percent of the cases, the CPA failed to gather sufficient audit evidence. In 71 percent of the cases, the CPA failed to exercise due professional care. Other violations relate to the absence of proper care in performing professional services including failing to apply GAAP [49 percent] (Mintz, p. 104).

The exercise of due care involves an understanding of the appropriate levels of care expected of a professional accountant in the circumstances. For example, a professional accountant is not expected to be all-knowing and all-seeing with regard to incidents of fraud that occur at a client or employer. However, if the professional becomes aware of these, there are expectations for follow-up and reporting that need to be observed.

An important aspect of the exercise of due care is the professional skepticism demonstrated. A professional accountant is not expected to accept everything he or she is told or shown as being true. The exercise of proper professional skepticism would involve the continuous comparison of representations received as to what would be considered reasonable.

Common law liability requires the professional accountant to perform professional services with due care. Due care is a basic principle and rule of conduct in the AICPA Code. Evidence of having exercised due care exists if the accountant can demonstrate having performed services with the same degree of skill and judgment possessed by others in the profession. Typically, an auditor would cite adherence to generally accepted audit standards (GAAS) as evidence of having exercised due care in an audit.

Independence

Independence is a complex standard that represents one of four sections of the AICPA Professional Code of Conduct that is essential for CPA's. To meet the independence standard, the CPA should avoid certain relationships that could impair his or her ability to be independent. Generally, these relationships fall into three categories: 1) financial relationships; 2) business relationships, and 3) family relationships.

Independence should be *in fact* or *in appearance.* Independence in fact is defined as the state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and professional skepticism. To appear to be independent, the CPA should avoid circumstances that would cause an informed third party to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the audit engagement had been compromised.

A CPA must be independent in fact and in appearance when performing an attest engagement in which a report will be issued on financial statements. Independence will be considered to be impaired if the CPA has or is committed to acquire any direct or material financial interest in the client. Independence is also impaired if the CPA is a trustee or executor or administrator of any estate if the trust or estate had or was committed to acquire any direct or material financial interest in the client. Independence is also impaired if loans exist between the CPA and other party for home mortgages or other secured loans. Independence also will be considered to be impaired if, during the period covered by the financial statements, and during the period of the professional engagement, the CPA was connected with the client as a promoter, underwriter, or voting trustee, a director or officer, or in any capacity equivalent to that of a member of management or of any employee;

- Was a trustee for any pension or profit-sharing plan of the client;
- Receives from a third party, or had a commitment to receive from the client or third party, with respect to services or products procured or to be procured by the client, other compensation which was material in relation to the aggregate normally-recurring fees charged annually to the client for reports on financial statements;
- Had a commitment from the client for a contingent fee;

Contingent fees are addressed in Rule 302 of the AICPA Professional Code of Conduct. Contingent fees are prohibited for preparation of financial statements or tax returns. The acceptance of a contingent fee may represent the appearance of a bias or a conflict of interest that impairs independence. Such conflicts are also promulgated by the Federal Trade Commission as early as 1985 with the banning of commissions and contingent fees by professional accountants.

A CPA's independence may be impaired by a close relative's association with a client. Close relatives include spouses and dependent persons, such as children, grandchildren, stepchildren, brothers, sisters, parents, grandparents, parents-in-law, and their respective spouses. The CPA must consider whether the strength of personal and business relationship, if any, puts distance between himself or herself and a close relative would lead a reasonable person who is aware of all the facts to conclude that the situation poses an unacceptable threat to the CPA's objectivity and appearance of independence. The CPA must also consider independence to be impaired with respect to a client if:

- during the period of the professional engagement or at the time of expressing an opinion, the CPA has knowledge of a close relative who has a material financial interest in the client;
- the CPA has a close relative who could exercise significant influence over the operative, financial, or accounting policies of the client or is otherwise employed in a position in which the close relative's activities are normally an element of or subject to significant internal accounting controls;

The previously mentioned examples of impaired independence are not intended to be all inclusive.

Reports or opinions can lack integrity if the professional CPA involved has failed to maintain independence from one of the persons likely to benefit or be harmed by the report, and this causes the CPA to bias the report toward the favored party. Charges of bias can be very hard to refute, so professionals are often admonished to avoid any situation or relationship that might lead to the perception of bias. If for any reason the CPA professional has reason to not be independent to perform the services, he or she should request to be reassigned or withdraw from the engagement. Not being independent can jeopardize a successful engagement.

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. 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.

Wrap-up: Code of Professional Conduct

The AICPA code of Professional Conduct is recognized as a model for the accounting profession. However, only members of this voluntary professional organization are subject to its ethics rules. CPA's are granted a license to practice in the various states by the states' board of accountancy. It is important to remember that the state board of accountancy grants the right to practice accounting in a given state and establishes standards of professional conduct including ethics rules.

The Code of Professional Conduct of the American Institute of Certified Public Accountants consists of two sections—(1) the Principles and (2) the Rules. The Principles provide the framework for the Rules, which govern the performance of professional services by members. The Council of the American Institute of Certified Public Accountants is authorized to designate bodies to promulgate technical standards under the Rules, and the bylaws require adherence to those Rules and standards.

The Code of Professional Conduct was adopted by the membership to provide guidance and rules to all members—those in public practice, in industry, in government, and in education—in the performance of their professional responsibilities.

The format of the Code of Professional Conduct as of June 1, 2011, is as shown below. Students should read and become familiar with the rules of the Code of Professional Conduct. It may be found at:

http://www.aicpa.org/research/standards/codeofconduct/downloadabledocuments/2011june1codeofprofessionalconduct.pdf

Code of Professional Conduct

This section includes the current version of the AICPA Code of Professional Conduct, beginning section follows.

- Section 50 - Principles of Professional Conduct
- Section 90 - Rules: Applicability and Definitions
- 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
- ET Appendixes
- ET Topical Index

Please spend some time navigating through the Code of Professional Conduct. Each item has significant detail to guide members on the behavior expected as related to each item.

Solving ethical dilemmas

Peter Drucker in 2001 refers to the Hipprocratic Oath of 2500 years ago when he writes about business ethics. A professional can promise he or she will "not knowingly do harm." He states that it is not an easy rule to live up to, but that "the oath's modesty and self-constraint make it the right rule for the ethics that managers need - the ethics of responsibility."

Given that ethical and moral dilemmas present themselves on a daily basis, what do the experts say are the steps for solving an ethical dilemma? Life and business are rarely simple, and between right and wrong there is a lot of gray area. How does one make an ethical decision?

There are two major approaches that philosophers use in handling ethical dilemmas. One is to focus on the practical consequences of what we do, and the other focuses on the actions themselves and weighs the rightness of the action alone. The first school of thought argues that if there is no harm, there is no foul. The second claims that some actions are simply wrong in and of themselves.

Here is a three step process for solving an ethical problem:

1. **Step One: Analyze the consequences**
   Who will be helped by what you do?
   Who will be harmed?
   What kind of benefits and harms are we talking about? (Some are more valuable or more harmful than others: good health, someone's trust and a clean environment are very valuable benefits, more so than a faster remote control device.)
   How does all of this look over the long run as well as the short run?

2. **Step Two: Analyze the actions**
   Consider all of the options from a different perspective, without thinking about the consequences.
   How do the actions measure up against moral principles like honest, fairness, equality, respecting the dignity of others, people's rights?
   (Consider the common good)
   Do any of the actions "cross the line?"
   If there is a conflict between principles or between the rights of different people involved, is there a way to see one principle as more important than the others?
   Which option offers actions that are least problematic?

3. **Step Three: Make a decision**
   Take both parts of your analysis into account and make a decision. This strategy at least gives you some basic steps you can follow.

Source: The Center for Business and Ethics at Loyola Marymount University

"Do the right thing. It will gratify some people and astonish the rest."

--Mark Twain

Decision-Making

How you make a decision will follow you into all venues---- personally and professionally. Decision-making is not a simple task; it requires your consistent modus operandi. You should be comfortable with the manner in which you make decisions. A standard model is suggested as shown below that is in Datar's book entitled Managerial Accounting follows:

5-Step Decision-Making Process
1. Identify the problem and uncertainties.
2. Obtain information.
3. Make predictions about the future.
4. Make decisions by choosing among alternatives.
5. Implement the decision, evaluate performance, and learn.

With this model, human activity generally prevails because management is primarily a human activity that encourages individuals to do their jobs better. For this reason, the model should recognize the behavioral elements of the decision-making process.

Anyone can behave inappropriately as Ariely writes in his book The (Honest) Truth About Dishonesty (p. 142). Since Roman times, we have heard "memento more," which means "remember your morality" (Ibid., p. 247). Being aware of whatever process we are doing is the crucial first step to creating better societies. Human elements are ever-present and pervasive. We may not understand how the social sciences work; sometimes we do not see certain things in ourselves. Yet, the real goal should be to consider ***human elements*** when making decisions; hence, the reason that ethics training is required.

Case Studies

Four case studies are included in this course; each presents ethical dilemmas. When presented with ethical dilemmas in an audit scenario, use the above three-step process to give consideration to a workable solution to the dilemma. Ethical dilemmas present pressure that can be imposed by top management on accountants and auditors to ignore situations so as to misrepresent items in the financial statements. Accountants have ethical obligations under the AICPA Code of Professional Conduct that obligate them to place the public interest ahead of all other interests including their own self-interest and that of an employer or client.

Case Study #1 The PeopleSoft Case – Independence Standard

On April 16, 2004, the SEC sanctioned Ernst & Young LLP because it was not independent in fact or appearance when it audited the financial statements of PeopleSoft for fiscal years 1994-99. The SEC's sanctions included a six-month suspension from accepting new SEC audit clients, disgorgement of audit fees (which were more than $1.6 million), an injunction against future violations, and an independent consultant report on its independence and internal quality controls.

The SEC found independence violations arising from Ernst & Young's business relationships with PeopleSoft while auditing the company's financial statements. These relationships created a mutuality of interests between the firm and PeopleSoft, creating a financial self-interest threat.

The SEC action against Ernst & Young (EY) indicates that the firm violated independence standards in its business dealings with the audit client as a result of the relationship that developed between the two entities relating to a system developed by EY for PeopleSoft. EY's Tax Group developed an in-house software program to assist clients with the tax consequences of managing employees with international assignments. The EY global expatriate management system (EY/GEMS) was enhanced with the use of PeopleTools, a software product created by EY's audit client, PeopleSoft. A business relationship was created whereby a license to use PeopleTools was granted to EY in return for a payment to PeopleSoft of 15 percent of each licensee fee it received from outside customers purchasing the new software, 30 percent of each license renewal fee, and a minimum royalty of $300,000, payable in 12 quarterly payments of $25,000 each.

The SEC found that EY and PeopleSoft had "symbiotic relationship" engaging in joint sales and marketing efforts, sharing considerable proprietary and confidential business information, and EY had partnered with PeopleSoft to accomplish increased sales and boost consulting revenues for EY. The findings of the SEC indicate that EY and PeopleSoft entered into a direct business relationship and shared a mutual interest in the success of EY/GEMS for PeopleSoft and acted together to promote the product so that a reasonable investor with knowledge of all of the facts would conclude that EY was closely identified in fact and appearance with its audit client. (From Mintz, p. 196).

Case Study #2 Armadillo Foods, Inc. - Integrity and Objectivity Principles

This is a hypothetical situation but one that occurred all too often during the accounting scandals of the 1990's and 2000's.

Armadillo Foods, Inc. is a large southwestern processor of armadillo-based food products. The CFO comes to you (the Controller) and says the earnings results for the quarter ending June 30, 2007, are 20 percent below financial analysts' estimates. As a public company, you know the stock price is likely to decline, perhaps significantly, after public disclosure of the earnings reduction for the second straight quarter in 2007. The CFO tells you that the CEO insists the company must "make the numbers" this quarter. You are told to find a way to make it happen. What would you do? Why?

The pressure that is applied by the CFO and CEO on the controller tests that person's commitment to act ethically. A controller who gives in to the pressure when the financial statements are not prepared in accordance with GAAP violates the "Integrity Principle" because the controller has subordinated professional judgment to the biased judgment of superiors. (Mintz, p. 183).

Case Study #3 Phar-Mor - Due Care Standard

The story of Phar-Mor (http://www.youtube.com/watch?v=NAMz8QR6c5w) shows how quickly a company that built its earnings on fraudulent transactions can dissolve like an Alka-Seltzer tablet. This case is from an actual situation that resulted in the bankruptcy of the company.

One day Stan Cherelstein, the controller of Phar-Mor, discovered cabinets stuffed with held checks totaling $10 million. Phar-Mor could not release the checks to vendors because it did not have enough cash in the bank to cover the amount. Cherelstein wondered what he should do.

Phar-Mor was a chain of discount drug stores, based in Youngstown, Ohio, that had been founded in 1982 by Michael Monus and David Shapira. The company grew from 15 to 310 stores in less than 10 years and had 25,000 employees. According to Litigation Release No. 14716 issued by the SEC, Phar-Mor had cumulatively overstated income by $290 million between 1987 through 1991. In 1992, prior to disclosure of the fraud, the company overstated income by an additional $238 million.

Coopers & Lybrand, prior to their merger with Price Waterhouse, was the auditor firm for Phar-Mor. The firm failed to detect the fraud as it was unfolding.

The fraud occurred by dumping the losses into a "bucket account" and then reallocating the sums to one of the company's hundreds of stores in the form of increases in inventory amounts. Phar-Mor issued fake invoices for merchandise purchases and made phony journal entries to increase inventory and decrease cost of sales. The company over counted and double counted merchandise in inventory.

The fraud was helped by the fact that the auditors from Coopers observed inventory in only four of 300 stores, which allowed the finance department at Phar-Mor to conceal the shortages. Moreover, Coopers had informed Phar-Mor in advance which stores they would visit. Phar-Mor executives fully stocked the four selected stores but allocated the phony inventory increases to the other 296 stores. Regardless of the accounting tricks, Phar-Mor was heading for collapse, and its suppliers threatened to cut the company off for nonpayment of bills.

Due professional care requires that Coopers & Lybrand conduct the audit with skepticism and gather sufficient evidence upon which to base an opinion. Based on the facts of the case, Coopers seems to have violated this standard. Observing inventory at only four out of 300 stores required that Coopers used analytical procedures to monitor carefully the inventory at the other 296 stores for unusual activities or build-ups. Coopers should have been confirming or testing accounts payable and found the delinquent payments to suppliers. Coopers should have calculated that the margins charged by Phar-Mor on goods could not sustain the income that Phar-Mor was reporting (Mintz, p.88).

Case Study #4 HealthSouth Corporation – Responsibility for Financial Reports

Richard Schrushy, CEO of HealthSouth Corporation, and the CFO, William F. Owens, certified financial statements and filed them with the SEC. The alleged fraud led to an earnings restatement of about $2.7 billion.

The HealthSouth story is a sad one, in that Schrushy was acquitted of all charges that he participated in the fraud and cover-up. Scrushy served as chair of the board at HealthSouth from 1984 through early 2003. He also served as CEO during that time, except for periods in late 2002 and early 2003. Still, the jury chose to believe Scrushy's claims of ignorance, even though five HealthSouth financial and accounting officers had admitted to their roles in the fraud and had accused Scrushy of knowing about the fraud. As U.S. District County Judge Sharon Lovelace Blackburn stated on December 9, 2005, before sentencing Owens to five years in prison for his part in the scandal, "life is not always fair" and the sentence "should be sufficient to serve as a deterrent and provide just punishment." Scrushy was acquitted; but the SEC brought a federal action against him that was successful and that led to the following penalties/sanctions:

- Permanently barred Scrushy from serving as an officer or director of a public company;
- Permanently enjoined Scrushy from committing future violations of the antifraud and other provisions of the federal securities laws;
- Required Scrushy to pay $81 million in disgorgement and civil penalties (Mintz, 200).

See excerpts of a speech by Aaron Beam, CFO at HealthSouth Corporation. As you view this video at (https://www.youtube.com/watch?v=R_K7bQpDJzg), envision how you would perform if asked to make the numbers at HealthSouth Corporation.

Fraud Considerations in an Audit

The Public Company Accounting Oversight Board (PCAOB) establishes audit standards for independent auditors and ethics standards for companies issuing stock on established exchanges. The independent auditor's responsibility is to audit and report on the financial statements prepared by management. Perceptions of the shortcomings in the effectiveness of independent audits erode public confidence in the integrity of financial reporting systems. In the past an "expectations gap" existed – that is, the difference between what the public and the users of financial statements perceived as the responsibilities of accountants and auditors and what accountants and auditor themselves saw as their responsibilities.

The audit standard titled ***Consideration of Fraud in a Financial Statement Audit*** (AU240) addresses ethics in an organization by identifying the organization's responsibility to create a culture of honesty and ethics and to communicate acceptable behavior and expectations of each employee clearly (Mintz, p. 271)

Areas of fraud considerations of which CPA's should be aware:

1) Describing the characteristics of fraud;
2) Exercising professional skepticism;
3) Discussing with engagement personnel the risks of material misstatement due to fraud;
4) Obtaining the information needed to identify risks of material misstatement due to fraud;
5) Identifying risks that may result in a material misstatement due to fraud;
6) Assessing the identified risks after taking into account an evaluation of the entity's programs and controls;
7) Responding to the results of the assessment;
8) Evaluating audit evidence;
9) Communicating about fraud to management, the audit committee, and others;
10) Documenting the auditor's consideration of fraud.

CPA's should be aware of the items listed above. They also should be aware of their responsibilities for public company financial statements in audits of public companies. The following video will illustrate how easy fraud can appear in human behavior.

How Fraud Hurts an Organization and Society

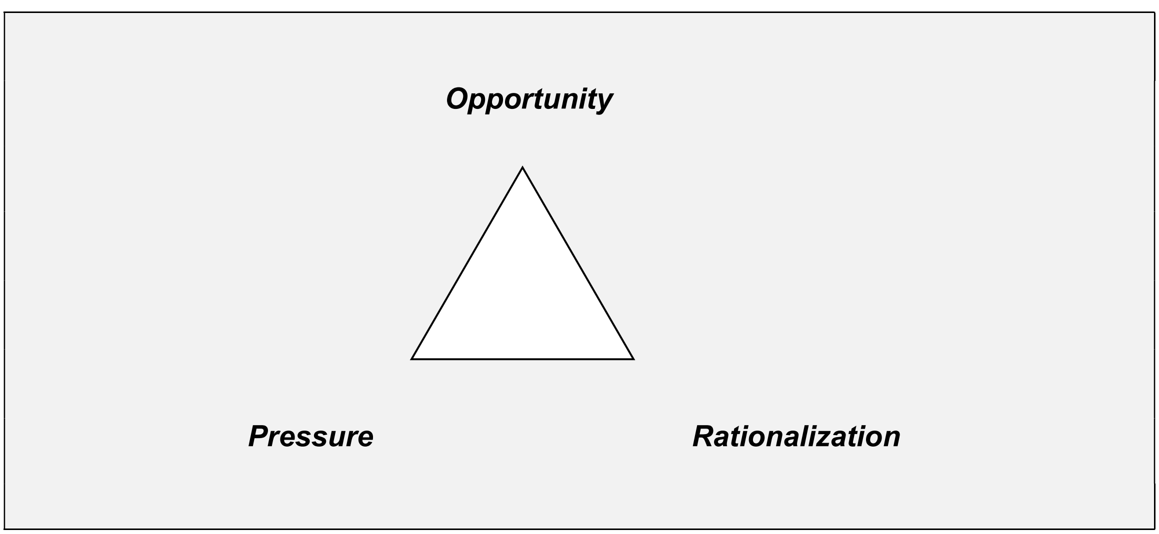
CPA's should also realize that fraud can occur in organizations because of human behavior. CPA's should understand that fraud hurts organizations and costs society money. To understand the characteristics of fraud, the following video will bring behavioral factors into focus. That video may be viewed at https://www.ted.com/talks/barry_schwartz_using_our_practical_wisdom

The Fraud Triangle

The Fraud Triangle defines fraudulent financial reporting as "intentional misstatements or omissions of amounts or disclosures in financial statements designed to deceive financial statement users where the effect causes the financial statements not to be presented, in all material respects, in conformity with GAAP" (Mintz, p. 277).

The Fraud Triangle is based on three sides of the triangle, as shown below and explained as follows:

Fraud Triangle



1. Incentives/Pressures to Commit Fraud

The incentive to commit fraud typically is a self-serving one. It may be caused by internal budget pressures or earnings expectations not being met. Personal pressures also might lead to fraud if a member of top management is deep in personal debt or has a gambling or drug problem.

2. Opportunity to Commit Fraud

The second side of the fraud triangle connects the pressure or incentive to commit fraud with the opportunity to carry out the act. Employees who have access to assets such as cash and inventory should be monitored closely through an effective system of internal controls that help safeguard assets.

3. Rationalization for the Fraud

Fraud perpetrators typically have some way to explain away their actions as acceptable. For corporate executives, rationalizations to commit fraud might include thoughts such as "we need to protect our shareholders and keep the stock price high," "all companies use aggressive accounting Practices," or "the problem is temporary and will be offset by future positive results."

PCAOB Standards

The PCAOB issues standards for the audit of public companies by registered CPA firms. In its standards, PCAOB recognizes the importance of internal control over financial reporting as the foundation for a financial statement audit. The usefulness of financial audit amounts can be questioned if the underlying system that produced the numbers is not reliable. PCAOB requires auditors to conduct an integrated audit wherein auditors examine the design and effectiveness of internal control sufficient to render an opinion on its effectiveness.

Audit standards have progressed since the turn of the century. In particular, the standards provide a framework to evaluate internal controls and assess audit risk, and they do a better job of identifying red flags indicating the fraud may be present. The Fraud Triangle provides a framework to evaluate risks of fraud and understand how to prevent and detect the possibility of fraud. A strong corporate governance system, including an independent audit committee, effective internal controls, and risk assessment procedures, is the best way to prevent fraud (Mintz, p. 251).

The PCAOB issues ethics and independence standards that apply to public companies. Rule 3526 *Communication with Audit Committees Concerning Independence,* requires that a registered public accounting firm must, prior to accepting an initial engagement describe to the audit committee of the issuer, in writing, all relationships between the registered public accounting firm or any affiliates of the firm, may reasonably be thought to bear on independence. The communication should address the potential effects of the relationships on the independence of the public accounting firm, should it be appointed the auditor, and document the substance of its discussion with the audit committee. The firm must also affirm to the audit committee that the public accounting firm is independent in compliance with Rule 3520 (Mintz, p. 250).

Revised PCAOB Standards

This weblink has the latest PCAOB Standards retrieved in January, 2021: https://pcaobus.org/oversight/standards/auditing-standards The rules and standards are continually revised and updated to align with various issuing agencies and authorities. Following are excerpts of important standards of which you should be aware. Students should check the online link to ensure they have all updates to the standards.

Auditing Standard No. 5

An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements (This AS supersedes Auditing Standard No. 2 and was renamed throughout the many revisions and alignments of PCAOB Standards.)

The Standard establishes requirements and provides direction that applies when an auditor is engaged to perform an audit of management's assessment of the effectiveness of internal control over financial reporting. It provides that effective internal control over financial reporting (ICFR) provides reasonable assurance retarding the reliability of financial reporting and the preparation of financial statements. If one or more material weaknesses exist, the company's ICFR cannot be considered effective.

The audit of ICFR should be integrated with the audit of financial statements. The auditor must plan and perform the work to achieve the objectives of both audits. *AS 5* standards include obtaining reasonable assurance whether the financial statements are free of material misstatement, whether caused by error or fraud, and whether management's assertion of the effectiveness of the company's ICFR is fairly stated in all material respects.

AS 6: Evaluating Consistency of Financial Statements

Standard was revised and aligned as late as 2008. The Standard establishes requirements and provides direction for the auditor's evaluation of consistency of the financial statements. *AS 6* states that a change in accounting principle is a change from one GAAP to another GAAP when there are two of more GAAPs that apply or when the accounting principle used is no longer generally accepted. The auditor should evaluate a material change in financial statement classification and the related disclosure to determine whether such a change is also a change in accounting principle or a correction of a material misstatement. For example, certain reclassifications might occur because those items were incorrectly classified in previously issued financial statements. In such situation, the reclassification is the correction of a misstatement. If the auditor determines the reclassification is a change in accounting principle or if the auditor determines the reclassification is a correction of a material misstatement in previously issued financial statements, he/she should address the matter as required by reporting standards.

AS 6115: Reporting on Whether a Previously Reported Material Weakness Continues to Exist

AS 6115 describes the steps to be used by auditors when a company voluntarily engages them to report on whether a material weakness is no longer present. The auditor's objective in performing work under this standard is to obtain reasonable assurance as to whether the previously reported material weakness still exists. The auditor should form a conclusion in a report that is communicated with the audit committee.

The standard delineates steps to be taken to evaluate whether a previously reported material weakness still exists. Auditors should ascertain that management accepts responsibility for internal controls and that they believe controls have been modified to correct any such reported weaknesses.

AS 8 – Audit Risk

The auditor has the responsible to reduce risk to an appropriately low level in order to obtain reasonable assurance that the financial statements are free of material misstatement. Reasonable assurance is obtained by reducing audit risk to an appropriately low level through applying due professional care, including obtaining sufficient appropriate audit evidence. Audit procedures should be designed to respond to assessed risks.

AS 9 – Audit Planning

This standard establishes requirements regarding planning an audit, including assessing matters that are important to the audit and establishing an audit strategy and audit plan. The auditor should perform the following activities at the beginning of the audit:

1. Perform procedures regarding continuance of the client relationship and the specific audit engagement.

2. Determine compliance with independence and ethics requirements in the engagement and reevaluate independence with changes in circumstances.

3. Establish an understanding of the terms of the audit engagement with the audit committee.

AS 10 – Supervision of Audit Engagement

This standard applies to the engagement partner and other members relating to supervision. The engagement partner should inform team members of their responsibilities including the objectives of the procedures they are to perform; the nature and timing of procedures they are to perform, and matters that could affect the procedures performed and matters of internal control.

AS 11 – Consideration of Materiality in Planning and Performing an Audit

This standard describes the auditor's responsibilities for consideration of materiality in planning and performing an audit. *AS 11* defines materiality as defined in legal cases. In interpreting federal securities laws, the Supreme Court of the United States has held that a fact is material if there is "substantial likelihood that the . . . fact would have been viewed by a reasonable investor as having significantly altered the 'total mix' of information made available. As the Supreme Court has noted, determinations of materiality require "delicate assessments of the inferences a 'reasonable shareholder' would draw from a given set of facts and the significance of those inferences to him/her . . ."

To obtain reasonable assurance about whether the financial statements are free of material misstatement, the auditor should plan and perform audit procedures to detect misstatements that would result in material misstatement of the financial statements. This includes being alert to matters that are noticed while performing audit procedures and being professionally skeptical.

AS 12 – Identifying and Assessment Risks of Material Misstatement

The risk assessment process discussed in this standard includes information-gathering to identify risks and an analysis of those identified risks. Following are some risk assessment procedures:

1. Obtaining an understanding of the company and its environment;
2. Obtaining an understanding of internal control over financial reporting;
3. Consideration of information from client acceptance and retention evaluation, audit planning activities, past audits, and other work performed for the company;
4. Performing analytical procedures;
5. Conducting a discussion among team members regarding risks of material misstatement;
6. Inquiring of the audit committee, management, and others within the company about the risks of material misstatement.

AS 13 – The Auditor's Responses to the Risks of Material Misstatement

The auditor must design and implement audit responses that address the risks of material misstatement that are identified and assessment in accordance with *AS 12, Identifying and Assessing Risks of Material Misstatement.*

AS 14 – Evaluating Audit Results

The evaluation process in this standard includes evaluation of misstatements identified during the audit, the overall presentation of the financial statement, and the potential for management bias in the financial statements. In forming an opinion as to the fairness of the financial statements, the audit should take into account all relevant audit evidence.

The auditor's evaluation of audit results includes the following:

- The results of analytical procedures;
- Misstatements accumulated during the audit;
- Qualitative aspects of the accounting practices;
- Conditions identified during the audit that relate to assessment of risk;
- The presentation of the financial statement, including all disclosures;

- The sufficiency and appropriateness of audit evidence.

AS 15 – Audit Evidence

Audit evidence is all information that is used by the auditor in arriving at conclusions on which the auditor's opinion is based. The auditor must plan and perform audit procedures to obtain sufficient audit evidence to provide a reasonable basis for his/her opinion. An audit in accordance with GAAS should be designed to detect risk of material misstatement and act accordingly to reduce risk to acceptable levels. Audit standards establish the framework in which auditory rely on professional judgment and ethical decision making to meet public interest obligations.

16 – Communication with Audit Committees

AS 16, Communications with Audit Committees requires the auditor to communicate with the company's audit committee regarding matters relating to the conduct of an audit and to obtain information from the audit committee during the audit (Mintz, p. 301). The auditor should inquire of the audit committee about whether it is aware of matters relevant to the audit, including, any violations of laws or regulations. The audit should communicate to the audit committee the following matters:

- Significant accounting policies and practices;
- Critical accounting policies and practices;
- Critical accounting estimates;
- Significant unusual transactions.

Summary of Professional Obligations

Accounting professions are subject to legal liability if they fail to follow generally accepted accounting principles (GAAP) and generally accepted auditing standards (GAAS) being unable to meet their ethical and professional obligations. There is need for a strong set of ethical values, including due care, professional skepticism, and ethical judgments necessary to assess risk and detect fraud in the financial statements. Auditors can meet their professional and ethical responsibilities by maintaining integrity when pressure exists to agree with others. No matter how trivial or extreme, one's integrity should be maintained no matter what the circumstances.

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