ETHICS FOR ACCOUNTANTS

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CHAPTER 1
ETHICS AND ETHICAL REASONING

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Define ethics.
2. Differentiate between amoral and ethical values.
3. List and characterize two systems of ethics.
4. Differentiate between legal versus ethical codes.
5. Discuss the development of law and ethics.
6. List examples of philosophers who contributed to the development of ethics.
7. State how culture, motivation, and power affect business ethics.
8. Describe what is meant by business ethics.
9. List and identify myths about business ethics.
10. Explain how to develop ethics management programs.

Ethics is the "science of morals". A moral is an accepted rule or standard of human behavior. The understanding of "accepted" is "accepted by society", and accepted only insofar as the behavior in question being behavior that affects others in the society, even if only indirectly. The implication of this definition is therefore that private actions that have no impact on others are a matter for personal morality, which is not of business or organizational concern.

However, the distinction between personal morality and business morality may not always be so clearly defined. This is because individuals bring personal values to their jobs and to the real or perceived problems of moral choice that confront them at work. Moral choices sometimes must be made because of tensions within individuals, between individuals, or between individuals and what they believe to be the values that drive their organizations.

Furthermore, business organizations do not operate in a social vacuum. Because of the ways business organizations can and do affect the lives and livelihoods of society at large, some would argue that business organizations are kind of "moral agents" in society. Therefore managers and general public alike often wrestle with defining exactly what constitutes the ethical way of doing business, and what constitutes proper constraints on individual self-interests, and by whom shall these constraints be imposed.

A further complexity results from the fact that businesses are increasingly becoming global in nature. Different countries have or seem to have vastly different customs and values. Understanding and assessing whether and how these different cultural and ethical conflicts should be taken into account is often most difficult.

ATTITUDE TO ETHICS

AMORAL:	Condone any actions that contribute to the corporate aim. Getting away with it is the key. No set of values other than greed.
LEGALISTIC:	Obey the letter of the law but not the spirit of it, especially if it conflicts with profits. Ethics ignored until it becomes **a** problem
RESPONSIVE:	Take the view that there is something to gain from ethical behavior, Using ethics as a tool to attain corporate aim.
EMERGING:	Ethical values becoming part of the culture. Codes of ethics being action documents, and likely to contain statements reflecting core value,
ETHICAL:	Total ethical profile. Everything done is ethical, and the right thing always done by everyone. The ideal.

In general, a key focus of ethics is the concept of integrity (or honesty). Integrity in broad terms will imply that no business-persons in the course of their business functions should be party to the falsification of any facts or information or make any statement which knowingly is misleading, false or deceptive in a material particular.

Another major focus of ethics is professional competence and due care, which implies that business professionals should always perform their functions in accordance with law and regulations. In other words, business transactions and professional functions should not be undertaken unless one possesses the required competence and technical skills.

A more controversial focus is the area of freedom from conflicts of interests. The preferred position of many is that one should always avoid concurrent involvement in any business, occupation or activity, which might result in the compromising of integrity, objectivity and independence of decision making.

ETHICAL SYSTEMS

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences
Deontology (Kantian ethics)	It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

In defining law and ethics and their relationship to each other it is necessary to distinguish between moral and legal rights and duties. Morally, a person's rights consist of claims that he can justly make to the conditions of well-being; his duties consist of what he can justly contribute to well being. Legal rights and duties - that is, claims and obligations enforceable at law - may or may not be fully in harmony with prevalent moral opinion systems in which law and ethics and religion are closely interwoven. The impact of moral opinion on law varies with the type of political structure and influence on public opinion.

In free societies the ultimate justification of law is that it serves moral ends. But the dependence of law on moral principles must not be taken to imply that there is a set of moral principles which can be lain down for guidance. However, most free societies are coming to be more or less consistent in principles that draw the line between law and morals. The task of ethics becomes two-fold: to bring out what is involved in the notion of a principle or norm of action and to recognize ideals that serve as agencies of guidance and control.

A number of consistent principles recognized in modern society are the individual, responsibility and equity. The end of law is to secure the greatest possible general individual self-assertion. In the Judeo-Christian ethic responsibility is a given: the best ordering of human society in which the individual may come to full manhood and satisfying existence. On the basis of equitable doctrine we can say confidently that morality is inseparable from the legal order; that right and wrong is part of the legal order.

DEFINITIONS

ETHICS: Ethics are standards of professional conduct and business practices adhered to by professionals in order to enhance their profession and maximize idealism, justice and fairness when dealing with the public, clients and other members of their profession (Merriam Webster).

LAWS: Laws are bodies of rules governing members of a community, state, organization, professional, etc ... and enforced by authority or compelling legislation (Merriam Webster).

LETTER vs. SPIRIT OF THE LAW: Being lawful is adhering to the letter of the law by following/obeying the rules and regulations. Being ethical is adhering to the spirit of the law or following you conscience or best moral judgment.

MORAL VALUES: Ethics in real estate deals with the law, rules, and regulations but has very little to say abut ethics and moral values. The subject is of such great importance in today's society, yet, it is only hinted at in the literature of real estate topics on law and ethics. There are things of deadly earnest that can only be safely mentioned under “cover of a joke." Ethics is one of those deadly earnest things.

Webster's Seventh New College Dictionary defines ethics as the principles of conduct governing an individual or group or a system of moral values. Moral is further defined as synonym of ethical meaning capable of right and wrong action when pertaining to an agency.

CULTURAL DIVERSITY: In our society the laws, rules, and regulations may be clear-cut but the interpretation, application and implementation are cloudy at best, especially, in a culturally diverse society. The religions and philosophies of the world speak most elegantly of the nature of ethics. The combining of the two systems or codes, the legal codes and moral codes, can try the patience of the wisest sages let alone of a realtor. The writers of past and present literature mirror the dilemma of ethical/moral conduct. Jules Renard stated "in morals always do as others do; in art never." While Ernest Hemingway stated "What is moral is what you feel good about after". Or "Character is like a tree and reputation is like a shadow. The shadow is what we think of it; the tree is the real thing." Anon.

SEPARATION: Ethics seems to be separated from the law like the state has been separated from the church by the First Amendment's establishment clause, "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; etc...." And yet, to explore the relationship between law and ethics we must look at the roots of our legal and ethical codes of conduct. The Greek, Roman and British empires have established our legal foundations while the great religions of our time Christianity, Judaism, Buddhism, Islamism, Hinduism, etc... have nurtured our moral foundations. Any attempt to separate the moral precepts of the great religions from modern day ethics would be amoral at its best and immoral at its worst. We can catch the gist of the dilemma between law and ethics in Lillian Hellman's saying: "cynicism is an unpleasant way of saying the truth". Ethics may not be fashionable today but as Lewis Mumford once stated, "trend is not destiny" and as Arthur C Clark further stated, "a faith that cannot survive collision with the truth is not worth many regrets."

ETHNIC ROOTS: The ethical value system of Real Estate Associations, for the most part in America, have derived from Judeo-Christian heritage. Society is a combination of pluralistic and or melting pot societies of diverse religions and cultures - which include Europeans, Hispanic, Blacks, Asians, Africans, among others. Set in this diverse background professional moral conduct appears to be based on a dichotomy of mutually exclusive groups or contradictory groups. While the laws, rules and regulations appear to be uniform codes, the ethics and morals appear to be diverse.

In trying to discern a variety of moral/ethical values and codes of conduct we can cite Bertrand Russell: "The most savage controversies are those about matters which there is no good evidence either way."

LEGAL vs. MORAL CODE: Fortunately, such is not the case with law and ethics, we can look at critical issues and separate the legal code from the moral code. For example, we can analyze the issue of murder. By law the issue of murder is a felony - a grave crime expressly declared by the common law or by statute. It may be further described as premeditated or first-degree murder or it may be due to negligence or third degree murder. The law in either instance deals with protection and retribution. By ethics, the issue of murder is based on a code of moral judgment like the Ten Commandments, "thou shalt not commit murder." Ethical codes deal with justice and rational behavior. Ethics is a code of moral behavior based on rational acts of behavior with the general good of society as its outcome.

RATIONAL ACTS: Further complications arise in understanding how we make moral judgment. Barbara Herman in her soon to be released textbook, *The Practice of Moral Judgment*, takes a look at the complications that arise when "we try to understand how we make moral judgments in an amoral world." Herman has stated that the 1980's emphasized material wealth --- and preparation for a lucrative profession. Judgments are based on experience and rightness where KANT describes rightness as rational Acts. The "law doesn't ...... have much to say about vast areas of human conduct and relations. Instead, people are guided by a wide variety of values and moral pressures from family, church, and peer groups. The difficulty is that - whatever the nature of your relation to morality - if you are in it for a payoff, it won't work."

ANALYSIS LAW – ETHICS: The law and ethics of a situation can be analyzed and separated into a cause and effect result. For example: In the style section of Los Angeles Herald Examiner, staff writer Tricia Crane stated in a headline article " No place for the children". The rental housing market, Osumi and others say, goes to elaborate lengths to keep kids out ...... Dick Osumi is in the trenches fighting a system that is becoming increasingly closed to the needs of children....California Landlords are using a loophole to get around the California law prohibiting `Adults only' apartment complexes. "Brian Hembacker, assistant counsel for the California Department of Fair Employment and Housing says over restrictive occupancy standards are being effectively used to create "Adults Only" complexes - despite the fact that they are illegal". The rule of law is clear but even clearer is the ethical issue.

THE LEGAL ISSUE: California law prohibiting "Adult Only" apartment complexes.

THE VIOLATION: Overly restrictive occupancy standards are being used to illegally bend the law.

THE ETHICAL ISSUE: The Los Angeles rental market and California landlords are becoming increasingly callous to the needs of children.

THE VIOLATION: The health and safety of children and families with children are in jeopardy.

ISSUE FOR A DECADE: The issue has been in the news for almost a decade. TIME staff writer Sharon Rosenhause in an article entitled "LAW BANNING ADULTS ONLY RENTALS TENTATIVELY OK'D", wrote in the Los Angeles Times: Los Angeles City Council backed an ordinance outlawing housing discrimination based on age. Its dramatic impact would be to prohibit "Adults only" apartment rentals. The law would be "healthy for the industry" because landlords "can't afford to close people out". In a poll survey reported by Pollster Mervin Field Los Angeles Times stated that "75% in the poll oppose any Adults only apartments".

EFFECTIVE ETHICS:

To be effective, ethics must be expressed as a set of principles, or values, a standard of conduct by which the individual guides his own behavior and judges that of others. It refers to our conduct, socially and in the business , and in attitude toward others. When one takes advantage of his/her position of trust to the detriment of another party solely for the purpose of one's own gain, we say he is unethical. Professional courtesy and ethics should not stop at those things which have been sanctioned by law.

HISTORICAL FOUNDATIONS OF LAW AND ETHICS

The great religions of the world gave birth to several concepts that evolved into structural precepts for society. A commonality of precepts evolved with the passing of tribal customs and tribal belief systems and the rise of the great religions of the world.

"The monotheistic idea of God unifies and coordinates the spiritual goods of the race. The unity of GOD involves the unity of all classes of men. This is a long step toward equality. The sense of sin became part and parcel of the common consciousness. It is a leveler and equalizer." For the good of the tribal society now becomes for the good of the individual. It must come to pass that a given society, if it is to retain the right to exist, must be continually extending the experience of its best things to men who were at one time outside, the pale of the best. The principle of individuality, once established, draws after it the principal of progress." "If it amounts to this, that wherever you find man, you find the eternal goods, and therefore the highest worth. The scale of market prices for the common man is forever disarranged by the discovery in him of something that is above price."

Two of the primary maxims in ethics are the utilitarian rule "Each man is to count for one, nobody for more than one". The second is Kant's--Always treat humanity, whether in yourself or another, as a person, and never as a thing."

"The only ground for counting every body as one, and nobody as more than one is the presence in all men of a something or other which possesses such value that existing social forms and economic accumulations cannot bid against it."

"The social question is the moral question, first, because its ultimate root is a choice between divergent ideals of the state, that , between different ways of viewing and organizing the total human life in time and space; and secondly, because, as a consequence, the question concerning the worth of the labor turns into the question concerning the worth of the laborer". The history of conscience is the history of the individual where 'conscience' means knowing along with " ...nothing can be good for one man that is not law for all men."

SELECT DEVELOPMENT OF LAW AND ETHIC

This section will review the historical evolution of law and ethics through select excerpts of legal philosophy from Plato to Hegel.

PLATO: Plato maintained that all wrong doing is involuntary and arises from ignorance since right conduct is happiness, and wrong conduct is unhappiness, and no one therefore would willingly choose wrong conduct which would lead to unhappiness. Plato's resolution was to make a distinction between acts which were remediable in damages and acts which require punishment between injury and wrongdoing. If there had been a wrongdoing, the guilty person must not only pay for the injury, but must also be punished,...the court must teach him virtue.

Plato endeavored to extend his ideas of code making from the civil to the criminal field, and to devise a penal code based upon rational principles. In the history of jurisprudence, no one has been more fully aware of the necessity of the reign of law for any state which desires to realize the ultimate values of happiness and well-being for its citizens.

ARISTOTLE: Aristotle assigned to jurisprudence what must always be its main task, the establishment of a rational legal order for a given society. "Every art and every inquiry and similarly every action and pursuit, is thought to aim at some good; and for this reason the good has rightly been declared to be that at which all things aim." Law may also be a means in the inculcation of established ethical ideals and the promotion of new ones. The precepts of the law are to live honorably, not to hurt another, to give each man his due." He further maintained that the state must train and educate its citizen in the spirit of the law - for there is no merit in the most valuable laws if citizens are not trained and educated early. "If a man is to lead the good life he must practice it a long time."

Aristotle left a powerful legacy on the law of property, contract, inheritance, possession, crime and punishment and tort.

CICERO: Cicero established a bridgehead between ancient and modern legal thought that was to be dominant in Western thinking. Justice is one; it binds all human society, and is based on one law, which is right reason applied to command and prohibition. Cicero's jurisprudence embraced a humanitarian ideal....that what people have always sought is equality of rights before the law. Laws were invented to speak to all men at all times in one and the same voice. He paved the way for identification of law and morality.

ST. THOMAS AQUINAS: "Law is defined by St. Thomas as an ordinance of reason for the common good, made by him who has care of the community, promulgated." His definition is an attempt to embrace all the law, the eternal, the natural as well as the human; there is an effort to include what is regarded as ethically necessary. Law is a rule or measure of Acts whereby one is induced to act or restrained from acting . The elements of law...insist that it is a form of reason, holds that it must be made for the common good, by the guardian of the community, and to teach men to lead the good life.

St. Thomas stated several principles that are inherent in the law: Law binds one to Act. Therefore, the first principle of human acts is the reason-modern substitutes for reasons have become utility, authority, experience. A second principle for common law asserts that choice between alternative rules of law shall rest on a deliberate balancing of possible ends and means. Third, the law must be for the common good. It rests on the ethical ideas that laws are rules of conduct which have as their final end the realization of happiness. Since, there are no limits to the good at which law aims, it is not restricted to the good of a particular person but always directed to the common good. Finally laws must be promulgated or made known to the people. Man should be informed of the laws he was expected to obey.

St. Thomas' argument for law as a necessity of human society is entirely an ethical one. The approach today attempts to show law in some sense as an essential constituent of society, generally, altogether apart from its function as an instrument in the promotion of ethical conduct. When the observance of the letter of the law is against the equality of justice and public good it is equitable to disregard it.

FRANCIS BACON: For Francis Bacon, there was only one end of law and that was the happiness of the citizens. He asserted that private rights were dependent ultimately for their security upon the preservation of public law extended to everything that affected the well being of the state. In Rome private law was that part which looked to the interests of individuals.

Bacon's ultimate achievement or ideal was that certainty was the primary necessity of law. The best law leaves the least to the discretion of the judge, and this can come about only if the laws are certain. Bacon's first remedy to achieve certainty is the basis of the theory of precedents and is therefore the root of the common law system of case law.

HOBBES: Hobbes distinguished law and right as complete opposites to each other. Right is the liberty which the laws leave us. The laws are the restraints by which we agree mutually to abridge one another's liberty. Hobbes emphasized the idea that morality was based on instructed prudence. In thinking of law he thus took his departure from neither the ethical nor the rational - his idea culminated in the doctrine that no positive law can be unjust. He admitted of the validity of ethical rules and conceded that they were anterior to the establishment of the state. Hobbes' idea became one of the most powerful weapons for the analysis of legal phenomena ever devised.

SPINOZA: His views contributed to the welfare of our social existence in that they taught social cooperation and contentment . He felt the attainment of virtuous habits is something for each man to achieve for himself if he can. Morality is not the business of the state--which is concerned solely with security. The roots of law in Spinoza's system is uniformity. He stated that " the moral judgment is determined by what a man would do if he were free to do it," and hence it is only necessary that he should think himself to be free in order to justify moral responsibility. Moral responsibility rests solely on the attitude displayed in so-called "choice".

LEIBNIZ: His central idea was that law should be taught both as a science and as a practical discipline. He insisted upon the necessity of a liberal education for the lawyer. When we train students in the law we are instructing them in one of the most vital functions of a culture – "the maintenance and development of a dominant order of society". For Leibniz God is the foundation of all-natural Right, God's existence serves as sufficient guarantee of the highest possible legal and moral condition in the universe. His philosophy was to exalt enlightenment, education and learning. He conceived justice as a communal virtue that is a virtue which preserves the community. Leibniz defined six types of communities: the marital community, the family community of master and servant, the community of the household, the civil community comprising the city, province and the state and finally the community of God - the church. The aim of the community was to attain happiness. For Leibinz the end of the law emphasized two tasks—one, a proper consideration of the human being and second, the attainment of the common end as the measure of social values.

LOCKE: Locke believed he could, through reason, frame a set of moral rules which would be universally applicable. He took the position that human reason needed the assistance of religion in order to work out a system of ethics. At the heart of Locke's theory of civil society was the idea of the law. The great and chief end of men uniting into commonwealths, and putting themselves under government, is the preservation of their property. Law to Locke was a branch of ethics, and laws in their essence were moral rules. He did not think of law as a command but as that which is set up by authority as a rule for the measure of conduct. In Locke's system the capacity of Supreme Power is fiduciary - it establishes a pattern to which behavior should conform--which associates rewards and penalties for conformity or infractions.....the end of law is not to abolish or restrain, but to preserve and enlarge freedom. Where there is no law there is no freedom.

HUME: Hume based his studies on human nature. In his system justice serves both an ethical and a sociological function. In ethics ...what is approved is pleasant or promotes human happiness. A legal system to be socially useful must adhere strictly to its rules even at the expense of injustice in individual cases. Hume advanced the contention that public utility is the sole origin of legal justice and the sole foundation of its merit. For example a criminal has fewer rights than an innocent man but he is nevertheless accorded some measure of protection by law. Hume distinguished many of the separate ideas which jurists now find in the concept "LAW". Property in the broad sense employed by Hume embraced the individual's rights to life, liberty and health. Hume's solution of why men obey law is essentially a sociological and not an ethical one. He attempted to show that morality was founded on feeling and not reason. Justice can be understood only on the basis of sympathy for the welfare of human life.

KANT: Kant developed his system of law on principles that originate in reason. The Kantian rule became the celebrated injunction: "Every man is free to do that which he wills provided he infringes not the equal liberty of any other man." (Herbert Spencer). Kant's conception of right became what he termed Universal Law of Right: Every action is right which in itself or in the maxim on which it proceeds, is such that it can exist along with the freedom of the will of each and all in action. Kant made a sharp distinction between ethics and law. Ethics as distinguished from law, does not impose upon me the obligation to make the fulfillment of rights a maxim of my conduct. Kant assigned possession two meanings, physical possession and rational or juridical possession. He stated anyone who would assert the right to a thing as his, must be in possession of it as an object. "The property right is essentially a guarantee of the exclusion of other persons from the use of handling the thing. To enforce this right the holder must be able to assert his right." Kant defines moveable property as everything that can be destroyed. Kant limits the right of taking possession of the soil to the extent of the capacity to defend it. Kant's important contribution is his idea that right is a thing that presupposes a collective will of all united in a relation of common possession. One of his most influential ideas is his theory of contract. Kant calls the transference of property to another its "alienation", and the act of united wills of two persons, by which what belongs to one passes to another, he terms "contract".

Kant held that four juridical acts are involved in every contract--two preparatory; an offer followed by an indication that the offer will be accepted; these two are followed by a promise and an acceptance. In civil law Kant's separation of offer and promise still prevail. By contract, Kant held, "I acquire the promise of another, as distinguished from the thing promised." His concept of the Criminal law turns on the idea of retributive justice. He defined crime as any transgression of the public law which makes him who commits it incapable of being a citizen.

FICHTE: For Fichte the basis of law is the idea of the legal relation. The conception of law is the conception of a relation between human beings. He defines this relationship as the compulsion upon each individual to restrict his freedom in recognition of the possibility of the freedom of others. He calls this the "relation of legality". In no sense is jurisprudence to be connected with morality. Jurisprudence is not a branch of ethics. Law merely permits but morality commands. Fichte's law is a law of freedom.

Individuals are free to accept or reject it. The end of law is a community of free beings. All positive laws follow the principle of right. They cannot be arbitrary and they must be such as every rational being would make them. Fichte reached the conclusion that natural law, or a legal relation between men, is not possible except in a commonwealth and under positive law. He asserted to supporting propositions: "all law is purely the law of reason", and "all law is the law of the state". Man separates himself from his citizenship in order to elevate himself with absolute freedom to morality; but in order to do so he becomes a citizen.

HEGEL: Hegel emphasized two ideas--will and personality. "Be a person and respect others as persons." From the ideas of will and personality he developed three categories of right -- possession of property, contract and wrongdoing and crime. Hegel's system is based upon a principle of knowledge, reason, which acts universally. The ethical rules which are to guide individuals must be given a universal form.

CONCLUSIONS

In the historical development of law there are many different points of view. It is for this reason that the law is unable to accept without modification many of the results of ethical inquiry. There are no properties of goodness and badness that states of affairs inherently possess, and no properties of rightness or wrongness that inhere in actions.

Value judgment in a broad sense compares contrasted ways of life; rationality, prudence and stability, (one of pleasure and happiness) versus the state of anxiety, confusion, inner turmoil and impulsive rashness. The first is a "good" way of life; the other is a "bad" way in terms of value. The best way of life involves the guidance of reason, and also the way of knowledge, of understanding, of relative freedom from error.

Moral responsibility rests solely on the attitude displayed in so-called "choice". The act of choosing is essentially a proper and stringent expression of the ethical. Whenever in a stricter sense there is a question of an either/or one can always be sure that the ethical is involved.

An ethic must first decide upon the kind of social effects which it desires to achieve and the kind which it desires to avoid. It must then decide, as far as our knowledge permits, what acts will promote the desired consequences; these acts it will praise, while those having a contrary tendency it will condemn. To the extent to which man has freedom, he needs a personal morality to guide his conduct. "Good and evil grow up together and are bound in an equilibrium that cannot be surrendered. The most we can do is try to tilt the equilibrium toward the good." The least we can do is be aware of our standards of conduct least "....the habit of being amoral should make the immoral come to seem right."

Ethical Reasoning and Accountants

The largest part of the prior research projects which have been done on ethical issues in accounting have generally avoided theoretical discussions about "right and wrong" or "good and bad" choices. Instead they have focused on determining whether or not accountants are abiding by the rules of professional conduct. We have already discussed the many philosophical theories of ethics earlier in this chapter, but there are basically two principles used to resolve ethical dilemmas, related to CPAs, which are utilitarianism and rule deontology.

Utilitarianism (teleological ethics)	The promotion that the best long-term interest of everyone concerned should be the moral standard: one should take those actions that lead to the greatest balance of good versus bad consequences

Deontology (Kantian ethics)	It deals with the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

In utilitarian, the focus is based on the consequences of an action rather than abiding by rules. Deontology, on the other hand, focuses on just the opposite. Under Deontology principles, an accountant would be more concerned with abiding by rules of professional conduct no matter what the consequences.

For example, a study was published in 1994, to determine how accountants, specifically auditors, used ethical reasoning when confronted with issues related to client confidentiality. Rule 301, *Confidential Client Information*, of the AICPA' Code of Professional Conduct states that a member in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations

(1) To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations

(2) To discharge his/her professional obligations properly under Conduct Rules 202 and 203

(3) To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization

(4) To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

In the study, a survey consisting of three different circumstances was sent to 100 randomly selected CPA's. Each CPA was asked to respond to each circumstance described using the following guide:

1) To inform or not inform a third party of confidential client information, and

2) To indicate which response given in 1) was considered "good ethical behavior" if the Code was disregarded. Respondents were also asked to provide justification for their answers.

The following are the circumstances they were given:

"Scenario 1: James Corporation employs the regional CPA firm of Green and Cash to audit its financial statements. The firm has been asked to prepare quarterly financial statements for the first quarter of 1986. Bob Ethics, a staff accountant, was assigned to do the work. During the course of preparing the statements, Bob discovered that James Corporation materially understated net income on last year's tax return. Bob informed his supervisor about this and the client is asked to prepare an amended tax return. The client, however, refused to take corrective action.

> Scenario 2: Johnson Manufacturing Corporation is a publicly owned company that manufactures equipment used by hospitals and medical laboratories. The company is audited by the national accounting firm of Adams & Pitre. One day, John, the senior in charge of the engagement overheard a conservation between two managers indicating that although they met inspection standards, they were aware of a defect in a particular piece of equipment, but they had not notified any of their customers because they felt the probability of malfunction was low. John takes this information to the controller and is told not to include it in the audit report. He then takes it to the manager on the engagement. The manager informs University Hospital, one of its clients, and also a major customer of Johnson Manufacturing Corporation, not to purchase any more equipment from Johnson. Johnson sues Adams & Pitre for violating the confidentiality rule.

> Scenario 3: William Johnson, a CPA, served as a director of Last National Bank for a year. As a director, William may be held liable for damages if he fails to use care and prudence in administering bank affairs and such action causes the bank to suffer a financial loss. In the course of an audit, William discovered a seriously weakened financial position in a client who has a large loan at Last National Bank. Disclosure of this condition to the other bank directors would minimize the bank's loss, however, since the audit has not been completed, this would represent a violation of Rule 301 of the Code.[1]"

According to the study, the following were the results, conclusions and implications:

> "Scenario 1. Given a Code, most (78%) respondents would not inform the IRS. This is in agreement with the rule of conduct. Although the variability increased, most CPAs (70%) in this situation, would make the same decision without a Code. This is consistent with the justification given that most CPAs perceived themselves to be an advocate of the client in a tax engagement. There was no perceived conflict in the rule of conduct and what most accountants perceived as good ethical behavior.

> Scenario 2. Most CPAs (78%) responding in this situation would adhere to the Code and not inform one client of information discovered while auditing another client. A large percentage (52%) of respondents, however, indicated that informing would be the "best ethical behavior." In most instances, "potential safety concerns" were cited as the

[1] "Ethical reasoning in confidentiality decisions," by Barbara L. Adams, Fannie L. Malone, and Woodrow James, Jr., The CPA Journal, July 1994

justification for considering informing as the "best ethical behavior." Thus, there appears to be some conflict in adhering to the Code and the moral value of some CPAs.

Scenario 3. Given a Code, a majority (78%) of CPAs would not inform, which is in agreement with the Code. A lesser percentage (53%), however, feel this is the best ethical behavior.

CONCLUSIONS AND IMPLICATIONS

The findings of this study indicate that CPAs usually adhere to the Code (rule deontology) in resolving issues involving confidentiality. However, such decisions are not always in accord with what they perceive as "good ethical behavior." The broad principles of the Code indicate that ethical conduct, in the truest sense, means more than abiding by a letter of a rule. It means accepting a responsibility to do what is honorable or doing that which promotes the greatest good to the greatest number of people, even if it results in some personal sacrifice. Somehow, the profession needs to emphasize the "greatest good" criterion more strongly in applying the rules of conduct."

CULTURE, MOTIVATION, POWER, AND BUSINESS ETHICS

Culture

Culture can be defined as everything in our surroundings made by people, both tangible items and intangible concepts and values. Language, religion, law, politics, technology, education, social organization, general values, and ethical standards are all included in this definition. Each nation has a distinctive culture, hence distinctive beliefs about what business activities are acceptable or unethical. Thus, with the emergence of international business, individuals encounter values, beliefs, and ideas that may differ from their own because of cultural differences. Cultural differences include differences in speech and body language. Problems of translation into another language often make it difficult for business people to express exactly what they mean to say. Language differences also create ethical issues in finance. For example, in Germany, a bribe to obtain a contract in a foreign country can be considered as an expense and be included in a loan application.

Cultural differences in body language also create difficulties in international business. Body language is nonverbal, usually unconscious, communication through gestures, posture, and facial expressions. For example, personal space, the distance at which one person feels comfortable when talking to another, varies from culture to culture. American and British business people prefer a larger space than do South American, Greek, and Japanese. The difference can cause uncomfortable feelings when people from different countries negotiate with each other. Other body language like finger pointing or a nod of the head mean different things as well. Finger pointing is considered rude in Asia and Africa, and the British use the nod of the head to mean that they hear, not that they agree. These cultural differences can result in miscommunications and insults and can harm business negotiations.

Motivation

Leadership is the ability or authority to guide and direct others toward achievement of a goal. It has a significant impact on ethical decision making because leaders have power to motivate others and enforce the organization's rules and policies as well as their own viewpoints. A leader's ability to motivate subordinates is a key consideration in maintaining an ethical organization. Motivation is a force within the individual that focuses his or her behavior to achieve a goal. To create motivation, an organization offers incentives to encourage employees to work toward organizational objectives. Understanding motivation is important in the management of others, and it helps explain their ethical behavior. For example, a person who aspires to higher positions in an organization may sabotage a coworker's project to make that person look bad. This unethical behavior is directly related to the first employee's motivation to rise in the organization.

From an ethics perspective, needs or goals may change as a person progresses through the ranks of the company. This shift may cause or help solve problems, depending on the current ethical status of the person relative to the company or society. It is possible that an individual's hierarchy of needs may influence motivation and ethical behavior. After basic needs such as food, working conditions, and survival are satisfied, resources are available for relatedness needs (social and interpersonal relationships) and growth needs (creative or productive activities) which may become important.

Examining the role of motivation in ethics is an attempt to relate business ethics with the broader social context in which workers live and the deeper moral assumptions on which society depends. Workers are individuals, and they will be motivated by a variety of personal interests. While it is emphasized that managers are positioned to exert pressure and obtain compliance on ethically related issues, it must be acknowledged that an individual's personal ethics and needs will significantly affect ethical decisions.

Power

Power refers to the influence leaders and managers have over the behavior and decisions of subordinates. An individual has power over others when his or her presence causes them to behave differently. Exerting power is one way to influence the ethical decision-making framework. The status and power of significant others are directly related to the amount of pressure they can exert on employees to conform to their expectations. A superior in an authority position can put strong pressure on employees to comply, even when their personal ethical values conflict with superior's wishes.

Professors John French and Bertram Ravin have defined five power bases from which one person may influence another: (1) reward power, (2) coercive power, (3) legitimate power, (4) expert power, and (5) referent power. These five bases of power can be used to motivate individuals either ethically or unethically.

Reward Power

Reward power refers to a person's ability to influence the behavior of others by offering them something desirable. Typical rewards might be money, status, or promotion. In the short run, however, reward power is not as effective as coercive power.

Coercive Power

Coercive power is essentially the opposite of reward power. Instead of rewarding a person for doing something, coercive power penalizes actions or behavior. Coercive power uses fear to change behavior. For this reason, it has been found to be more effective in changing behavior in the short run than in the long run. Coercion is often employed in situations of extreme imbalance of power. In firms that use coercive power, relationships usually break down in long run.

Legitimate Power

Legitimate power stems from the belief that a certain person has the right to exert influence and that certain others have an obligation to accept it. The titles and positions of authority that organizations bestow on individuals appeal to this traditional view of power. Many people readily comply to those who wield legitimate power, sometimes committing acts that are contrary to their beliefs and values. Such strong loyalty to authority figures can be seen in corporations with strong charismatic leaders and centralized structures.

Expert Power

Expert power is derived from a person's knowledge or perception of knowledge. Expert power usually stems from a superior's credibility with his or her subordinates. Credibility, and thus expert power, is positively related to the number of years a person has worked in a firm or industry, to the person's education, or to the honors he or she has received for performance. Expert power can cause ethical problems when it is used to manipulate others to gain an unfair advantage.

Referent Power

Referent power may exist when one person perceives that his or her goals or objectives are similar to another's. The second person may attempt to influence the first to take actions that lead both to achieve their objectives. For this power base to be effective, however, some sort of empathy must exist between the individuals. Identification with others helps boost the decision maker's confidence when making a decision, thus providing an increase in referent power.

DOCUMENT FILLS A VOID OF PRACTICAL BUSINESS ETHICS INFORMATION FOR LEADERS AND MANAGERS

Current Literature is Focused on Needs of Philosophers, Academics and Social Critics -- Leaders and Managers Require More Practical Information About Managing Ethics

Managing ethics in the workplace holds tremendous benefit for leaders and managers, benefits both moral and practical. This is particularly true today when it is critical to understand and manage highly diverse values in the workplace.

However, the field of business ethics has traditionally been the domain of philosophers, academics and social critics. Consequently, much of today's literature about business ethics is not geared toward the practical needs of leaders and managers -- the people primarily responsible for managing ethics in the workplace. The most frequent forms of business ethics literature today typically include: a) philosophical, which requires extensive orientation and analysis; b) anthologies, which require much time, review and integration; c) case studies, which require numerous cases, and much time and analyses to synthesize; and d) focus on social responsibility, which includes many examples of good and bad actions taken by companies. (This lack of practical information is not the fault of philosophers, academic or social critics. The problem is the outcome of insufficient involvement of leaders and managers in discussion and literature about business ethics. More leaders and managers must become involved. This guidebook aims to increase that involvement.)

What's Conspicuously Missing is the "How to" of Managing Ethics in the Workplace

But it isn't from lack of examples that managers aren't better at managing ethics in the workplace -- they require more practical information about managing ethics. This problem was explained very well by Stark in his article, "What's the Matter with Business Ethics?" published in the *Harvard Business Review* (1993, May/June, pp. 38-48). Brenner (*Journal of Business Ethics,* V11, pp. 391:399) notes "while much has been written about individual components of ethics programs, especially about codes of ethics, the literature is much more limited on ethics programs." Wong and Beckman (*Journal of Business Ethics,* V11, pp. 173-178) note that "researchers are claiming that current literature is filled with strong arguments for more ethical corporate leadership and incorporation of ethics in business curriculum, but what is conspicuously missing is the "how to" in actually putting ethical goals and theories into practical action."

Myths Abound About Business Ethics, e.g., "Ethics is Simply to Do What's Right"

Lack of involvement from leaders and managers in the field of business ethics (again, this is the fault of no one or of everyone) has spawned a great deal of confusion and misunderstanding among leaders and managers about business ethics. McDonald and Zepp, in their article "What

Should Be Done? A Practical Approach to Business Ethics" (*Management Decision*, 28, 1, 1990, pp. 9-13), note that when someone brings up the topic of business ethics "... it tends to bring up cynicism, righteousness, paranoia, and laughter." Many leaders and managers believe business ethics is religion because it seems to contain a great deal of preaching. Or, they believe it to be superfluous because it seems to merely assert the obvious: "do good!"

Business Ethics Literature is Often Far Too Simplistic -- So Many Leaders and Managers Think Business Ethics is Irrelevant

Stark notes that "often ethicists advance a kind of moral absolutism that avoids many of the difficult and most interesting questions." Case studies to explore ethical dilemmas are often far too simplistic, presented as if every real-life situation has a right and wrong e.g., "should I lie, cheat or steal?" Consequently, many managers believe business ethics is irrelevant because too much business ethics training avoids the real-to-life complexities in leading organizations. (This document contains samples of real-to-life, complex ethical dilemmas, in a subsection, "Examples of Real-to-Life Complex Ethical Dilemmas" in the upcoming section "Ethics Tools: Resolving Ethical Dilemmas.") Bob Dunn, President and CEO of San Francisco-based Business for Social Responsibility, explains, "Ethical decisions aren't as easy as they used to be. Now, they're the difference between right -- and right." Preston Townley, in his speech "Business Ethics: Commitment to Tough Decisions" (*Vital Speeches*, January 1992, pp. 208-211), states that "... it ought to be fairly easy to choose between right and wrong by relying on principles, but business activity often demands that we select from alternatives that are neither wholly right or wholly wrong."

WHAT IS BUSINESS ETHICS?

"What is ethics?" Simply put, ethics involves learning what is right or wrong, and then doing the right thing -- but "the right thing" is not nearly as straightforward as conveyed in a great deal of business ethics literature. Most ethical dilemmas in the workplace are not simply a matter of "Should Bob steal from Jack?" or "Should Jack lie to his boss?"

(Many ethicists assert there's always a right thing to do based on moral principle, and others believe the right thing to do depends on the situation — ultimately it's up to the individual.) Many philosophers consider ethics to be the "science of conduct." Ethics includes the fundamental ground rules by which we live our lives. Philosophers have been discussing ethics for at least 2500 years, since the time of Socrates and Plato. Many ethicists consider emerging ethical beliefs to be "state of the art" legal matters, i.e., what becomes an ethical guideline today is often translated to a law, regulation or rule tomorrow. Values which guide how we ought to behave are considered moral values, e.g., values such as respect, honesty, fairness, responsibility, etc. Statements around how these values are applied are sometimes called moral or ethical principles.

So What is "Business Ethics"? The concept has come to mean various things to various people, but generally it's coming to know what it right or wrong in the workplace and doing what's right

— this is in regard to effects of products/services and in relationships with stakeholders. Wallace and Pekel explain that attention to business ethics is critical during times of fundamental change — times much like those faced now by businesses, both nonprofit or for-profit. In times of fundamental change, values that were previously taken for granted are now strongly questioned. Many of these values are no longer followed. Consequently, there is no clear moral compass to guide leaders through complex dilemmas about what is right or wrong. Attention to ethics in the workplace sensitizes leaders and staff to how they should act. Perhaps most important, attention to ethics in the workplaces helps ensure that when leaders and managers are struggling in times of crises and confusion, they retain a strong moral compass. However, attention to business ethics provides numerous other benefits, as well (these benefits are listed later in this document).

Note that many people react that business ethics, with its continuing attention to "doing the right thing," only asserts the obvious ("be good," "don't lie," etc.), and so these people don't take business ethics seriously. For many of us, these principles of the obvious can go right out the door during times of stress. Consequently, business ethics can be strong preventative medicine. Anyway, there are many other benefits of managing ethics in the workplace. These benefits are explained later in this document.

Two Broad Areas of Business Ethics

1. *Managerial mischief.* Madsen and Shafritz, in their book "Essentials of Business Ethics" (Penguin Books, 1990) further explain that "managerial mischief" includes "illegal, unethical, or questionable practices of individual managers or organizations, as well as the causes of such behaviors and remedies to eradicate them." There has been a great deal written about managerial mischief, leading many to believe that business ethics is merely a matter of preaching the basics of what is right and wrong. More often, though, business ethics is a matter of dealing with dilemmas that have no clear indication of what is right or wrong.

2. *Moral mazes.* The other broad area of business ethics is "moral mazes of management" and includes the numerous ethical problems that managers must deal with on a daily basis, such as potential conflicts of interest, wrongful use of resources, mismanagement of contracts and agreements, etc.

Business ethics is now a management discipline. Business ethics has come to be considered a management discipline, especially since the birth of the social responsibility movement in the 1960s. In that decade, social awareness movements raised expectations of businesses to use their massive financial and social influence to address social problems such as poverty, crime, environmental protection, equal rights, public health and improving education. An increasing number of people asserted that because businesses were making a profit from using our country's resources, these businesses owed it to our country to work to improve society. Many researchers, business schools and managers have recognized this broader constituency, and in their planning and operations have replaced the word "stockholder" with "stakeholder," meaning to include employees, customers, suppliers and the wider community.

The emergence of business ethics is similar to other management disciplines. For example, organizations realized that they needed to manage a more positive image to the public and so the recent discipline of public relations was born. Organizations realized they needed to better manage their human resources and so the recent discipline of human resources was born. As commerce became more complicated and dynamic, organizations realized they needed more guidance to ensure their dealings supported the common good and did not harm others -- and so business ethics was born.

Note: 90% of business schools now provide some form of training in business ethics. Today, ethics in the workplace can be managed through use of codes of ethics, codes of conduct, roles of ethicists and ethics committees, policies and procedures, procedures to resolve ethical dilemmas, ethics training, etc.

Ten Myths About Business Ethics

Business ethics in the workplace is about prioritizing moral values for the workplace and ensuring behaviors are aligned with those values — it's values management. Yet, myths abound about business ethics. Some of these myths arise from general confusion about the notion of ethics. Other myths arise from narrow or simplistic views of ethical dilemmas.

1. ***Myth: Business ethics is more a matter of religion than management.*** Diane Kirrane, in "Managing Values: A Systematic Approach to Business Ethics," (*Training and Development Journal*, November 1990), asserts that "altering people's values or souls isn't the aim of an organizational ethics program — managing values and conflict among them is ..."

2. ***Myth: Our employees are ethical so we don't need attention to business ethics.*** Most of the ethical dilemmas faced by managers in the workplace are highly complex. Wallace explains that one knows when they have a significant ethical conflict when there is presence of a) significant value conflicts among differing interests, b) real alternatives that are equality justifiable, and c) significant consequences on "stakeholders" in the situation. Kirrane mentions that when the topic of business ethics comes up, people are quick to speak of the Golden Rule, honesty and courtesy. But when presented with complex ethical dilemmas, most people realize there's a wide "gray area" when trying to apply ethical principles.

3. ***Myth: Business ethics is a discipline best led by philosophers, academics and theologians.*** Lack of involvement of leaders and managers in business ethics literature and discussions has led many to believe that business ethics is a fad or movement, having little to do with the day-to-day realities of running an organization. They believe business ethics is primarily a complex philosophical debate or a religion. However, business ethics is a management discipline with a programmatic approach that includes several practical tools. Ethics management programs have

practical applications in other areas of management areas, as well. (These applications are listed later on in this document.)

4. ***Myth: Business ethics is superfluous -- it only asserts the obvious: "do good!"*** Many people react that codes of ethics, or lists of ethical values to which the organization aspires, are rather superfluous because they represent values to which everyone should naturally aspire. However, the value of a codes of ethics to an organization is its priority and focus regarding certain ethical values in that workplace. For example, it's obvious that all people should be honest. However, if an organization is struggling around continuing occasions of deceit in the workplace, a priority on honesty is very timely -- and honesty should be listed in that organization's code of ethics. Note that a code of ethics is an organic instrument that changes with the needs of society and the organization.

5. ***Myth: Business ethics is a matter of the good guys preaching to the bad guys.*** Some writers do seem to claim a moral high ground while lamenting the poor condition of business and its leaders. However, those people well versed in managing organizations realize that good people can take bad actions, particularly when stressed or confused. (Stress or confusion are not excuses for unethical actions -- they are reasons.) Managing ethics in the workplace includes all of us working together to help each other remain ethical and to work through confusing and stressful ethical dilemmas.

6. ***Myth: Business ethics is the new policeperson on the block.*** Many believe business ethics is a recent phenomenon because of increased attention to the topic in popular and management literature. However, business ethics was written about even 2,000 years ago -- at least since Cicero wrote about the topic in his *On Duties.* Business ethics has gotten more attention recently because of the social responsibility movement..

7. ***Myth: Ethics can't be managed.*** Actually, ethics is always "managed" -- but, too often, indirectly. For example, the behavior of the organization's founder or current leader is a strong moral influence, or directive if you will, on behavior or employees in the workplace. Strategic priorities (profit maximization, expanding marketshare, cutting costs, etc.) can be very strong influences on morality. Laws, regulations and rules directly influence behaviors to be more ethical, usually in a manner that improves the general good and/or minimizes harm to the community. Some are still skeptical about business ethics, believing you can't manage values in an organization. Donaldson and Davis (*Management Decision,* V28, N6) note that management, after all, is a value system. Skeptics might consider the tremendous influence of several "codes of ethics," such as the "10 Commandments" in Christian religions or the U.S. Constitution. Codes can be very powerful in smaller "organizations" as well.

8. ***Myth: Business ethics and social responsibility are the same thing.*** The social responsibility movement is one aspect of the overall discipline of business ethics. Madsen and Shafritz refine the definition of business ethics to be: 1) an application of ethics to the corporate community, 2) a way to determine responsibility in business dealings, 3) the identification of important business

and social issues, and 4) a critique of business. Items 3 and 4 are often matters of social responsibility. (There has been a great deal of public discussion and writing about items 3 and 4. However, there needs to be more written about items 1 and 2, about how business ethics can be managed.) Writings about social responsibility often do not address practical matters of managing ethics in the workplace, e.g., developing codes, updating polices and procedures, approaches to resolving ethical dilemmas, etc.

9. ***Myth: Our organization is not in trouble with the law, so we're ethical.*** One can often be unethical, yet operate within the limits of the law, e.g., withhold information from superiors, fudge on budgets, constantly complain about others, etc. However, breaking the law often starts with unethical behavior that has gone unnoticed. The "boil the frog" phenomena is a useful parable here: If you put a frog in hot water, it immediately jumps out. If you put a frog in cool water and slowly heat up the water, you can eventually boil the frog. The frog doesn't seem to notice the adverse change in its environment.

10. ***Myth: Managing ethics in the workplace has little practical relevance.*** Managing ethics in the workplace involves identifying and prioritizing values to guide behaviors in the organization, and establishing associated policies and procedures to ensure those behaviors are conducted. One might call this "values management." Values management is also highly important in other management practices, e.g., managing diversity, Total Quality Management (TQM), and strategic planning.

Ten Benefits of Managing Ethics in the Workplace

Many people are used to reading or hearing of the moral benefits of attention to business ethics. However, there are other types of benefits, as well. The following list describes various types of benefits from managing ethics in the workplace.

1. ***Attention to business ethics has substantially improved society.*** A matter of decades ago, children in our country worked 16-hour days. Workers' limbs were torn off and disabled workers were condemned to poverty and often to starvation. Trusts controlled some markets to the extent that prices were fixed and small businesses choked out. Price fixing crippled normal market forces. Employees were terminated based on personalities. Influence was applied through intimidation and harassment. Then society reacted and demanded that businesses place high value on fairness and equal rights. Anti-trust laws were instituted. Government agencies were established. Unions were organized. Laws and regulations were established.

2. ***Ethics programs help maintain a moral course in turbulent times.*** As noted earlier in this document, Wallace and Pekel explain that attention to business ethics is critical during times of fundamental change -- times much like those faced now by businesses, both nonprofit or for-profit. During times of change, there is often no clear moral compass to guide leaders through complex conflicts about what is right or wrong. Continuing attention to ethics in the workplace

sensitizes leaders and staff to how they want to act -- consistently.

3. ***Ethics programs cultivate strong teamwork and productivity.*** Ethics programs align employee behaviors with those top priority ethical values preferred by leaders of the organization. Usually, an organization finds surprising disparity between its preferred values and the values actually reflected by behaviors in the workplace. Ongoing attention and dialogue regarding values in the workplace builds openness, integrity and community -- critical ingredients of strong teams in the workplace. Employees feel strong alignment between their values and those of the organization. They react with strong motivation and performance.

4. ***Ethics programs support employee growth and meaning.*** Attention to ethics in the workplace helps employees face reality, both good and bad -- in the organization and themselves. Employees feel full confidence they can admit and deal with whatever comes their way. Bennett, in his article "Unethical Behavior, Stress Appear Linked" (*Wall Street Journal*, April 11, 1991, p. B1), explained that a consulting company tested a range of executives and managers. Their most striking finding: the more emotionally healthy executives, as measured on a battery of tests, the more likely they were to score high on ethics tests.

5. ***Ethics programs are an insurance policy -- they help ensure that policies are legal.*** There is an increasing number of lawsuits in regard to personnel matters and to effects of an organization's services or products on stakeholders. As mentioned earlier in this document, ethical principles are often state-of-the-art legal matters. These principles are often applied to current, major ethical issues to become legislation. Attention to ethics ensures highly ethical policies and procedures in the workplace. It's far better to incur the cost of mechanisms to ensure ethical practices now than to incur costs of litigation later. A major intent of well-designed personnel policies is to ensure ethical treatment of employees, e.g., in matters of hiring, evaluating, disciplining, firing, etc. Drake and Drake (*California Management Review*, V16, pp. 107-123) note that "an employer can be subject to suit for breach of contract for failure to comply with any promise it made, so the gap between stated corporate culture and actual practice has significant legal, as well as ethical implications."

6. ***Ethics programs help avoid criminal acts "of omission" and can lower fines.*** Ethics programs tend to detect ethical issues and violations early on so they can be reported or addressed. In some cases, when an organization is aware of an actual or potential violation and does not report it to the appropriate authorities, this can be considered a criminal act, e.g., in business dealings with certain government agencies, such as the Defense Department. The recent Federal Sentencing Guidelines specify major penalties for various types of major ethics violations. However, the guidelines potentially lowers fines if an organization has clearly made an effort to operate ethically.

7. ***Ethics programs help manage values associated with quality management, strategic planning and diversity management -- this benefit needs far more attention.*** Ethics programs identify preferred values and ensuring organizational behaviors are aligned with those values.

This effort includes recording the values, developing policies and procedures to align behaviors with preferred values, and then training all personnel about the policies and procedures. This overall effort is very useful for several other programs in the workplace that require behaviors to be aligned with values, including quality management, strategic planning and diversity management. TQM includes high priority on certain operating values, e.g., trust among stakeholders, performance, reliability, measurement, and feedback. Eastman and Polaroid use ethics tools in their quality programs to ensure integrity in their relationships with stakeholders. Ethics management techniques are highly useful for managing strategic values, e.g., expand marketshare, reduce costs, etc. McDonnell Douglas integrates their ethics programs into their strategic planning process. Ethics management programs are also useful in managing diversity. Diversity is much more than the color of people's skin -- it's acknowledging different values and perspectives. Diversity programs require recognizing and applying diverse values and perspectives -- these activities are the basis of a sound ethics management program.

8. ***Ethics programs promote a strong public image.*** Attention to ethics is also strong public relations -- admittedly, managing ethics should not be done primarily for reasons of public relations. But, frankly, the fact that an organization regularly gives attention to its ethics can portray a strong positive to the public. People see those organizations as valuing people more than profit, as striving to operate with the utmost of integrity and honor. Aligning behavior with values is critical to effective marketing and public relations programs. Consider how Johnson and Johnson handled the Tylenol crisis versus how Exxon handled the oil spill in Alaska. Bob Dunn, President and CEO of San Francisco-based Business for Social Responsibility, puts it best: "Ethical values, consistently applied, are the cornerstones in building a commercially successful and socially responsible business."

9. ***Overall benefits of ethics programs:*** Donaldson and Davis, in "Business Ethics? Yes, But What Can it Do for the Bottom Line?" (Management Decision, V28, N6, 1990) explain that managing ethical values in the workplace legitimizes managerial actions, strengthens the coherence and balance of the organization's culture, improves trust in relationships between individuals and groups, supports greater consistency in standards and qualities of products, and cultivates greater sensitivity to the impact of the enterprise's values and messages.

10. ***Last - and most -- formal attention to ethics in the workplace is the right thing to do.***

One Description of a Highly Ethical Organization

Mark Pastin, in *The Hard Problems of Management: Gaining the Ethics Edge* (Jossey-Bass, 1986), provides the following four principles for highly ethical organizations:

1. They are at ease interacting with diverse internal and external stakeholder groups. The ground rules of these firms make the good of these stakeholder groups part of the organizations' own good.

2. They are obsessed with fairness. Their ground rules emphasize that the other persons' interests count as much as their own.

3. Responsibility is individual rather than collective, with individuals assuming personal responsibility for actions of the organization. These organizations' ground rules mandate that individuals are responsible to themselves.

4. They see their activities in terms of purpose. This purpose is a way of operating that members of the organization highly value. And purpose ties the organization to its environment.

Note the following characteristics of a high integrity organization:

1. There exists a clear vision and picture of integrity throughout the organization.
2. The vision is owned and embodied by top management, over time.
3. The reward system is aligned with the vision of integrity.
4. Policies and practices of the organization are aligned with the vision; no mixed messages.
5. It is understood that every significant management decision has ethical value dimensions. Everyone is expected to work through conflicting-stakeholder value perspectives.

Ethics Management Programs: An Overview

About Ethics Management Programs

Organizations can manage ethics in their workplaces by establishing an ethics management program. Brian Schrag, Executive Secretary of the Association for Practical and Professional Ethics, clarifies. "Typically, ethics programs convey corporate values, often using codes and policies to guide decisions and behavior, and can include extensive training and evaluating, depending on the organization. They provide guidance in ethical dilemmas." Rarely are two programs alike.

"All organizations have ethics programs, but most do not know that they do," wrote business ethics professor Stephen Brenner in the *Journal of Business Ethics* (1992, V11, pp. 391-399). "A corporate ethics program is made up of values, policies and activities which impact the propriety of organization behaviors."

Bob Dunn, President and CEO of San Francisco-based Business for Social Responsibility, adds: "Balancing competing values and reconciling them is a basic purpose of an ethics management program. Business people need more practical tools and information to understand their values and how to manage them."

Benefits of Managing Ethics as a Program

There are numerous benefits in formally managing ethics as a program, rather than as a one-shot effort when it appears to be needed. Ethics programs:

1. Establish organizational roles to manage ethics
2. Schedule ongoing assessment of ethics requirements
3. Establish required operating values and behaviors
4. Align organizational behaviors with operating values
5. Develop awareness and sensitivity to ethical issues
6. Integrate ethical guidelines to decision making
7. Structure mechanisms to resolving ethical dilemmas
8. Facilitate ongoing evaluation and updates to the program
9. Help convince employees that attention to ethics is not just a knee-jerk reaction done to get out of trouble or improve public image

Eight Guidelines for Managing Ethics in the Workplace

The following guidelines ensure the ethics management program is operated in a meaningful fashion:

1. ***Recognize that managing ethics is a process.*** Ethics is a matter of values and associated behaviors. Values are discerned through the process of ongoing reflection. Therefore, ethics programs may seem more process-oriented than most management practices. Managers tend to be skeptical of process-oriented activities, and instead prefer processes focused on deliverables with measurements. However, experienced managers realize that the deliverables of standard management practices (planning, organizing, motivating, controlling) are only tangible representations of very process-oriented practices. For example, the process of strategic planning is much more important than the plan produced by the process. The same is true for ethics management. Ethics programs do produce deliverables, e.g., codes, policies and procedures, budget items, meeting minutes, authorization forms, newsletters, etc. However, the most important aspect from an ethics management program is the process of reflection and dialogue that produces these deliverables.

2. ***The bottom line of an ethics program is accomplishing preferred behaviors in the workplace.*** As with any management practice, the most important outcome is behaviors preferred by the organization. The best of ethical values and intentions are relatively meaningless unless they generate fair and just behaviors in the workplace. That's why practices that generate lists of ethical values, or codes of ethics, must also generate policies, procedures and training that translate those values to appropriate behaviors.

3. ***The best way to handle ethical dilemmas is to avoid their occurrence in the first place.*** That's why practices such as developing codes of ethics and codes of conduct are so important. Their development sensitizes employees to ethical considerations and minimize the chances of unethical behavior occurring in the first place.

4. ***Make ethics decisions in groups, and make decisions public, as appropriate.*** This usually produces better quality decisions by including diverse interests and perspectives, and increases the credibility of the decision process and outcome by reducing suspicion of unfair bias.

5. ***Integrate ethics management with other management practices.*** When developing the values statement during strategic planning, include ethical values preferred in the workplace. When developing personnel policies, reflect on what ethical values you'd like to be most prominent in the organization's culture and then design policies to produce these behaviors.

6. ***Use cross-functional teams when developing and implementing the ethics management program.*** It’s vital that the organization’s employees feel a sense of participation and ownership in the program if they are to adhere to its ethical values. Therefore, include employees in developing and operating the program.

7. ***Value forgiveness.*** This may sound rather religious or preachy to some, but it’s probably the most important component of any management practice. An ethics management program may at first actually increase the number of ethical issues to be dealt with because people are more sensitive to their occurrence. Consequently, there may be more occasions to address people’s unethical behavior. The most important ingredient for remaining ethical is trying to be ethical. Therefore, help people recognize and address their mistakes and then support them to continue to try operate ethically.

8. ***Note that trying to operate ethically and making a few mistakes is better than not trying at all.*** Some organizations have become widely known as operating in a highly ethical manner, e.g., Ben and Jerrys, Johnson and Johnson, Aveda, Hewlett Packard, etc. Unfortunately, it seems that when an organization achieves this strong public image, it's placed on a pedestal by some business ethics writers. All organizations are comprised of people and people are not perfect. However, when a mistake is made by any of these organizations, the organization has a long way to fall. In our increasingly critical society, these organizations are accused of being hypocritical and they are soon pilloried by social critics. Consequently, some leaders may fear sticking their necks out publicly to announce an ethics management program. This is extremely unfortunate. It's the *trying* that counts and brings peace of mind -- not achieving an heroic status in society.

Six Key Roles and Responsibilities in Ethics Management

Depending on the size of the organization, certain roles may prove useful in managing ethics in the workplace. These can be full-time roles or part-time functions assumed by someone already in the organization. Small organizations certainly will not have the resources to implement each the following roles using different people in the organization. However, the following functions points out responsibilities that should be included somewhere in the organization.

1. ***The organization's chief executive must fully support the program.*** If the chief executive isn't fully behind the program, employees will certainly notice -- and this apparent hypocrisy may cause such cynicism that the organization may be worse off than having no formal ethics program at all. Therefore, the chief executive should announce the program, and champion its development and implementation. Most important, the chief executive should consistently aspire to lead in an ethical manner. If a mistake is made, admit it.

2. ***Consider establishing an ethics committee at the board level.*** The committee would be charged to oversee development and operation of the ethics management program.

3. ***Consider establishing an ethics management committee.*** It would be charged with implementing and administrating an ethics management program, including administrating and training about policies and procedures, and resolving ethical dilemmas. The committee should be comprised of senior officers.

4. ***Consider assigning/developing an ethics officer.*** This role is becoming more common, particularly in larger and more progressive organizations. The ethics officer is usually trained about matters of ethics in the workplace, particularly about resolving ethical dilemmas.

5. ***Consider establishing an ombudsperson.*** The ombudsperson is responsible to help coordinate development of the policies and procedures to institutionalize moral values in the workplace. This position usually is directly responsible for resolving ethical dilemmas by interpreting policies and procedures.

6. ***Note that one person must ultimately be responsible for managing the ethics management program.***

Ethics Tools: Codes of Ethics

About Codes of Ethics

According to Wallace, "A credo generally describes the highest values to which the company aspires to operate. It contains the `thou shalt's. A code of ethics specifies the ethical rules of operation. It's the `thou shalt not's." The Conference Board, a leading business membership organization, found that 76% of corporations surveyed had codes of ethics.

Some business ethicists disagree that codes have any value. Usually they explain that too much focus is put on the codes themselves, and that codes themselves are not influential in managing ethics in the workplace. Many ethicists note that it's the *developing* and *continuing dialogue* around the code's values that is most important.

Occasionally, employees react to codes with suspicion, believing the values are "motherhood and apple pie" and codes are for window dressing. But, when managing a complex issue, especially in a crisis, having a code is critical. More important, it's having developed a code. In the mid-70s, Johnson and Johnson updated their credo in a series of challenge meetings. Bob Kniffin, Vice President of External Affairs, explains, "We pored over each phrase and word. We asked ourselves, `Do we still believe this?' Our meetings resulted in some fine tuning, but basically we didn't change the values. The meetings infused the values in the minds of all of us managers." Many believe this process guided them in their well-known decision to pull Tylenol bottles off the shelves and repackage them at a $100 million expense. Kniffin offers some sound, practical advice. "In a crisis, there's no time for moral conclusions. Get those done beforehand. But also realize there's no substitute for sound crisis management. For example, have a list of people with fundamental knowledge, such as who transports your products where and when."

Developing Codes of Ethics

Note that if your organization is quite large, e.g., includes several large programs or departments, you may want to develop an overall corporate code of ethics and then a separate code to guide each of your programs or departments.

Also note that codes should not be developed out of the Human Resource or Legal departments alone, as is too often done. Codes are insufficient if intended only to ensure that policies are legal. All staff must see the ethics program being driven by top management.

Note that codes of ethics and codes of conduct may be the same in some organizations, depending on the organization's culture and operations and on the ultimate level of specificity in the code(s).

Consider the following guidelines when developing codes of ethics:

1. ***Review any values need to adhere to relevant laws and regulations;*** this ensures your organization is not (or is not near) breaking any of them. (If you are breaking any of them, you may be far better off to report this violation than to try hiding the problem. Often, a reported violation generates more leniency than outside detection of an unreported violation, particularly per the new Federal Sentencing Guidelines.) Increase priority on values that will help your organization operate to avoid breaking these laws and to follow necessary regulations.

2. ***Review which values produce the top three or four traits of a highly ethical and successful product or service in your area,*** e.g., for accountants: objectivity, confidentiality, accuracy, etc.

Identify which values produce behaviors that exhibit these traits.

3. ***Identify values needed to address current issues in your workplace.*** Appoint one or two key people to interview key staff to collect descriptions of major issues in the workplace. Collect descriptions of behaviors that produce the issues. Consider which of these issues is ethical in nature, e.g.., issues in regard to respect, fairness and honesty. Identify the behaviors needed to resolve these issues. Identify which values would generate those preferred behaviors. There may be values included here that some people would not deem as moral or ethical values, e.g., team-building and promptness, but for managers, these practical values may add more relevance and utility to a code of ethics.

4. ***Identify any values needed, based on findings during strategic planning.*** Review information from your SWOT analysis (identifying the organization's strengths, weaknesses, opportunities and threats). What behaviors are needed to build on strengths, shore up weaknesses, take advantage of opportunities and guard against threats?

5. ***Consider any top ethical values that might be prized by stakeholders.*** For example, consider expectations of employees, clients/customers, suppliers, funders, members of the local community, etc.

6. ***Collect from the above steps, the top five to ten ethical values which are high priorities in your organization (see item #7 below for examples).***

7. ***Examples of ethical values might include*** (the following list is the "Six Pillars of Character" developed by The Josephson Institute of Ethics)**:**

(a) *Trustworthiness:* honesty, integrity, promise-keeping, loyalty
(b) *Respect:* autonomy, privacy, dignity, courtesy, tolerance, acceptance
(c) *Responsibility:* accountability, pursuit of excellence
(d) *Caring:* compassion, consideration, giving, sharing, kindness, loving
(e) *Justice and fairness:* procedural fairness, impartiality, consistency, equity, equality, due process
(f) *Civic virtue and citizenship:* law abiding, community service, protection of environment

8. ***Compose your code of ethics; attempt to associate with each value, two example behaviors which reflect each value.*** Critics of codes of ethics assert that they seem vacuous because many only list ethical values and don't clarify these values by associating examples of behaviors.

9. ***Include wording that indicates all employees are expected to conform to the values stated in the code of ethics.*** Add wording that indicates where employees can go if they have any questions.

10. ***Obtain review from key members of the organization.*** Get input from as many members as possible.

11. ***Announce and distribute the new code of ethics (unless you are waiting to announce it along with any new codes of conduct and associated policies and procedures).*** Ensure each employee has a copy and post codes throughout the facility.

12. ***Update the code at least once a year.*** As stated several times in this document, the most important aspect of codes is developing them, not the code itself. Continued dialogue and reflection around ethical values produces ethical sensitivity and consensus. Therefore, revisit your codes at least once a year -- preferably two or three times a year.

13. ***(Note that you cannot include values and preferred behaviors for every possible ethical dilemma that might arise.*** Your goal is to focus on the top ethical values needed in your organization and to avoid potential ethical dilemmas that seem mostly likely to occur.)

Ethics Tools: Codes of Conduct

About Codes of Conduct

"Codes of conduct specify actions in the workplace and codes of ethics are general guides to decisions about those actions," explains Craig Nordlund, Associate General Counsel and Secretary at Hewlett Packard. He suggests that codes of conduct contain examples of appropriate behavior to be meaningful.

The Conference Board found that codes of conduct are increasingly sophisticated and focused at lower levels in companies. Departments frequently have their own codes. Be careful, though. An organization could be sued for breach of contract if its practices are not in accord with its policies. That's why legal departments should review codes of conduct and other ethics policies. Also, that's why it's critical for organizations to review their policies at least once a year to ensure they are in accordance with laws and regulations.

Developing a Code of Conduct

Note that if your organization is quite large, e.g., includes several large programs or departments, you may want to develop an overall corporate code of conduct, and then a separate code to guide each of your programs or departments. Consider the following guidelines when developing codes of conduct:

1. ***Identify key behaviors needed to adhere to the ethical values proclaimed in your code of ethics***, including ethical values derived from review of key laws and regulations, ethical behaviors needed in your product or service area, behaviors to address current issues in your workplace, and behaviors needed to reach strategic goals.

2. ***Include wording that indicates all employees are expected to conform to the behaviors specified in the code of conduct.*** Add wording that indicates where employees can go if they have any questions.

3. ***Obtain review from key members of the organization.*** Be sure your legal department reviews the drafted code of conduct.

4. ***Announce and distribute the new code of conduct*** (unless you are waiting to announce it along with any associated policies and procedures). Ensure each employee has a copy and post codes in each employee's bay or office.

5. ***(Note that you cannot include preferred behaviors for every possible ethical dilemma that might arise.)***

6. ***Examples of topics typically addressed by codes of conduct include***: preferred style of dress, avoiding illegal drugs, following instructions of superiors, being reliable and prompt, maintaining confidentiality, not accepting personal gifts from stakeholders as a result of company role, avoiding racial or sexual discrimination, avoiding conflict of interest, complying with laws and regulations, not using organization's property for personal use, not discriminating against race or age or sexual orientation, and reporting illegal or questionable activity. *Go beyond these traditional legalistic expectations in your codes -- adhere to what's ethically sensitive in your organization, as well.* (Note that, as with codes of ethics, you may be better off to generate your own code of conduct from scratch rather than reviewing examples from other organizations.)

Ethics Tools: Policies and Procedures

1. ***Update policies and procedures to produce behaviors preferred from the code of conduct,***

including, e.g., personnel, job descriptions, performance appraisal forms, management-by-objectives expectations, standard forms, checklists, budget report formats, and other relevant control instruments to ensure conformance to the code of conduct. In doing so, try to avoid creating ethical dilemmas such as conflicts-of-interest or infringing on employee's individual rights.

2. ***There are numerous examples of how organizations manage values through use of policies and procedures.*** For example, we're most familiar with the value of social responsibility. To produce behavior aligned with this value, organizations often institute policies such as recycling waste, donating to local charities, or paying employees to participate in community events. In another example, a high value on responsiveness to customers might be implemented by instituting policies to return phone calls or to repair defective equipment within a certain period of time. Consider the role of job descriptions and performance appraisals. For example, an advanced technology business will highly value technical knowledge, creativity and systems thinking. They use job descriptions and performance appraisals to encourage behaviors aligned with these values, such as rewarding advanced degrees, patents, and analysis and design skills.

3. ***Include policies and procedures to address ethical dilemmas.*** See the next section, "Ethics Tools: Resolving Ethical Dilemmas," to select a method which is most appropriate to your organization's culture and operations.

4. ***Include policies and procedures to ensure training of employees about the ethics management program.*** See a following section, "Ethics Tools: Training."

5. ***Include policies and procedures to reward ethical behavior and impose consequences for unethical behavior.***

6. ***Include a grievance policy for employees to use to resolve disagreements with supervisors and staff.***

7. ***Consider establishing an ethics "hotline."*** This function might best be provided by an outside consultant, e.g., lawyer, clergyperson, etc. Or, provide an anonymous "tip" box in which personnel can report suspected unethical activities, and do so safely on an anonymous basis.

8. ***Once a year, review all personnel policies and procedures.*** If yours is a small organization, consider including all staff during this review. Take a full day for all staff to review policies and procedures, and suggest changes.

Ethics Tools: Resolving Ethical Dilemmas (with Real-to-Life Examples)

Definition of an Ethical Dilemma. Perhaps too often, business ethics is portrayed as a matter of resolving conflicts in which one option appears to be the clear choice. For example, case studies are often presented in which an employee is faced with whether or not to lie, steal, cheat, abuse another, break terms of a contract, etc. However, ethical dilemmas faced by managers are often more real-to-life and highly complex with no clear guidelines, whether in law or often in religion.

As noted earlier in this document, Doug Wallace, Twin Cities-based consultant, explains that one knows when they have a significant ethical conflict when there is presence of a) significant value conflicts among differing interests, b) real alternatives that are equality justifiable, and c) significant consequences on "stakeholders" in the situation.

An ethical dilemma exists when one is faced with having to make a choice among these alternatives.

Real-to-Life Examples of Complex Ethical Dilemmas

- "A customer (or client) asked for a product (or service) from us today. After telling him our price, he said he couldn't afford it. I know he could get it cheaper from a competitor. Should I tell him about the competitor -- or let him go without getting what he needs? What should I do?"
- "Our company prides itself on its merit-based pay system. One of my employees has done a tremendous job all year, so he deserves strong recognition. However, he's already paid at the top of the salary range for his job grade and our company has too many people in the grade above him, so we can't promote him. What should I do?"
- "Our company prides itself on hiring minorities. One Asian candidate fully fits the job requirements for our open position. However, we're concerned that our customers won't understand his limited command of the English language. What should I do?"
- "My top software designer suddenly refused to use our e-mail system. He explained to me that, as a Christian, he could not use a product built by a company that provided benefits to the partners of homosexual employees. He'd basically cut himself off from our team, creating a major obstacle to our product development. What should I do?"
- "My boss told me that one of my employees is among several others to be laid off soon, and that I'm not to tell my employee yet or he might tell the whole organization which would soon be in an uproar. Meanwhile, I heard from my employee that he plans to buy braces for his daughter and a new carpet for his house. What should I do?"

- "My computer operator told me he'd noticed several personal letters printed from a computer that I was responsible to manage. While we had no specific policies then against personal use of company facilities, I was concerned. I approached the letter writer to discuss the situation. She told me she'd written the letters on her own time to practice using our word processor. What should I do?"

- "A fellow employee told me that he plans to quit the company in two months and start a new job which has been guaranteed to him. Meanwhile, my boss told me that he wasn't going to give me a new opportunity in our company because he was going to give it to my fellow employee now. What should I do?"

Three Methods to Resolve Ethical Dilemmas

Organizations should develop and document a procedure for dealing with ethical dilemmas as they arise. Ideally, ethical dilemmas should be resolved by a group within the organization, e.g., an ethics committee comprised of top leaders/managers and/or members of the board. Consider having staff members on the committee, as well. The following three methods can be used to address ethical dilemmas. Methods include an ethical checklist, a ten-step method and a list of key questions. (Note that The Golden Rule is probably the most common method to resolve ethical dilemmas. The rule exists in various forms in many of the world religions.)

Method One - Ethical Checklist

Twin Cities-based consultants, Doug Wallace and Jon Pekel, suggest the following ethical checklist to address ethical dilemmas. If necessary, revise your decision and action plan based on results of the this test.

Ethical Checklist		Circle the appropriate answer on the scale; "1" = not at all; "5" = totally yes				
1.	**Relevant Information Test.** Have I/we obtained as much information as possible to make an informed decision and action plan for this situation?	1	2	3	4	5
2.	**Involvement Test.** Have I/we involved all who have a right to have input and/or to be involved in making this decision and action plan?	1	2	3	4	5
3.	**Consequential Test.** Have I/we anticipated and attempted to accommodate for the consequences of this decision and action plan on any who are significantly effected by it?	1	2	3	4	5
4.	**Fairness Test.** If I/we were assigned to take the place of any one of the stakeholders in this situation, would I/we perceive this decision and action plan to be essentially fair, given all of the circumstances?	1	2	3	4	5

5.	**Enduring Values Test.** Do this decision and action plan uphold my/our priority enduring values that are relevant to this situation?	1	2	3	4	5
6.	**Universality Test.** Would I/we want this decision and action plan to become a universal law applicable to all similar situation, even to myself/ourselves?	1	2	3	4	5
7.	**Light-of-Day Test.** How would I/we feel and be regarded by others (working associates, family, etc.) if the details of this decision and action plan were disclosed for all to know?	1	2	3	4	5
8.	**Total Ethical Analysis Confidence Score**. Place the total of all circled numbers here.					
How confident can you be that you have done a good job of ethical analysis?						
7-14 15-21 22-28 29-35	Not very confident Somewhat confident Quite confident Very confident					

Source: Doug Wallace and Jon Pekel, Twin Cities-based consultants in the Fulcrum Group.

Method Two - Ten-Step Method of Decision Making

Steps	**Notes**		
1. What Are The Known Facts In The Situation?			
2. Who Are The Key Stakeholders, What Do They Value And What Are Their Desired Outcomes?			
3. What Are The Underlying Drivers Causing The Situation?			
4. In Priority Order What Ethical Principles Or Operating Values Do You Think Should Be Upheld In This Situation?			
5. Who Should Have Input To, Or Be Involved In, Making This Decision?			
6. List Any Alternative And Action Plans That Would: A) Prevent Or Minimize Harm To Stakeholders B) Uphold The Priority Values For This Situation C) Be A Good Solution To The Situation	Alternative 1	Alternative 2	Alternative 3
7. Build A Worse-Case Scenario For Your Preferred Alternative To See How It Affects The Stakeholders. Rethink And Revise Your Preferred Alternative If Necessary.			

8. Add A Preventative Ethics Component To Your Action Plan That Deals With The Underlying Drivers Causing The Situation Listed In Step 3.	
9. Evaluate Your Chosen Decision And Action Plan Against The Checklist On The Reverse Side.	
10. Decide And Build An Action Plan, And Implement And Monitor It.	

Source: Doug Wallace and Jon Pekel, Twin Cities-based consultants in the Fulcrum Group.

Method Three - Twelve Questions to Address Ethical Dilemmas

1. Have you defined the problem accurately?
2. How would you define the problem if you stood on the other side of the fence?
3. How did this situation occur in the first place?
4. To whom and to what do you give your loyalty as a person and as a member of the corporation?
5. What is your intention in making this decision?
6. How does this intention compare with the probable results?
7. Whom could your decision or action injure?
8. Can you discuss the problem with the affected parties before you make your decision?
9. Are you confident that your position will be as valid over a long period of time as it seems now?
10. Could you disclose without qualm your decision or action to your boss, your CEO, the board of directors, your family, society as a whole?
11. What is the symbolic potential of your action if understood? misunderstood?
12. Under what conditions would you allow exceptions to your stand?

Source: Adapted from: Nash, L. (1981). Ethics Without the Sermon. *Harvard Business Review*, (59).

Ethics Tools: Training

The ethics program is essentially useless unless all staff members are trained about what it is, how it works and their roles in it. The nature of the system may invite suspicion if not handled openly and honestly. In addition, no matter how fair and up-to-date is a set of policies, the legal system will often interpret employee behavior (rather than written policies) as de facto policy. Therefore, all staff must be aware of and act in full accordance with policies and procedures (this is true, whether policies and procedures are for ethics programs or personnel management). This full accordance requires training about policies and procedures.

Training Basics for Supervisors and Learners

1. Orient new employees to the organization's ethics program during new-employee orientation.
2. Review the ethics management program in management training experiences.
3. Involving staff in review of codes is strong ethics training.
4. Involving staff in review of policies (ethics and personnel policies) is strong ethics training.
5. One of the strongest forms of ethics training is practice in resolving complex ethical dilemmas. Have staff use any of the three ethical-dilemma-resolution methods in this guidebook and apply them to any of the real-to-life ethical dilemmas also listed in this guidebook.
6. Include ethical performance as a dimension in performance appraisals.
7. The best ethics trainer: Bill Goodman, Chief Human Resource Officer at Aveda, describes, "We start our training even in our job ads," then adds, "but the best trainer is the behavior of our leaders."

CHAPTER 2
AICPA ETHICS

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Differentiate between rulings and principles of the AICPA' Code of Professional Conduct.
2. Briefly describe the six principles.
3. List the eleven rules.
4. Outline ethics rulings on independence.
5. List consulting services prohibited by the Sarbanes-Oxley (SOX) Act of 2002..
6. Outline the standards for tax services
7. Explain disciplinary mechanisms within the profession.
8. List the key features of corporate responsibility law (Sarbanes-Oxley act).

This chapter covers the AICPA's *Code* of *Professional Conduct,* Statements on Standards for Consulting Services, and the disciplinary systems within the accounting profession. This chapter has six subunits. The first section is a condensed but comprehensive summary of the AICPA Code of Conduct. The second section contains summaries of AICPA Ethics Interpretations and Professional Ethics Rulings under the 11 Rules of Conduct. The third section addresses Statements on Standards for Tax Services. The fourth section lists some of the consulting services prohibited by the Sarbanes-Oxley (SOX) Act of 2002. The fifth section covers disciplinary systems within the profession. The final section outlines the key features of the SOX.

AICPA's CODE OF PROFESSIONAL CONDUCT

It consists of two sections: Principles and Rules. The six principles, which provide the framework for the rules, are goal-oriented and aspirational but nonbinding.

Synopses of the Six Principles

1. *Responsibilities.* Members should exercise sensitive professional and moral judgments when carrying out their professional responsibilities. Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism. A distinguishing mark of a profession is acceptance of its responsibility to the public.

2. *The Public Interest.* Members should act to benefit the public interest, honor the public trust, and demonstrate commitment to professionalism. The AICPA adopted the ethical

standards because a distinguishing mark of a profession is an acceptance of responsibility to the public.

3. *Integrity.* Members should perform all professional responsibilities with the highest sense of integrity to maintain public confidence.

4. *Objectivity and Independence.* A member should maintain objectivity and be free of conflicts of interest. A member in public practice should be independent in fact and appearance when providing attestation services. Objectivity is a state of mind, a quality that lends itself to a member's services. It is a distinguishing feature of the profession. The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interest.

5. *Due Care.* A member should follow the profession's technical and ethical standards, strive for improved competence and quality services, and discharge professional responsibility to the best of the member's ability. Members must adequately plan and supervise any activity for which they are responsible.

6. *Scope and Nature of Services.* A member in public practice should follow the Principles of the *Code of Professional Conduct* in determining the nature and scope of services.

Synopses of the Eleven Rules

Rule 101 — *Independence.* A member in public practice should be independent when performing professional services as required by standards-setting bodies.

(1) In this context, rules of the state boards of accountancy, state CPA societies, the Independence Standards Board, the SEC, the General Accounting Office, and other bodies may be relevant.

(2) Relevant AICPA standards-setting bodies are the Auditing Standards Board (ASB), Accounting and Review Services Committee, and Management Consulting Services Executive Committee. The foregoing bodies are all authorized to promulgate attestation standards.

(3) The ASB issues Statements on Auditing Standards. Thus, SAS 1 is consistent with the requirement for auditors to maintain an independence in mental attitude. To inspire public confidence, an auditor must not only be independent (intellectually honest) but also be recognized as independent (free of any obligation to, or interest in, the client).

(4) The fourth general attestation standard likewise requires practitioners to maintain an independence in mental attitude when performing attest engagements.

(5) Under Statements on Standards for Accounting and Review Services, an accountant may not report on a review of the financial statements of a nonpublic entity if (s)he is not independent.

(6) According to the AICPA's Statements on Standards for Attestation Engagements, a practitioner must also be independent to examine or apply agreed-upon procedures to prospective financial statements.

(7) SEC independence regulations were revised in accordance with the Sarbanes-Oxley Act of 2002.

   (a) Audit committees must preapprove the services performed by accountants (permissible nonaudit services and all audit, review, and attest engagements). Approval must be either explicit or in accordance with detailed policies and procedures. If approval is by the latter, the audit committee must be informed, and no delegation of its authority to management is allowed. However, preapproval is not needed for nonaudit services representing less than 5% of the annual amount paid to the accountant if (1) the services were not recognized as nonaudit at the time of the engagement, and (2) the audit committee approves prior to completion of the audit.

   (b) An issuer must disclose in its proxy statement or annual filing fees paid to the accountant segregated into four categories: (1) audit, (2) audit-related, (3) tax, and (4) all other. The disclosure is for the two most recent years and must describe the services in (2)-(4).

   (c) The lead and concurring (reviewing) audit partners must rotate every 5 years, with a 5-year time-out period. Other audit partners must rotate every 7 years, with a 2-year time-out.

   (d) An accountant is not independent if, during the audit and the period of the professional engagement, any audit partner (excluding specialty partners such as tax partners) earns or receives compensation for selling services (excluding audit, review, or attest services) to the audit client.

   (e) Conflicts of interest. An accounting firm is not independent with respect to an audit client if a former partner, principal, shareholder, or professional employee accepts employment with a client if (s)he has a continuing financial interest in the firm or is in a position to influence the firm's operations or financial policies. Moreover, an accounting firm is not independent if a CEO, CFO, controller, or person in an equivalent position for an issuer was employed by that firm and participated in any capacity in the audit of that issuer during the year before the beginning of the audit.

(f) Communications with the audit committee by the accounting firm must include (1) all critical accounting policies and practices; (2) all material alternative accounting policies and practices within GAAP that were discussed with management; and (3) other material written communications with management, such as management representations and schedules of unadjusted audit differences. These communications must be prior to filing the audit report with the SEC.

COMMENTARY: Integrity can often be difficult to interpret due to faulty omissions or commissions that are often a result of honest error or a lack of integrity.

Rule 102 — *Integrity and Objectivity.* A member shall maintain objectivity and integrity, be free of conflicts of interest, not knowingly misrepresent facts, and not subordinate his/her judgment to others when performing professional services.

Rule 201 — *General Standards.* A member shall comply with the following:

(1) Undertake only those services that the member can reasonably expect to complete with professional competence.

(2) Exercise due professional care when performing professional services.

(3) Adequately plan and supervise performance of professional services.

(4) Obtain sufficient relevant data to provide a reasonable basis for conclusions in relation to any professional service.

(a) Proficiency. Auditors must have adequate technical training and proficiency. According to SAS 1, both education and experience, as well as proper supervision, are necessary. Objectivity and independent judgment are necessary in the preparation of the audit opinion. An auditor must have experience and seasoned judgment to accept final responsibility for an audit opinion.

(b) Due professional care must be exercised in the planning and performance of the audit and the preparation of the report. According to SAS 1, an auditor should have the degree of skill commonly possessed by other auditors and must exercise it with reasonable care and diligence. An auditor should also exercise professional skepticism. The exercise of due professional care allows the auditor to obtain reasonable assurance. Absolute assurance is impracticable due to characteristics of fraud such as concealment by collusion, withheld or falsified documentation, or management override of controls.

Rule 202 — *Compliance with Standards.* A member who performs professional services must comply with promulgated standards.

Rule 203 — *Accounting Principles.* A member shall not express an opinion or make an affirmative statement about conformity with GAAP or state that (s)he is not aware of any material modifications that should be made to achieve conformity with GAAP, given any departure from an accounting principle promulgated by bodies designated by the AICPA Council to establish such principles that has a material effect on the financial statements or data taken as a whole. However, if the member can demonstrate that, due to unusual circumstances, the financial statements or data would have been misleading without a departure from GAAP, the member can comply with the rule by describing the departure, its approximate effects, if practicable, and the reasons compliance with the principle would be misleading.

Rule 301 — *Confidential Client Information.* A member in public practice cannot disclose confidential client information without the client's consent. However, this Rule does not affect a CPA's obligations

(1) To comply with a validly issued and enforceable subpoena or summons or with applicable laws and regulations

(2) To discharge his/her professional obligations properly under Conduct Rules 202 and 203

(3) To cooperate in a review of the CPA's professional practice under AICPA or state CPA society or board of accountancy authorization

(4) To initiate a complaint with or respond to any inquiry made by the professional ethics division, trial board of the AICPA, or an investigative or disciplinary body of a state society or board of accountancy

Rule 302 — *Contingent Fees.* A contingent fee is established as part of an agreement under which the amount of the fee is dependent upon the finding or result.

(1) The receipt of contingent fees by a member is prohibited when the member performs an audit, a review, a compilation when the report will be used by third parties and the report does not disclose the CPA's lack of independence, or an examination of prospective financial information.

(2) A contingent fee is not permitted for preparing an original or amended tax return or claim.

(3) Fees are not deemed to be contingent if fixed by courts or other public authorities, or in tax matters, if they are based on the results of judicial proceedings or the findings of

governmental agencies.

COMMENTARY: Contingency fees are considered to be infringements of a CPAs ability to be independent. However, if the contingency fee is determined by a government agency, court or public authority then it is not considered to be detrimental to the CPA’s independence.

Rule 501 — *Acts Discreditable.* A member shall not commit an act that is discreditable to the profession. Withholding as a result of nonpayment of fees for a completed engagement certain information contained in the client's books would not be considered such an act. The member's duty to return client records is absolute. However, the duty to return other information not related to the client's books and records is not absolute. Although the client's financial information may be incomplete as a result, if fees for a completed engagement have not been paid, such other information may be withheld. Thus, the duty to return is conditional upon payment of fees with respect to information such as adjusting, closing, combining, or consolidating entries and information normally found in books of original entry and general or subsidiary ledgers.

Rule 502 — *Advertising and Other Forms of Solicitation.* A member in public practice shall not seek to obtain clients by advertising or other forms of solicitation done in a false, misleading, or deceptive manner. Solicitation through coercion, overreaching, or harassing conduct is prohibited.

Rule 503 — *Commissions and Referral Fees.* A member in public practice shall not accept a commission for recommending or referring to a client any product or service, or for recommending or referring any product or service to be supplied by a client, if the member performs for that client an audit, a review, a compilation when a third party will use the financial statement and the report does not disclose the CPA’s lack of independence, or an examination of prospective financial information.

(1) Permitted commissions must be disclosed to any person or entity to whom the member recommends a product or service.

(2) A member who accepts a referral fee for recommending services of a CPA or who pays a referral fee to obtain a client must disclose the arrangement to the client. A referral fee is compensation for recommending or referring any service of a CPA to any person. Referral fees are not considered commissions.

Rule 505 — *Form of Organization and Name.* A member may practice public accounting only in a form of organization allowed by law or regulation that conforms with resolutions of the AICPA Council.

1) The firm name must not be misleading.

2) Names of past owners may be included in the name of the successor organization.

3) A firm cannot designate itself as “members of the AICPA” unless all CPA owners are members.

Definitions. The following are summaries of selected ethics definitions.

- *Attest engagement* — One that requires independence.

- *Attest engagement team* — Participants in the engagement, including partners who perform concurring or second reviews and all employees and contractors retained by the firm, but excluding specialists.

- *Close relatives* — Parents, siblings, or nondependent children.

- *Covered member* — (1) An individual on the attest engagement team or who is able to influence the engagement, (2) a partner or manager who provides at least 10 hours of nonattest services to a client, (3) a partner in the office where the lead engagement partner primarily practices in relation to the engagement, (4) the firm (including its benefit plans), and (5) an entity that can be controlled by the foregoing parties.

- *Financial institution* — An entity that normally makes loans to the public.

- *Firm* — A form of organization permitted by law or regulation that is consistent with the resolutions of the AICPA’s Council and practices public accounting. The term “firm” includes partners except for the purposes of Rule 101.

- *Immediate family* — A covered member’s spouse, equivalent of a spouse, or dependents.

- *Individual in a position to influence the attest engagement* — One who (1) evaluates the attest engagement partner or recommends his/her compensation; (2) directly supervises or manages that partner, including all levels above such supervisor or manager; (3) consults with the engagement team about technical or industry-related issues; or (4) participates in or oversees quality control for the engagement, including all senior levels.

- *Joint closely held investment* — An investment in any entity or property by the member and (1) the client, (2) the client’s officers or directors, or (3) an owner who can exercise significant influence if the investment permits such parties to control the entity or property.

- *Key position* — One in which an individual is primarily responsible for (1) significant accounting functions supporting material financial statement components, or (2) for the preparation of the statements. A key position is also one able to influence financial statement content, for example, director, CEO, CFO, general counsel, chief accountant, director of internal audit, or treasurer.

- *Normal lending procedures, terms, and requirements* — Those reasonably comparable with those for similar loans to others from the financial institution in the period when a commitment was made for a loan to a covered member.

- *Period of the professional engagement* — This period starts at the earlier of when the member signs an initial engagement letter to perform attest services or begins to perform. It continues for the entire professional relationship and does not end with the issuance of a report and start again with the next year's engagement. It ends with the later of notification by the member or client or by issuance of a report.

NOTE: Common law does not recognize privileged communication between a CPA and client. In some states and in some federal tax matters, however, the auditor may be protected by a privilege created by statute.

INTERPRETATIONS AND RULINGS

Interpretations and rulings are presented for each of the eleven Rules. The Interpretations are in outline format followed by brief summaries of the Rulings.

Rule 101 — *Independence.*

A. Interpretation 101-1 (Interpretation of Rule 101)

1. Independence is impaired if, during the period of the professional engagement, a covered member

1) Had a direct financial interest or a material indirect financial interest in the client.
2) Was a trustee of any trust or executor of any estate that had a direct or material indirect financial interest in the client AND (1) the covered member's position conferred investment authority, (2) the trust/estate owned more than 10% of the client, or (3) the interest of the trust/estate was more than 10% of its total assets.
3) Had any joint, closely held investment that was material to the covered member.
4) Had a loan to or from a client, any of its officers or directors, or an individual owning at least 10% of the client. Exceptions are grandfathered loans and certain other permitted loans.

2. Independence is impaired if, during the period of the professional engagement, a firm partner or professional employee, such individual's immediate family, or a group of these individuals acting together owned more than 5% of the client.

3. Independence is impaired if, during the period covered by the financial statements or during the period of the professional engagement, a firm, or partner or professional employee of the firm, was

1) Also associated with the client as an officer, director, employee, promoter, underwriter, or voting trustee, or in a management capacity.
2) A trustee for any pension or profit-sharing trust of the client.

4. An individual may have been employed by the client or associated with the client in a capacity listed in Interpretation 101-3. Independence is impaired if (1) the employment or association overlapped the engagement, and (2) the individual participated in the engagement or was able to influence it. Independence is also impaired if the individual was otherwise a covered member relative to the client unless the individual dissociates from the client by

1) Ending any relationship described in Interpretation 101-3.
2) Disposing of any direct or material indirect financial interest in the client,
3) Collecting or repaying any loans to or from the client (except as permitted under the rules for grandfathered loans),
4) Ceasing participation in any client-sponsored employee benefit plan (unless the client is legally required to allow participation and the individual pays the full cost), and
5) Liquidating or transferring any vested benefits in a client plan as soon as legally permitted. This is not required if a large penalty would result.

5. A covered member's immediate family is subject to Rule 101. However, independence is not impaired solely because

1) An immediate family member was employed by the client in a non-key position.
2) As part of his or her employment, an immediate family member of one of the following participated in a benefit plan that is a client, is sponsored by a client, or invests in a client if the plan is offered to all similarly situated employees:
    a) A partner or manager who provided at least 10 hours of nonattest services to the client
    b) Any partner in the office where the lead engagement partner primarily practiced in relation to the engagement

6. Independence is impaired if an individual who is participating on the engagement team, who can influence the engagement, or who is a partner in the office where the lead engagement

partner primarily practices, has a close relative who

1) Occupied a key position with the client,
2) Held a material financial interest in the client that was known to the individual, or
3) Held a financial interest that permitted significant influence over the client.

7. Because listing all situations in which an appearance of a lack of independence might arise is not feasible, members also should consider whether a relationship between the member and the client or an associate of the client might lead to a reasonable conclusion that independence is lacking.

8. Under Rule 101, materiality is determined by aggregating the interests of the covered member and his/her immediate family.

B. Interpretation 101-2 (Employment or association with attest clients)

A former partner or professional employee (POPE) of the firm who is employed by or associated with an attest client in a key position impairs the firm's independence unless

(1) Amounts due to the former POPE are not material to the firm, and the payment formula is fixed during the payout period. Retirement benefits may also be adjusted for inflation, and interest may be paid.

(2) The former POPE cannot influence the firm's operations or financial policies.

(3) Once employed or associated with the client, the former POPE does not participate or appear to participate in, and is not associated with, the firm, regardless of compensation, for example, by consulting, use of an office, or inclusion in membership lists.

(4) The engagement team considers the risk that the POPE's knowledge of the audit plan will reduce audit effectiveness.

(5) The firm assesses when team members can effectively deal with the POPE.

(6) The engagement is reviewed to determine whether team members maintained professional skepticism in dealings with the POPE.

A team member's consideration of employment or association with the client impairs independence absent prompt reporting to the firm and removal from the team.

C. Interpretation 101-3 (Performance of nonattest services)

1) Before a member and his or her firm performs nonattest services (such as tax or consulting services) for an attest client, (s)he must comply with Interpretation 101-3 to avoid impairment of independence. If the applicable independence rules of an authoritative body (e.g., the SEC or a state board of accountancy) are more restrictive, the member must comply with them.

2) General Requirements. Performing management functions or making management decisions impairs independence, but providing advice, research, and recommendations does not.

    a) The member should be satisfied that the client will make an informed judgment about the results of nonattest services and be able to designate a competent employee (preferably a senior manager) to oversee the services; evaluate their adequacy and results; make management decisions and perform management functions; accept responsibility for results; and establish and maintain internal controls.

    b) The member and client should agree about the objectives and limitations of the engagement, the services to be performed, and mutual responsibilities. The understanding should be documented in writing. This requirement does not apply to routine services, those provided before the client became an attest client, and those performed before 2005.

3) General activities that impair independence include

    a) Exercise or possession of authority over transactions on a client's behalf
    b) Preparing source documents evidencing transactions
    c) Custody of client assets
    d) Supervision of client employees in normal activities
    e) Determining member recommendations to be implemented
    f) Reporting to the board on behalf of management
    g) Service as a stock transfer or escrow agent, registrar, or general counsel

4) Examples of nonattest services that may not impair independence if the general requirements are met include bookkeeping, disbursement, benefit plan administration (e.g., preparing participant account valuations and statements), investment advisory, finance, executive search, business risk consulting, and IT (but designing a system or operating a network impairs independence).

5) An appraisal, valuation, or actuarial service impairs independence if the results are material to the financial statements and significant subjectivity is involved. For example, a valuation for a business combination, but not an actuarial

valuation for a pension liability, usually involves significant subjectivity. Furthermore, appraisal, valuation, and actuarial services not performed for financial statement purposes do not impair independence if the other requirements of Interpretation 101-3 are satisfied.

6) Internal audit assistance services impair independence unless the member ensures that the client understands its responsibility for internal control and managing the internal audit function. Accordingly, the member must ensure that the client designates a competent individual to oversee internal audit; determines the scope, risk, and frequency of its activities; evaluates its findings; and evaluates the adequacy of its procedures.

   a) The member should be satisfied that the client's governing body is informed about his/her role so that it can develop proper guidelines.
   b) The member may assist in preliminary risk assessment, preparation of the audit plan, and recommendation of priorities.
   c) Independence is impaired if the member, among other things, performs an ongoing monitoring or control function, determines which control recommendations are adopted, reports to the board on behalf of management, approves or is responsible for the overall audit work plan, or is a client employee or manager (or the equivalent).
   d) Services that are normal extensions of the external audit scope (e.g., confirming receivables or analyzing balances) and engagements under the attestation standards do not impair independence.

7) SEC regulations promulgated under the Sarbanes-Oxley Act of 2002 prohibit auditors of public companies from performing certain nonaudit services:

   a) Appraisal and other valuation services.
   b) Designing and implementing financial information systems.
   c) Internal auditing or actuarial functions unless the firm reasonably concludes it will not examine such work during the financial statement audit.
   d) Management services.
   e) Human resource services.
   f) Bookkeeping if the firm also conducts an audit.
   g) Expert services not pertaining to the audit.
   h) Investment banking or advisory services.
   i) Broker-dealer services.

D. Interpretation 101-4 (Honorary directorships and trusteeships of non-for-profit organizations)

A member in an honorary position will not impair independence if (s)he is associated with the financial statements of a not-for-profit organization that (s)he allows to use his/her name on letterheads and circulated materials to lend prestige to the organization. However, the member should not be able to vote or participate in board or management decisions and should be identified as an honorary director or trustee.

E Interpretation 101-5 (Loans from financial institution clients)

1) Grandfathered loans. Independence is not impaired by (a) unsecured loans that are not material to the covered member's net worth or (b) secured loans (including home mortgages) provided that the loans were obtained from a financial institution under its normal lending procedures, terms, and requirements. However, loans are grandfathered only if

   a) They were kept fully current at all times after the borrower became a covered member, and the terms did not change in a way not allowed in the original agreement.
   b) They were obtained
      i) From a financial institution before it became a client requiring independence;
      ii) From a client not requiring independence and were sold to one requiring independence;
      iii) Prior to February 5, 2001 and satisfied the requirements of the Interpretation then effective;
      iv) During the period from February 5, 2001 through May 31, 2002, and the covered member complied with SEC regulations then effective; or
      v) After May 31, 2002 from a client requiring independence before the borrower became a covered member relative to the client.

2) The date a grandfathered loan is obtained is the date a loan commitment or line of credit was granted.

3) The collateral for a secured grandfathered loan must equal or exceed the remaining balance of the loan during its term. If the loan exceeds the value of collateral, this excess must not be material to the covered member's net worth.

4) In the case of a limited partnership in which covered members have a combined interest exceeding 50% or a general partnership in which covered members control the partnership, the loan is ascribed to each covered member based on his/her legal liability as a limited or general partner. Even if this amount is zero, renegotiating the loan or entering into a new loan that is not an "other permitted

loan" is deemed to impair independence.

5) Other permitted loans. The following loans are permitted even if the client is one for which independence is required, provided that they are obtained under normal lending procedures, terms, and requirements and are always kept current:

   a) Automobile loans and leases collateralized by the automobile
   b) Loans fully collateralized by the cash surrender value of insurance
   c) Loans fully collateralized by cash deposits
   d) Credit cards and overdraft reserve accounts with an aggregate outstanding balance of $10,000 or less on a current basis by the payment due date

F. Interpretation 101-6 (Effect of actual or threatened litigation)

1) Litigation between client and member
   a) Independence is impaired when litigation is begun by
      i) The present management alleging deficiencies in audit work
      ii) The member alleging management fraud or deceit
   b) An expressed intention by the management to litigate against the member for alleged deficiencies in audit work will impair independence if it is probable that the claim will be filed.
   c) Independence is not impaired when the threatened or actual litigation is not related to the audit and the amount is not material. Examples include disputes over billings for services and results of tax advice.

2) Litigation by security holders (primary litigation)

   a) Shareholders may bring a class action against the client company or its management without impairing independence. Often the member and the client are both defendants, but if cross-claims are filed, adverse interests may arise and independence may be impaired.
   b) Cross-claims filed by the client to protect a right to legal redress in the event of a future adverse decision do not impair independence in the absence of a significant risk of a material settlement.
   c) Cross-claims against the member by an underwriter do not impair independence if no similar claims are made by the client.
   d) Cross-claims filed against the member by persons who are also officers or directors of other clients do not usually impair independence with respect to the other clients.

3) Other third-party litigation

a) Litigation may be commenced against the member by a creditor or insurer that alleges reliance on financial statements of the client. This litigation does not affect independence if the client is not the plaintiff or is a nominal plaintiff. Independence may be impaired if the third party (e.g., an insurance company) is also a client of the member and there is a significant risk of a material settlement.

4) If a reasonable person would conclude that litigation poses an unacceptable risk of impairment of independence, the member should disengage or disclaim an opinion for lack of independence.

G. Interpretation 101-8 (Financial interests in nonclients having investor or investee relationships with the client)

1) Independence is impaired when

a) A member has a direct or material indirect financial interest in the nonclient if the investee is material to the investor.
b) A member has a material interest in a nonclient who is an immaterial investee of the client investor.
c) A member can exercise significant influence over a nonclient investor who has an immaterial interest in the client investee.

2) Independence is not impaired if a member did not know about the financial interests described above.

H. Interpretation 101-10 (Effect on independence of relationships with entities included in governmental financial statements)

1) A financial reporting entity's basic financial statements (BFS) issued in accordance with U.S. GAAP include the government-wide statements (reporting governmental activities, business-type activities, and discretely presented component units), fund financial statements (reporting major funds, nonmajor governmental and enterprise funds, internal service funds, blended component units, and fiduciary funds), and other entities disclosed in the notes of the BFS. Disclosures should be made in the notes to the BFS about related organizations, joint ventures, jointly governed organizations, etc.

2) An auditor of the BFS of the entity must be independent of it. Nevertheless, a primary auditor need not be independent with respect to any fund, component unit, or disclosed entity if (s)he explicitly relies on reports by other auditors on such fund, etc. Moreover, (s)he need not be independent of a disclosed entity if

the reporting entity is not financially accountable for it and the required disclosure does not include financial information.

a) Neither the covered member nor a member of his/her immediate family should occupy a key position with a fund, component unit, or disclosed entity.

3) An auditor of the statements of a fund, component unit, or disclosed entity who is not auditing the primary government must be independent only of the statements reported on. Nevertheless, the covered member or a member of his/her immediate family may not occupy a key position with the primary government.

I. Interpretation 101-11 (Independence and attest engagements)

1) This interpretation applies only to engagements, other than examinations and reviews, covered by SSAEs when the use of the report is restricted.

2) The following covered members and their immediate families must be independent in relation to the responsible party:

   a) An individual on the attest engagement team.

   b) An individual who directly supervises or manages the attest engagement partner.

   c) Individuals who consult with the attest engagement team about technical or industry-related matters specific to the engagement.

3) Independence is impaired if the firm had a material relationship with the responsible party prohibited under Rule 101.

4) A firm may provide nonattest services to the responsible party that are prohibited due to an association as an employer, director, officer, promoter, voting trustee, or pension trustee. However, if they do not relate directly to the subject matter of the attest engagement, independence is not impaired.

5) When the party that engages the firm is not the responsible party or associated therewith, individuals on the attest engagement need not be independent of the party that engaged the firm. However, they should consider their responsibilities regarding conflicts of interest.

J. Interpretation 101-12 (Independence and cooperative arrangements with clients)

1) Independence is impaired if, during the engagement or at the time of expressing an opinion, a member's firm had any material cooperative arrangement with the client.

   a) A cooperative arrangement means joint participation in a business activity.

K. Interpretation 101-14 (Effect of APSs on independence rules)

1) The independence rules for an alternative practice structure (APS) apply to all structures in which "the 'traditional firm' engaged in attest services is closely aligned with another organization, public or private, that performs other professional services." For example, a CPA firm may be sold to another entity having subsidiaries or divisions such as a bank, an insurance company, a broker-dealer, and entities providing nonattest services (tax, management consulting, etc.). The owners and employees of the CPA firm become employees of one of the parent's subsidiaries or divisions and may offer nonattest services. Moreover, the original owners of the acquired CPA firm create a new CPA firm to offer attest services. The majority ownership of the new firm must be held by CPAs, but it leases employees, offices, and equipment from the parent, which may also provide advertising and perform back office functions. The owners of the new CPA firm pay a negotiated amount for such services.

2) In the example above, the term "member or a member's firm" includes the new CPA firm (the firm) and any leased or employed person or entity.

3) When two or more new CPA firms are "closely aligned" with another organization, issues arise as to whether owners of one perform services or have significant economic interests in another. Thus, if an owner of one performs services for another, (s)he is deemed to be an owner of both. Similar issues arise regarding managers (leased or otherwise).

4) In an APS, persons and entities included in "member or a member's firm" are closely aligned with other persons and entities. The latter include direct superiors who can directly control the activities of an owner or manager. A direct superior is an immediate superior who can direct the activities of an owner or manager so as to be able to directly or indirectly derive a benefit. Direct superiors are subject to the same independence rules as persons included

in "member or a member's firm."

5) An indirect superior (defined to include a spouse, cohabitant, or dependents of an indirect superior) is one or more levels above a direct superior and does not have a direct reporting relationship with the new CPA firm's owners and managers. Less restrictive standards apply to indirect superiors and to other entities in the consolidated group.

a) These parties may not have a relationship involving a direct financial interest or an indirect material financial interest with an attest client of the new CPA firm that is material.

b) These parties also should not exercise significant influence over the attest client.

c) Other entities in the consolidated group and their employees may not be promoters, underwriters, directors, officers, or voting trustees of an attest client. However, with the foregoing exceptions, indirect superiors and other consolidated entities may provide services to an attest client that a member could not without impairing independence.

6) The new CPA firm may not perform a service requiring independence for any entity in the consolidated group.

7) Independence is impaired with regard to an attest client who exercises significant influence over, or has a material investment in, the parent.

8) Referrals within the consolidated group are subject to the provisions regarding conflicts of interest.

Ethics Rulings on Independence — Rule 101.

Independence Not Impaired

1. Membership in a client trade association provided the member is not an officer or a director, or in a position equivalent to management.

2. The member provides advisory services for a client.

3. A member is designated to serve as an executor of an individual's estate that owns the majority of the stock of a corporation. Independence with respect to the corporation is not impaired unless the member serves as executor.

4. A CPA is a director of a federated fund-raising organization, e.g., United Way, and audits local charities receiving funds. Independence with respect to the charities is not impaired unless the organization exercises managerial control over them.

5. A CPA has a pro rata share of securities in a social club, unless (s)he is on the governing board or takes part in management.

6. A member serves on a citizens' committee advising a county and on another committee advising the state where the county is located.

7. A CPA's ownership of shares in a mutual fund that holds some of a client's shares. Independence becomes impaired if the indirect interest becomes material or the CPA has significant influence over the mutual fund.

8. A member and a client bank serve in a co-fiduciary capacity with respect to an estate, provided the estate assets are not material.

9. A client financial services company has custody of a covered member's assets (not in depository accounts); services are provided under its normal procedures, terms, and requirements; and any assets subject to risk of loss are immaterial to the member's net worth.

10. Independence is not impaired if a member audits an employee benefit plan unless a partner or professional employee of the firm had significant influence over the employer(s); was in a key position with the employer; or was associated with the employer as a promoter, underwriter, or voting trustee.

11. The mere servicing of a member's loan by a client financial institution.

12. When a covered member has a checking or savings account, certificate of deposit, or money market account in a client financial institution, provided the amounts are fully insured. Uninsured amounts do not impair independence if they are immaterial or if they are reduced to an immaterial balance within 30 days. A firm's independence is not impaired if the probability is remote that the depository institution will have financial difficulty.

13. Membership in a client credit union if all the following are met:

    1. Each member qualifies to join the credit union without regard to the professional services.

    2. The member's vote must not have significant influence over policies.

    3. Loans must be limited to grandfathered and other permitted loans made under normal procedures, terms, and requirements.
    4. Any deposits with the credit union must meet the conditions in number 12.

14. A member's service as treasurer of a mayoral campaign organization. Independence is

impaired with respect to the organization itself, but not the political party of the candidate or the city.

15. If a member leases property to or from a client under an operating lease with terms comparable to those of similar leases, and all amounts are paid in accordance with the lease. If, however, the lease is a capital lease, independence would be impaired unless the lease is tantamount to a permitted loan.

16. Inclusion of a clause in an engagement letter providing for member indemnification by the client.

17. A predispute agreement with a client to use alternative dispute resolution (ADR) techniques.

18. Commencement of an ADR proceeding. However, Interpretation 101-6 applies, and independence may be impaired if the proceeding is sufficiently similar to litigation because the parties have material adverse interests, e.g., in binding arbitration.

19. Performing extended audit services regarding reporting on internal control if management assumes responsibility for control, and management does not rely on the member's work as the primary basis for its assertion.

Independence Impaired

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1. Acceptance of more than a token gift from a client.

2. The member signs or cosigns checks or purchase orders or exercises general supervision to ensure compliance as a representative of a creditors' committee in control of a debtor corporation.

3. The member serves as an elected legislator in a municipal body at the same time as (s)he is performing an audit of that body.

4. With respect to a foundation and an estate if the member is a trustee of the foundation that is the beneficiary of the estate.

5. A CPA serves on the board of directors of a client nonprofit social club.

6. A CPA is on a client's committee that administers the deferred compensation program.

7. A CPA is a director of a company and an auditor of the profit sharing and retirement trust.

8. A CPA owns an immaterial amount of bonds in a municipal authority (considered a loan).

9. With respect to a common interest realty association (CIRA) as a result of owning or leasing realty. But no impairment occurs if the CIRA has governmental functions, the CPA's annual

assessment is immaterial, sale of the CIRA or common assets does not result in a distribution to the member, CIRA creditors have no recourse to the member, and the CPA is not a manager or employee of the C IRA.

10. A CPA owns an investment club that holds a client's shares (a direct financial interest).

11. A member of a university's faculty audits the student senate fund (the member will audit functions performed by the university, which is his/her employer).

12. If billed or unbilled fees, or a note arising from the fees, for client services rendered more than 1 year before the current year's report date remain unpaid. Not applicable if the client is in bankruptcy.

13. When a CPA is on the board of directors of a fund-raising organization; unless the position is honorary.

14. If a member's retirement or savings plan has a direct or material indirect financial interest in a client.

15. A direct financial interest in a client whether or not the interest is placed in a blind trust.

16. For both partnerships, when two limited partnerships have the same general partner and a member has a material interest in one of the partnerships.

17. The use of partners, shareholders, and professional employees from another firm that is not independent of the client. Their work can be used in the same manner as that of internal auditors.

18. A CPA's service on a client's advisory board unless it

    a. Is in fact advisory.
    b. Has no authority to make management decisions, and
    c. Is distinct from the board of directors with few common members.

19. A CPA who is not independent may not express an audit opinion or issue a review report, but (s)he may issue a compilation report disclosing the lack of independence.

20. A member who is a general partner in a partnership that invests in a client. If the member is a limited partner, independence would not be impaired unless the interest in the client is material.

21. If a member is a limited partner in a limited partnership (LP) and the client is a general partner, the member lacks independence with respect to the LP, the client if the client has a material interest in the LP, and a subsidiary of the LP if the member's interest is material.

22. A member's joint interest in a vacation home with a principal shareholder of a client will be considered a "joint closely held business investment' (even if it is only intended for personal

use) if the interest is material.

23. Unless a loan from a nonclient subsidiary of a client parent is “grandfathered” or “permitted” under Interpretation 101-5, it impairs independence with respect to the parent. However, a loan from a nonclient parent does not impair independence with respect to a client subsidiary if the subsidiary is not material to the parent.

24. If a report was issued when a member was independent, (s)he may reissue it or consent to its use when his/her independence is impaired provided (s)he did not do any post-audit work (not including reading subsequent statements or inquiries of subsequent auditors) while not independent.

25. Agreeing to indemnify a client for losses arising from lawsuits, etc., that relate directly or indirectly to client acts impairs independence.

26. When a member has significant influence over an entity with significant influence over a client.

27. Independence is impaired with respect to the client and the plan if a member participates in a client’s health and welfare plan. But, if participation arises from permitted employment of the immediate family of the covered member, no impairment occurs provided the plan is offered to all employees in equivalent positions.

28. When investment contributions by a member are invested or managed by a nonclient firm that offers financial services products (FSP5) that allow the member to direct his/her investment, independence is impaired if the FSP is invested in that client, whether or not the member directs the investment (a direct interest). If the member does not have authority to direct the investment, and the FSP invests in the client, an indirect interest results. If it is material to the member, independence is impaired. If the FSP invests only in the member’s clients, the interest is direct, and independence is impaired.

29. A member’s performing investment management or custodial services for an employee benefit plan sponsored by a client impairs independence regarding the plan. Independence is also impaired regarding the client-sponsor of a defined benefit plan if the assets involved are material to the plan or sponsor. Independence is not impaired regarding a client-sponsor of a defined contribution plan if the member performs no management functions and does not have custody of the assets.

Rule 102— *Integrity and Objectivity.*

a. Interpretation 102-1. Knowing misrepresentations of facts include knowingly making materially false and misleading entries in financial statements or records, failing to make corrections in materially false or misleading statements or records when the member has such authority, or signing a document with materially false and misleading information.

b. Interpretation 102-2. If a conflict of interest arises that could impair objectivity. When a member performs a professional service, Rule 102 will not prohibit the service if disclosure is made to and permission is obtained from the appropriate parties. However, an independence objection cannot be overcome by disclosure and consent. The following are examples of situations in which objectivity may be impaired:

1) Performing litigation services for the plaintiff when the defendant is a client

2) Providing tax or personal financial planning (PFP) services to both parties to a divorce

3) Suggesting that a PFP client invest in a business in which the member has an interest

4) Providing tax or PFP services to family members with conflicting interests

5) Performing consulting services for a client that is a major competitor of a company in which the member has a significant financial interest, occupies a management position, or exercises influence

6) Serving on a board of tax appeals that hears matters involving clients

7) Providing services in connection with a real estate purchase from a client

8) Referring a tax or PFP client to a service provider that refers clients to the member under an exclusive arrangement

9) Referring a client to a service bureau in which the member or a partner in the member’s firm has a material interest

c. Interpretation 102-3. In dealings with an employer’s external accountant, a member must be candid and not knowingly misrepresent facts or fail to disclose material facts.

d. Interpretation 102-4. If a member and his/her supervisor have a dispute about statement preparation or recording of transactions, the member should do nothing if the supervisor’s position is an acceptable alternative and does not materially misrepresent the facts.

1) If the member concludes that a material misstatement would result, (s)he

should consult the appropriate higher level(s) of management and should consider documenting relevant matters.

2) If, after such discussions, the member concludes that action was not taken, (s)he should consider the continuing relationship with the employer, the obligation to communicate with third parties, and the desirability of consulting legal counsel.

e. Interpretation 102-5. Educational services, e.g., teaching and research, are professional services subject to Rule 102.

f. Interpretation 102-6. Professional services involving client advocacy are governed by the Code, e.g., Rules 201, 202, 203, and 102. If independence is required for a service, Rule 101 also applies.

1) If the service stretches the bounds of performance standards, exceeds sound and reasonable professional practice, or compromises credibility, and therefore poses an unacceptable risk of injury to the member's or the firm's reputation, the propriety of accepting the engagement should be considered.

Ethics Rulings on Integrity and Objectivity — Rule 102.

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1. A member in public practice should not ordinarily serve as a director of a bank if it engages in significant transactions with his/her clients. The rules on confidential client information and conflict of interest may be violated.

2. The use of the CPA designation by a member not in public practice if it implies the member is independent of his/her employer is an intentional misrepresentation. The member should clearly indicate the employment title in any transmittal in which (s)he uses the CPA designation. If the member states that a financial statement conforms with GAAP, Rule 203 applies.

3. A member is a director of a federated fund-raising organization from which local charities that are clients (with significant relationships with the member) receive funds. If the significant relationship is disclosed and consent is received from the appropriate parties, performance of services not requiring independence is allowed.

4. A company approaches a member to provide PFP or tax services for its executives, who consent to the arrangement and are aware of any relationship the member has with the company. The result of the services could be recommendations adverse to company interests. Rule 102 and Rule 301 do not prohibit acceptance of the engagement if the member believes (s)he can perform objectively. The member should consider informing all parties of possible results. The member should also consider responsibilities to the company

and to the executives under Rule 301.

5. Service as an expert witness does not constitute client advocacy.

6. If a member is an officer, director, or principal shareholder of an entity having a loan to or from a client, independence is impaired with respect to that client if the member controls the entity, unless the loan is specifically permitted. If the member does not control the entity, the guidance in the interpretations should be considered. Disclosure and consent may therefore overcome the conflict-of-interest objection and permit the performance of the professional service for the client, provided the member believes it can be done with objectivity.

Rule 201 — *General Standards.*

a. Interpretation 201-1. A member should have the competence to complete professional services according to professional standards and with reasonable care and diligence.

    1) Competence involves technical qualifications and the ability to supervise and evaluate the work. It relates to knowledge of standards, techniques, and technical subject matter and to the ability to exercise sound judgment.

    2) In some cases, additional research and consultation is a normal part of performing services. However, if a member cannot gain sufficient competence, (s)he should suggest the engagement of someone competent.

Rule 202 — *Compliance with Standards.* No interpretations.

Rule 203 — *Accounting Principles.*

a. Interpretation 203-1. Professional judgment should be used in determining what constitutes unusual circumstances requiring a departure from established principles to prevent the financial statements or data from being misleading. Events that may justify such departures are new legislation or evolution of a new form of business transaction. An unusual degree of materiality or conflicting industry practices ordinarily do not justify departures.

b. Interpretation 203-2. The body designated to establish accounting principles for nongovernmental entities is the FASB. Unsuperseded SFASs, ARB5, and APB Opinions are accounting principles within the meaning of Rule 203. The GASB, with respect to Statements of Governmental Accounting Standards, is the designated body for state and local governments. The Federal Accounting

Standards Advisory Board (FASAB), with respect to its Statements of Federal Accounting Standards adopted and issued beginning in March 1993, is the designated body for federal governmental entities.

c. Interpretation 203-4. Rule 203 applies to all members regarding any affirmative statement about GAAP conformity.

   1) Thus, Rule 203 applies to members who sign client reports to regulatory agencies, creditors, or auditors that contain such representations.

Ethics Rulings on General and Technical Standards — Rules 201, 202, 203.

1. The member has a responsibility to make sure that a subcontractor (s)he has selected has the professional qualifications and skills needed.

2. A member is not required to be able to perform all the services of a newly hired systems analyst. But the member must be qualified to supervise and evaluate the specialist's work.

3. If a member submits financial statements in his/her capacity as an officer, shareholder, partner, director, or employee to a third party, the member's relationship to the entity should be clearly communicated. No implication of independence should be made. Rule 203 applies if the communication states that the financial statements conform with GAAP. If the member acts as a public practitioner or submits the statements on his/her public practitioner's letterhead, (s)he should comply with applicable standards, including disclosure of lack of independence.

4. Rule 203 applies to members who perform litigation support services.

Rule 301 — *Confidential Client Information*

a. Interpretation 301-3. The rule against disclosure of confidential information does not prohibit the review of a member's professional practice pursuant to a purchase, sale, or merger of the practice. However, appropriate precautions (e.g., a written confidentiality agreement) should be taken so that the prospective buyer does not disclose any confidential client information.

Rule 302 — *Contingent Fees.*

a. Interpretation 302-1. An example of circumstances in which a contingent fee is not allowed is the preparation of an amended income tax return for a client claiming a refund of taxes because of an inadvertent omission of a proper deduction.

1) Examples of circumstances in which a contingent fee is allowed include

    a) Representation of a client in an examination by a revenue agent
    b) Representation of a client who is obtaining a private letter ruling
    c) Filing an amended tax return claiming a refund based on a tax issue that is the subject of a test case involving a different taxpayer

Ethics Rulings on Responsibilities to Clients — Rules 301 and 302.

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1. A member may use an outside service to process tax returns provided (s)he takes all necessary precautions to prevent the release of confidential information.

2. A member may give a client's profit and loss percentages to a trade association provided the member has permission from the client.

3. A member who withdrew from an engagement because of fraud on a client's tax return should suggest that the successor obtain permission from the client to reveal the reasons for leaving.

4. A member may use a records-retention agency to store client records, but the responsibility for confidentiality still lies with the member.

5. A member may work for a municipality in verifying that proper amounts of taxes have been paid by the area businesses. Members are prohibited from releasing any confidential information obtained in their professional capacity.
6. A member may reveal a client's name without permission unless disclosure would constitute release of confidential information.

7. A member performing a consulting service must maintain the confidentiality of nonclient outside sources. If the client does not agree to this arrangement, the member should withdraw.

8. Knowledge and expertise obtained from a prior engagement may be used on behalf of a current client provided that the details of the other engagement are not revealed without permission.

9. A member who prepares a joint tax return should consider both spouses to be clients. After the spouses have divorced, the member will not violate Rule 301 if (s)he releases information to either spouse. But the legal implications should be discussed with an attorney.

10. A contingent fee or commission is considered to be received when the performance of related services is complete and the fee or commission is determined.

11. Rule 301 does not prohibit a member from releasing confidential client information to the

member's liability insurance carrier solely to assist the defense against a claim against the member.

12. A member may make disclosures necessary to initiate, pursue, or defend legal or alternative dispute resolution proceedings. Rule 301 does not prohibit compliance with laws or regulations.

13. A member who provides investment advisory services for an attest client for a percentage of the investment portfolio violates Rule 302 unless the fee is a specified percentage of the portfolio, the dollar amount of the portfolio is determined at the beginning of each quarterly (or longer) period and is adjusted only for the client's additions or withdrawals, and the fee arrangement is not renewed more often than quarterly.

14. Providing investment advisory services to the owners, officers, or employees of an attest client or to a nonattest client employee benefit plan sponsored by an attest client for a contingent fee does not violate Rule 302. Referring for commission the products or services of a nonclient or a nonattest client to the foregoing parties does not violate Rule 503 if the commission is disclosed to them. However, the member should consider the possible conflict of interest and also Rule 301.

15. See Ethics Ruling 25 under Rule 503.

Rule 501 — *Acts Discreditable*

a. Interpretation 501-1. Client records must be returned after a client demands them even if fees have not been paid. This ethical standard applies even if the state in which the member practices grants a lien on certain records in his/her possession.

   1) Client records are defined as "any accounting or other records belonging to the client that were provided to the member by or on behalf of the client."

   2) However, "a member's workpapers — including, but not limited to, analyses and schedules prepared by the client at the request of the member — are the member's property, not client records, and need not be made available."

   3) Moreover, the duty to return is not absolute regarding certain other information. Examples include adjusting, closing, combining, and consolidating entries; information usually found in the journals and ledgers; and tax and depreciation carryforward information. When the engagement is complete, this information should be made available upon

request in the medium in which it is requested if it exists in that medium. But information need not be converted from a nonelectronic format to an electronic one. Furthermore, the information need not be provided if all fees due the member have not been paid.

b. Interpretation 501-2. When a court or administrative agency has made a final determination that a member has violated an antidiscrimination law, (s)he is deemed to have committed an act discreditable.

c. Interpretation 501-3. In a governmental audit, failure to adhere to applicable audit standards, guides, procedures, statutes, rules, and regulations is an act discreditable to the profession unless the report discloses the failure and the reasons therefore.

d. Interpretation 501-4. Negligently making, or permitting or directing another to make, materially false and misleading entries in the financial statements or records; negligently failing to correct materially false and misleading statements when the member has such authority; or negligently signing, or permitting or directing another to sign, a document with materially false and misleading information is an act discreditable.

e. Interpretation 501-5. A member must follow GAAP and the requirements of governing bodies, commissions, or regulatory agencies when preparing financial statements or related information or in performing attest services for entities subject to their jurisdiction. A material departure from the requirements is an act discreditable unless the member discloses the reasons.

f. Interpretation 501-6. Solicitation or knowing disclosure of May 1996 or later CPA examination questions or answers is an act discreditable.

g. Interpretation 501-7. Failing to comply with laws regarding timely filing of personal or firm tax returns or timely remittance of taxes collected for others is an act discreditable.

Rule 502 — *Advertising and Other Forms of Solicitation.*

a. Interpretation 502-2. False, misleading, or deceptive acts are prohibited because they are against public interest. These prohibited activities include

1) Creating false expectations of favorable results
2) Implying the ability to influence any court, regulatory agency, or similar body
3) Representing that specific services will be performed for a stated fee when

it is likely at the time of the representation that the fees will be substantially increased and the client is not advised of the possibility

4) Other representations that would cause a reasonable person to misunderstand or be deceived

b. Interpretation 502-5. Members are permitted to render services to clients of third parties. If the third party obtained its clients through advertising, the members must ascertain that all promotional efforts were within the Rules of Conduct. Members must not do through others what they are prohibited from doing themselves.

Rule 503 — *Commissions and Referral Fees.* No interpretations.

Rule 505 — *Form of Organization and Name.*

a. According to the relevant AICPA Council Resolution, a member may practice public accounting only in a firm or organization with certain characteristics.

1) If such an entity performs any audit under the SASs, a review under the SSARSs, or an examination of prospective information under the SSAEs or holds itself out as a firm of CPAs, an entity must have the following attributes:

a) CPAs must own a majority of the firm in terms of financial interests and voting rights.

b) A non-CPA owner, including an investor or commercial enterprise, must be actively engaged in providing services to clients as his/her/its principal occupation.

c) A CPA must have ultimate responsibility for all services provided.

d) A non-CPA owner must have a baccalaureate degree.

e) Non-CPA owners cannot hold themselves out to be CPAs, must abide by the Code, must complete the work-related CPE requirements, and are ineligible for AICPA membership.

f) Owners must own their equity in their own right.

g) Ownership must be transferred to the firm or to other qualified owners within a reasonable time if the owner ceases to be actively engaged in the firm.

2) The characteristics of all other entities are considered to be whatever is legally permissible except as indicated in 3) below.

3) If a firm or organization not meeting the foregoing requirements performs compilations under SSARSs, a CPA must have ultimate responsibility for any such services and for each business unit performing such services. Moreover, any compilation report must be signed individually by a CPA.

b. Interpretation 505-2. A member in the practice of public accounting may own an interest in a separate business that performs the services for which standards are established. If the member, individually or with his/her firm or members of the firm, controls the separate business (as defined by U.S. GAAP), the entity and all its owners and employees must comply with the Code. Absent such control, the member, but not the separate business, its other owners, and its employees, would be subject to the Code.

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c. Interpretation 505-3. The overriding focus of the Council Resolution, the Code, and other AICPA requirements is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. However, in the context of alternative practice structures (APSs), CPAs may own the majority of financial interests in the attest firm, but substantially all revenues may be paid to another entity in return for services and the lease of employees, equipment, etc. Nevertheless, given the previously mentioned safeguards, if the CPA-owners of the attest firm remain financially responsible under state law, they are deemed to be in compliance with the financial-interests requirement of the Resolution.

Ethics Rulings on Other Responsibilities and Practices — Rules 501 -503, and 505.

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1. A firm may arrange with a bank to collect notes issued by a client in payment of fees.

2. A CPA employed by a firm with one or more non-CPA practitioners must obey the Rules of Conduct. If the CPA becomes a partner, (s)he is responsible for compliance with the Rules of Conduct by all associated practitioners.

3. A CPA who teaches a course is responsible for determining that promotional efforts are within Rule 502.

4. A member not in public practice who is controller of a bank may use the CPA title on bank stationery and in paid advertisements.

5. A member who is an attorney and a CPA may use a letterhead with both titles on it.

6. A member interviewed by the press should observe the Rules of Conduct and not provide information that the member could not publish.

7. A member may serve as a director of a consumer credit company if (s)he does not audit the company and avoids conflicts of interest.

8. Although members may share an office, have the same employees, etc., they should not use a letterhead with both their names unless a partnership exists.

9. CPA firms that wish to form an association are not allowed to use the title of an association (e.g., Smith, Jones & Associates) because the public may believe a true partnership exists instead of an association. Each firm should use its own letterhead indicating the others as correspondents.

10. A CPA and a non-CPA who dissolve their partnership should sign an audit report, after dissolution, in a way not implying a partnership.

11. The title “nonproprietary partner” should not be used by someone who is not a partner because it is misleading.

12. A member may have his/her own CPA practice and be a partner of a public accounting firm all other members of which are noncertified.

13. A partnership may continue to practice using the managing partner’s name as the firm name after (s)he withdraws. “And Company” should be added to the partnership name.

14. If a CPA forms a partnership with a non-CPA, the CPA is responsible for the non-CPA’s violation of the Code.

15. A firm may use an established firm name in different states even though the roster of partners differs.

16. When two partnerships merge, they may retain a title that includes a retired or former partner’s name.

17. A newsletter, tax booklet, etc., not prepared by the member or member’s firm (member) may be attributed to the member if the member has a reasonable basis to believe the information attributed to the member is not false, misleading, or deceptive.

18. If a CPA in public practice forms a separate business that centralizes billing services for physicians, the CPA must comply with the Rules of Conduct because this service is of a type performed by public accountants.

19. CPA firms that are associated for joint advertising and other purposes should practice under

their own names and indicate the association in other ways.

20. A CPA is not required to give the client a prepared tax return if the engagement to prepare the return is terminated prior to completion. Only the records originally provided by the client must be returned.

21. The designation "Personal Financial Specialists" may only be used on a letterhead when all partners or shareholders have the AICPA-awarded designation. However, the individual members holding the designation may use it after their names.

22. A member is permitted to purchase a product and resell it to a client. Any profits collected are not considered a commission because the member had title to the product and assumed the risks of ownership.

23. A member may contract with a computer hardware maintenance servicer to support a client's computer operations and charge a higher fee to the client than the servicer charges the member.

24. A member's spouse may provide services to the member's attest client for a contingent fee or refer products or services for a commission to or from the member's attest client, provided the spouse's activities are separate from the member's practice and the member is not significantly involved. However, a conflict of interest issue may arise.

25. A CPA may not refer for commissions products to clients through distributors and agents when the CPA is performing any of the services described in Rule 503. If the services are not being provided by the CPA, (s)he may refer the products provided (s)he discloses the commissions to the clients

26. Individuals associated with a client may be involved in an internal dispute, and each may request client records and other information. The CPA is under an obligation to supply certain information specified by Interpretation 501-1. This obligation is satisfied by turning over any required information to the designated client representative.

27. A CPA in partnership with non-CPAs may sign the firm name to a report and below it affix his/her name with the CPA designation. However, it must be clear that the partnership does not consist entirely of CPAs.

28. Unless permitted by contract, if the relationship of a member who is not an owner of a firm is terminated, (s)he may not take or retain originals or copies from the firm's client files or proprietary information without permission.

29. See Ethics Ruling 14 under Rule 302.

CASE STUDIES

1. THE CASE OF THE ALMOST STOLEN CLIENTS*

RULES THAT APPLY:
AICPA Rule 502 Advertising or Other Forms of Solicitation

THE PLAYERS:
Respondent: Mr. Knotmee
Complaint Submitted by: The Firm

CASE DETAILS:
In a letter to the ICPAS**, The Firm indicated that Mr. Knotmee, a former employee, improperly solicited clients of The Firm after his departure. In particular, The Firm stated that:

- At time of Mr. Knotmee's termination, he was asked to return all copies of any client lists and information. However, he failed to comply with this request.
- Prior to Mr. Knotmee's termination, his personnel file disappeared, which contained the non-compete agreement.
- In a solicitation (marketing) letter, Mr. Knotmee claims to employ current employees of The Firm. However, these employees have stated that they indeed do not work for Mr. Knotmee.

The Firm disputed some of the claims that Mr. Knotmee made in his marketing letter. Among the disputed claims:

- Mr. Knotmee stated he was a consulting manager at The Firm. - The Firm argued that he was classified as staff.
- Mr. Knotmee stated that he parted company with The Firm on April 15, 19xx. - The Firm stated that Mr. Knotmee was terminated on March 31 on the same year and that the reasons Mr. Knotmee gave for his dismissal are not representative of reality.
- Mr. Knotmee stated that many of The Firm's associates worked in conjunction with Mr. Knotmee's company. - The Firm stated that there are NO employees at The Firm who work for Mr. Knotmee's company.
- In Mr. Knotmee's resume, he stated that he is a member of the AICPA. - The Firm knows this to be false.

The ICPAS contacted Mr. Knotmee to inform him of the complaint made by The Firm, and to request a meeting. In the meeting between Mr. Knotmee and the ICPAS, Mr. Knotmee conceded that he should not have claimed to be member of AICPA since he is not. He stated that it was an oversight and he did not attempt to deceive. He also was under the impression that it is the responsibility of The Firm to prove advertising material is false. The Ethics Committee informed him that it is the obligation of the member to verify his own advertising materials. Mr. Knotmee supported his fee claims by presenting invoices by The Firm and by other accounting firms. However, since that type of information is confidential, it could not be disclosed, otherwise it would violate another ethics rule (Rule 301).

Mr. Knotmee said that although he has no employees now except himself, the persons he listed on his solicitation letter would work with him on his request. Mr. Knotmee did not receive any clients from the marketing letter. He promised to refrain from soliciting The Firm's clients in the future.

CONCLUSION:
The ICPAS found prima facie evidence that Mr. Knotmee had violated Rule 502.

CORRECTIVE ACTION:
The ICPAS and the AICPA instructed Mr. Knotmee to immediately comply with the ICPAS Code of Professional Conduct, to take and pass the AICPA course, Professional Ethics for CPAs, and to submit evidence that he has passed course.

LESSONS LEARNED:
While we all like to make our resumes as informative as possible, make sure the information is correct, and that you don’t pretend to be who you are not. Information that is false, misleading, or deceptive can get you into big trouble!

2. THE CASE OF THE HARMLESS MISTAKES*

RULES THAT APPLY:
AICPA 201 - General Standards
AICPA 501 - Acts Discreditable of the Code of Professional Conduct

THE PLAYERS:
Respondent: Mr. Happy
Complainant: Mr. Grumpus
Client: Company RED

CASE DETAILS:
In a letter to the ICPAS**, Mr. Grumpus indicated that Mr. Happy and his company billed excessively for work done for Company RED that was considered substandard because it contained errors in projected financial statements. Mr. Grumpus also claimed that the overly aggressive collections method that Mr. Happy used was of low professional conduct. Mr. Happy is a former employee of Mr. Grumpus and his company.
Mr. Happy responded via an interview with the ICPAS and indicated that the error in the projected financial statements was a failure to include the amount of interest expense in the determination of net income. Mr. Happy indicated that the mistake was in the software formula, causing the subtotal not to foot. Mr. Happy said that the error was immaterial. If materiality is based on projected revenue, the errors amounted to less than two percent for each of the three years in question. If it is based on percentage of

error on net income, the errors amount to 40%, 15%, and 6% for the same years. Mr. Grumpus relied on the PPC Forecasts and Projections Guide in determining materiality issue. As stated in the PPC guide materiality could be as high as twice that used for the historical financial statements.

Mr. Happy also said that the projected financial statements were not relied upon and that the users were sophisticated financial professionals who caught the error and made manual and mental corrections to the statements. The error had no effect on the complainant's analysis of the projected venture and did not affect their conclusions about not pursuing the venture. The ICPAS investigator contacted Company RED and discovered that had the numbers been correct, the merger would not have been completed anyway due to seller related issues. Mr. Happy said that an offer to reissue the financial statements was made and that Company RED declined. The ICPAS investigator told Mr. Happy that he should have notified Company RED in writing to state that the financial statements should be reissued.

The second issue concerning unpaid fees are being contested by Company RED as being too high due to excessive hours and credits that have not been applied as stated. Mr. Happy has not issued the billing credit on the advice of legal counsel. The interest charges per the respondent and the complainant have been eliminated from the statements submitted. The ethics committee feels that at this point, the fees should be settled between the parties and will not be an issue in the ethics investigation.

CONCLUSION:

The case was closed with a determination that no violation of the Code of Professional Conduct occurred. In a letter to Mr. Happy, the committee suggested that as a protective measure, he should put in writing any offers to reissue financial reports should such circumstances arise in the future.

CORRECTIVE ACTION:

None.

LESSONS LEARNED:

While fee disputes are a common source of complaints to the Ethics Committee, they generally do not get involved in them. However in this case the Committee debated whether the work product was being relied on. The Committee determined that although the projection was materially flawed, the principle users had discovered the error and took the error into consideration during their negotiations. At this point, the projection was no longer being relied on.

If a document is in error and the accountant knows this, it is the accountant's responsibility to take all efforts to make all users aware of this, typically through recalling a report and reissuing. However, if the report is not being relied on due to the "staleness" of the document, or the "special purpose" nature of the document having expired, there is no need to recall the report.

3. **THE CASE OF THE INADEQUATE ACCOUNTANT***

RULES THAT APPLY:
AICPA Rule 202 - Compliance with Standards
AICPA Rule 203 - Accounting Principles
THE PLAYERS:
Respondent: Mr. Indigo
Complainant: Mr. Whiner
Audited Party: Loser Township

CASE DETAILS:
Mr. Indigo performed an audit of the financial statements of the Loser Township for the year ended March 31, 19xx.
Mr. Whiner wrote in a letter to the ICPAS that Mr. Indigo's audit contained major deficiencies. The ICPAS notified Mr. Indigo of the complaint. The ICPAS Ethics Committee investigators met with Mr. Indigo at his office.
At the meeting, Mr. Indigo made the following statements:

- The Loser Township is one of three municipal clients. Their principle practice is in tax and monthly work.
- The firm has not completed a quality review as of yet. The review was scheduled for March 19xx, but was not started. None of the governmental audit work appears to follow yellow book standards.
  The firm has available to it, the AICPA audit guide Audits of State and Local Governmental Units and referred to it during the audit.
- The firm also utilized a PPC Guide on Auditor's Reports in drafting its report on the Loser Township financial statements.

The following deficiencies were discussed and noted at the meeting:

- The financial statements presented a prior year column that was also audited by Mr. Indigo. However, the auditor's opinion made no reference to the prior year. Other statements were inaccurate or missing.
- Based on review of the footnotes to the financial statements, the following notes were not present:
  Reporting entity note;
    - Description of funds;
    - Detail on property tax recognition
    - Change of general fixed asset-shown as an exhibit not part of the notes;
    - Insurance coverage for cash and investment disclosure;
    - Disclosure on interfund transfers.
- The statements, including the footnotes, would not be a complete disclosure and, as such, are not "liftable" as presented.
- The following items were not present in the workpapers:

- Assessment of Risk
- Determination of Materiality
- Evidence of Review
- Evidence of Planning

CONCLUSION:
The committee found evidence that Mr. Indigo violated Rule 202 - Compliance with Standards, and Rule 203 - Accounting Principles

CORRECTIVE ACTION:
The Committee instructed Mr. Indigo to comply immediately with professional standards applicable to professional service he performs. They also instructed him to complete 16 hours of specified CPE courses within one year, and show evidence of completion.

LESSONS LEARNED:
Don’t try to do work that is unfamiliar or new to you. Accounting standards have become very complex and specialized. This accountant mainly did monthly and tax work, and only had a few municipal clients. In a case such as this, he may have been better off referring the municipal client to an auditor with more expertise in this field. Another option is to do a joint venture with another firm that has more experience. The corrective action in this case focused on trying to educate the member in the area in which he had some inadequacy. But remember that all the CPE in the world can’t take the place of experience.

*Special thanks to Dr. Howard A. Kanter of the DePaul University School of Accountancy and the ICPAS Ethics Committee for developing and maintaining the Ethics Case Studies.

** ICPAS refers to Illinois CPA Society

CONSULTING SERVICES PROHIBITED BY SARBANES-OXLEY ACT OF 2002

Title II of the Sarbanes-Oxley Act of 2002 prohibits most "consulting" services outside the scope of practice of auditors.

(a) These services are prohibited even if pre-approved by the issuer's audit committee.
(b) Prohibited services include:

- Bookkeeping and related services,
- Design and implementation of financial information systems,
- Appraisal or valuation services (including fairness opinions and contribution-in-kind reports), (*Note:* The valuations relate to financial statement items and not valuations per se.)
- Actuarial services,
- Internal audit outsourcing, *Note:* "Operational" internal audits are allowed.
- Services that provide any management or human resources,
- Investment or broker/dealer services, and
- Legal and "expert services unrelated to the audit."
- Any other service that the board determines, by regulation, is impermissible.

(c) Services Not Prohibited. Firms, however, may provide tax services (including tax planning and tax compliance) or others that are not listed, provided the firm receives pre-approval from the board. However, certain tax planning products, like tax avoidance services, may be considered prohibited nonaudit services.

STANDARDS FOR TAX SERVICES

The AICPA has issued eight Statements on Standards for Tax Services. The statements are enforceable under the AICPA's *Code of Professional Conduct.*

SSTS No. 1 — *Tax Return Positions*

a. An AICPA member should not recommend a position unless (s)he has a good faith belief that the position has a realistic possibility of being sustained if challenged. A member may reach such a position on the basis of well-reasoned articles or treatises or pronouncements of the taxing authority.

b. A member should not prepare or sign a return if (s)he knows it takes a position that cannot be recommended as stated in a. above.

c. Despite a. and b., a member may recommend a position that is not frivolous (knowingly advanced in bad faith and improper) if (s)he advises disclosures. The member may prepare or sign a return containing such a position if the position is properly disclosed.

d. A member should advise the taxpayer of possible penalties associated with the recommended tax return position.

e. A member should not recommend a position that

1) Exploits the taxing authority's audit selection process, or
2) Is advanced solely to obtain leverage in the bargaining process.

f. A member has the right and responsibility to be an advocate for the taxpayer. A taxpayer has no obligation to pay more taxes than legally owed.

SSTS No.2— *Answers to Questions on Returns*

a. A member should make a reasonable effort to obtain appropriate answers to all questions on a tax return before signing as preparer.
b. Examples of reasonable grounds for omitting an answer

1) Information is not readily available, and the answer is insignificant with respect to taxable income or loss or the tax liability.
2) Genuine uncertainty exists as to the meaning of the question in relation to the particular return.
3) The answer to the question is voluminous, and the return states that the data will be supplied upon examination.

c. A taxpayer is not required to explain on the return the omission of an answer when reasonable grounds exist for the omission. The member should consider whether the omission causes the return to be incomplete.

SSTS No. 3— *Certain* ***Procedural Aspects of Preparing Returns***

a. A member may rely without verification on information provided by the taxpayer or third parties. Reasonable inquiries should be made if information appears to be incorrect, incomplete, or inconsistent on its face or on the basis of other facts known. Prior returns should be consulted if feasible.

b. Inquiries should be made to determine whether the taxpayer has met requirements to maintain books, records, or documentation to support deductions.

c. A member who prepares a return should consider information known from another taxpayer's return if it is relevant, its consideration is necessary, and its use does not violate any law or rule of confidentiality.

SSTS No.4— ***Use of Estimates***

a. A member may use the taxpayer's estimates if it is impracticable to obtain exact data, and the estimates are reasonable under the facts.

b. Estimates should be presented so as not to imply greater accuracy than exists.

c. The taxpayer is responsible for providing the estimated data.

d. Appraisals and valuations are not considered estimates.

SSTS No.5— ***Departure from a Position Previously Conducted in an Administrative Proceeding or Court Decision***

a. The treatment of an item as determined in an administrative proceeding or a court decision does not restrict the recommendation of a different tax treatment in later years, unless the taxpayer is bound to a specified treatment in the later year.

SSTS No.6— ***Knowledge of Error: Return Preparation***

a. The member should inform the taxpayer upon becoming aware of an error in a previously filed return or that the taxpayer did not file a required form.

b. The member should recommend measures to take.

c. The member is not obligated to inform the taxing authority and may not do so without the taxpayer's permission, unless required by law.

d. If the member is requested to prepare a return when the taxpayer has not corrected a previous year's error, the member should consider whether to continue a professional relationship with the taxpayer or withdraw.

e. If the member prepares the current return, the member should take reasonable steps to ensure that the error is not repeated.

SSTS No.7— ***Knowledge of Error: Administrative Proceedings***

a. The responsibilities are the same as stated in SSTS No. 6 except that they relate to representation of a taxpayer in an administrative proceeding.

b. The taxpayer's agreement must be obtained to disclose the error to the taxing authority.

c. Errors include a position on a return that no longer meets these standards (SSTS No. 1) because of retroactive legislation, judicial decisions, or administrative pronouncements. An error does not include an item with an insignificant effect.

SSTS No. 8— *Form and Content of Advice to Clients*

a. When providing tax advice to a taxpayer, a member should use judgment to ensure that the advice reflects professional competence and meets the taxpayer's needs.

b. When advising or consulting on tax matters, the member should follow SSTS No. 1.

c. A member is not obligated to communicate with the taxpayer when subsequent developments affect previous advice. However, (s)he is obligated to do so when helping to implement the plans associated with the advice or when undertaking the obligation by specific agreement.

d. Tax advice can be in any form. However, important, unusual, or complicated transactions should be in writing.

NOTE: Members may use a trade name as long as it is not deceptive or misleading. "Pay Less" may be construed as misleading for a tax service.

DISCIPLINARY SYSTEMS WITHIN THE PROFESSION

1. The AICPA's disciplinary mechanisms include the Professional Ethics Division and a joint trial board..

a. The Professional Ethics Division investigates ethics violations. It imposes sanctions in less serious cases. For example, it may require an AICPA member to take additional CPE courses as a remedial measure.

b. More serious infractions come before a joint trial board panel, which can acquit, admonish (censure), suspend, or expel a member. It may also take such other disciplinary, remedial, or corrective action as it deems to be appropriate. The *CPA Letter* publishes information about suspensions and expulsions.

1) A decision of a trial board panel may be appealed to the full trial board. The determination of this body is conclusive.

2) Upon the member's exhaustion of legal appeals, automatic expulsion without a hearing results when a member has been convicted of, or has received an adverse judgment for,

a) Committing a felony
b) Willfully failing to file a tax return
c) Filing a fraudulent tax return on the member's or a client's behalf
d) Aiding in preparing a fraudulent tax return for a client

3) Automatic expulsion also occurs when a member's CPA certificate is revoked by action of any governmental agency, e.g., a state board of accountancy.

4) Expulsion from the AICPA or a state society does not bar the individual from the practice of public accounting.

a) A valid state-issued license is required to practice.

b) Thus, violation of a state code of conduct promulgated by a board of accountancy is more serious than expulsion from the AICPA because it may result in revocation of the CPA certificate.

c. Joint Ethics Enforcement Program (JEEP)

1) The AICPA and most state societies have agreements that permit referral of an ethics complaint either to the AICPA or to a state society.

2) The AICPA handles matters of national concern, those involving two or more states, and those in litigation.

a) JEEP also promotes formal cooperation between the ethics committees of the AICPA and of the state societies.

2. The SEC, IRS, and PCAOB may also discipline accountants.

a. The SEC may seek an injunction from a court to prohibit future violations of the securities laws. Moreover, under its Rule of Practice 2(e), the SEC may conduct administrative proceedings that are quasi-judicial.

1) Pursuant to such proceedings, it may suspend or permanently revoke the right to practice before the SEC, including the right to sign any document filed by an SEC registrant, if the accountant

a) Does not have the qualifications to represent others

b) Lacks character or integrity

c) Has engaged in unethical or unprofessional conduct

d) Has willfully violated, or willfully aided and abetted the violation of, the federal securities laws or their rules and regulations

2) Suspension by the SEC may also result from

a) Conviction of a felony, or a misdemeanor involving moral turpitude
b) Revocation or suspension of a license to practice
c) Being permanently enjoined from violation of the federal securities acts

3) Some Rule 2(e) proceedings have prohibited not only individuals but also accounting firms from accepting SEC clients.

4) Under the Securities Law Enforcement Act of 1990, the SEC may impose civil penalties in administrative proceedings of up to $100,000 for a natural person and $500,000 for any other person. Furthermore, the SEC may order a violator to account for and surrender any profits from wrongdoing and may issue cease-and-desist orders for violations.

b. The IRS may prohibit an accountant from practicing before the IRS if the person is incompetent or disreputable or does not comply with tax rules and regulations.

1) The IRS may also impose fines.

c. The PCAOB was established by the Sarbanes-Oxley Act of 2002.

1) A firm's registration application must contain information about a firm's quality control and a description of all actions pending against it. This information may have a great effect on enforcement actions and potential punishments. Moreover, the firm must give consent to cooperate with PCAOB investigations.

2) The PCAOB has rule-making authority regarding quality control, ethics and auditing standards. These rules, especially those governing quality control, will have great relevance to enforcement actions.

3) The PCAOB will inspect large firms annually and report violations to the SEC and state authorities. All attestation engagements, notably those in litigation, may be reviewed. The inspection also involves a quality control assessment. Furthermore, the inspection report must include the firm's response. The firm then has twelve months to correct the reported weaknesses.

4) The PCAOB has substantially the same investigatory scope with respect to accountants as the SEC. The PCAOB may request that the SEC issue subpoenas to third parties, and it may deregister any uncooperative firm.

5) The PCAOB has no injunctive power, but it may institute administrative proceedings. It may seek disassociation of a person from a registered firm, suspension (temporary or permanent) of the firm's registration, or a penalty of up to $15 million. The extreme cases in which the harshest penalties may be imposed include repeated instances of negligent misconduct. By contrast, the SEC may impose the severest punishments when the firm has engaged in just one instance of highly unreasonable conduct.

3. State boards of accountancy and state CPA societies also have codes of ethics and/or rules of conduct.

a. State boards are governmental agencies that license CPAs to use the designation "Certified Public Accountant" and prohibit non-CPAs from performing the attest function. They can suspend or revoke licensure through administrative process.

1) Like the AICPA, state boards have trial boards to conduct administrative hearings.

b. State societies are voluntary, private organizations that can admonish, suspend, or expel members.

NOTE: A CPA may not claim to be endorsed by the Institute. A member may, however, state that (s)he is a member.

CORPORATE RESPONSIBILITY LAW (SARBANES-OXLEY ACT)
(www.whitehouse.gov/infocus/corporateresponsibility/)

President George W. Bush signed the Sarbanes-Oxley Act of 2002 (Public Law 107-204) on Tuesday, July 30, 2002. Congress presented the act to the president on July 26, 2002, after passage in the Senate by a 99-0 vote and in the House by a 423-3 margin.

As enacted, the law will directly impact the following groups:

1. CPAs and CPA firms auditing public companies;
2. Publicly traded companies, their employees, officers, and owners—including holders of more than 10 percent of the outstanding common shares. This category would include

CPAs employed by publicly traded companies as chief financial officers (CFOs) or in the finance department;
3. Attorneys who work for or have as clients publicly traded companies; and
4. Brokers, dealers, investment bankers and financial analysts who work for these companies.

The Act changes how publicly traded companies are audited, and reshapes the financial reporting system. This Act adopts tough new provisions to deter and punish corporate and accounting fraud and corruption, ensures justice for wrongdoers, and protects the interests of workers and shareholders.

This law improves the quality and transparency of financial reporting, independent audits, and accounting services for public companies. It also:

- Creates a Public Company Accounting Oversight Board (**www.pcaobus.org**) to enforce professional standards, ethics, and competence for the accounting profession;
- Strengthens the independence of firms that audit public companies;
- Increases corporate responsibility and the usefulness of corporate financial disclosure;
- Increases penalties for corporate wrongdoing;
- Protects the objectivity and independence of securities analysts; and
- Increases Securities and Exchange Commission resources.

Under this law, CEOs and chief financial officers must personally vouch for the truth and fairness of their company's disclosures. And those financial disclosures will be broader and better than ever before.

Corporate officials will play by the same rules as their employees. In the periods when workers are prevented from buying and selling company stock in their pensions or 401 (k)s, corporate officials will also be banned from any buying or selling.

Corporate misdeeds will be found and punished. This law authorizes new funding for investigators and technology at the SEC to uncover wrongdoing. The SEC will now have the administrative authority to bar dishonest directors and officers from ever again serving in positions of corporate responsibility. The penalties for obstructing justice and shredding documents are greatly increased.

Specifics

<u>New Public Company Accounting Oversight Board (PCAOB)</u>

- The law establishes a five-member accounting oversight board that is subject to Securities and Exchange Commission (SEC) oversight.

- Though the board oversees accounting firms, only two members of the board may be CPAs.
- The SEC will appoint the board.
- Duties of the board include registering public accounting firms that prepare audit reports; and establishing or adopting auditing, quality control, ethics and independence standards.
- The board also inspects, investigates and disciplines public accounting firms and enforces compliance with the act.
- **Registration with the Board Is Mandatory.** For public accounting firms, foreign or domestic, that participate in the preparation or issuance of any audit report with respect to a public company. Registration and annual fees collected from each registered CPA firm will go towards the costs of processing and reviewing applications and annual reports.
- **Seven-Year Record Retention Requirement.** PCAOB must adopt a rule to require registered CPA firms to prepare and maintain audit work papers and other information related to an audit for at least seven years in sufficient detail to support the conclusions reached in the audit report. (A separate criminal provision requires retention of all audit and review workpapers for five years from the end of the fiscal year in which the audit or review was completed.)
- **Cooperation with CPA Groups.** The board will cooperate with professional accountant groups and advisory groups to increase the effectiveness of the standards setting process. (The PCAOB may cooperate, but authority to set standards rests with the PCAOB, subject to SEC review.)
- **Annual Inspections.** Inspection of registered public accounting firms shall occur annually for every registered public accounting firm that regularly provides audit reports for more than 100 issuers (at least once every three years for registered firms that audit fewer than 100 issuers).
- **Investigations.** The board may investigate any act, omission or practice by a registered firm or an individual associated with a registered firm for any possible violation of the act, the board's rules, professional standards, or provisions of the securities laws relating to the preparation and issuance of audit reports.
  (a) The board may require testimony or documents and information (including audit work papers) from a registered firm or individual associated with a registered firm or in the possession of any other person.
- Sanctions for violations that the board finds may include:
  (a) Suspension or revocation of a registration;
  (b) Suspension or bar of a person from further associating with any registered public accounting firm;

(c) Limitations on the activities of a firm or person associated with the firm; and
(d) Penalize the firm up to $2 million per violation, up to a maximum of $15 million.
(e) Individuals employed or associated with a registered firm who violate the act can face penalties that range from required additional continuing professional education (CPE) or training, disbarment of the individual from further association with any registered public accounting firm, or even a fine up to $100,000 for each violation, up to a maximum of $750,000.
(1) A portion of the penalties collected will go to accounting scholarships.

- **Funding.** The law also provides independent funding for the Financial Accounting Standards Board (FASB). While the SEC and American Institute of CPAs (AICPA) both have recognized FASB as the standard setting body for accounting principles, federal authority to issue auditing, quality control, ethics and independence standards may seriously impact the AICPAs' role in official pronouncements.

  (a) **Source.** The budget for the board and FASB will be payable from "annual accounting support fees" set by the board and approved by the Commission. The fees will be collected from publicly traded companies and will be determined by dividing the average monthly equity market capitalization of the company for the preceding fiscal year by the average monthly equity market capitalization of all such companies for that year.

<u>Other Requirements for CPA Firms</u>

- **Audit Reports Require Concurring Partner Review.** Requires a concurring or second partner's review and approval of all audit reports and their issuance.

- **"Revolving Door" Employment of CPAs with Audit Clients Is Banned.** A registered CPA firm is prohibited from auditing any SEC registered client whose chief executive, CFO, controller or equivalent was on the audit team of the firm within the past year.

- **Audit Partner Rotation Required.** Audit partners who either have performed audit services or been responsible for reviewing the audit of a particular client must be rotated every five consecutive years. CPAs should read carefully the requirements for rotation of both the partner-in-charge and the concurring review partner for certain organizational constraints.
  (a) **No Firm Rotation Requirement.** Firm rotation is not required. However, the U.S. Comptroller General will study and review the potential effects of mandatory rotation and will report its findings to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services.

- **CPA Firms Are Required to Report Directly to the Audit Committee.**

- **CPA Firm Consolidations to Be Studied.** The U.S. Comptroller General will conduct a study analyzing the impact of the merger of CPA firms to determine if consolidation leads to higher costs, lower quality of services, impairment of auditor independence, or lack of choice.

- **Corporate and Criminal Fraud Accountability.** Changes to the securities laws can penalize anyone found to have destroyed, altered, hid or falsified records or documents to impede, obstruct or influence an investigation conducted by any federal agency, or in bankruptcy, with fines or up to 20 years imprisonment, or both.

- **Current Requirements for Audit Firms.** Accountants are required to maintain all audit or review workpapers for a period of five years from the end of the fiscal period in which the audit or review was concluded.

- **Additional Rules.** The law requires the SEC to promulgate rules and regulations on the retention of any and all materials related to an audit, including communications, correspondence and other documents created, sent or received in connection with an audit or review.
  (a) **Penalties.** For violating the requirement or the rules that will be developed will result in a fine, or up to 10 years imprisonment, or both.

<u>Internal Control Report.</u>
Under Section 404 of the act, management must establish and document internal control procedures and include in the annual report a report on the company's **internal control over financial reporting.** This report is to include

1. A statement of management's responsibility for internal control;
2. Management's assessment of the effectiveness of internal control as of the end of the most recent fiscal year;
3. Identification of the framework used to evaluate the effectiveness of internal control (such as the report of the Committee of Sponsoring Organizations);
4. A statement about whether significant changes in controls were made after their evaluation, including any corrective actions; and
5. A statement that the external auditor has issued an attestation report on management's assessment.

Because of Section 404, two audit opinions are expressed: one on **internal control** and one on the **financial statements**. The auditor must attest to and report on management's assessment.

The auditor must evaluate whether the structure and procedures

- Include records accurately and fairly reflecting the firm's transactions.
- Provide reasonable assurance that transactions are recorded so as to permit statements to be prepared in accordance with GAAP.

The auditor's report also must describe any material weaknesses in the controls. The evaluation is not to be the subject of a separate engagement but be in conjunction with the audit of the financial statements.

Of Note to Industry Members—Requirements for Corporations, Their Officers and Board Members

- **No Lying to the Auditor.** The act makes unlawful for an officer or director or anyone acting for a principal to take any action to fraudulently influence, coerce, manipulate or mislead the auditing CPA firm.

- **Code of Ethics for Financial Officers.** The SEC is mandated to issue rules adopting a code of ethics for senior financial officers.

- **Financial Expert Requirement.** The SEC is required to issue rules requiring a publicly traded company's audit committee to be comprised of at least one member who is a financial expert.

- **Audit Committee Responsible for Public Accounting Firm.** The Act vests the audit committee of a publicly traded company with responsibility for the appointment, compensation and oversight of any registered public accounting firm employed to perform audit services.

NOTE: The Act requires that the audit committee of a public company hire and pay the external auditors.

- **Audit Committee Independence.** Requires audit committee members to be members of the board of directors of the company, and to otherwise be independent.

- **CEOs & CFOs Required to Affirm Financials.** Chief executive officers (CEOs) and CFOs must certify in every annual report that they have reviewed the report and that it does not contain untrue statements or omissions of material facts.
  (a) **Penalty for Violation.** If material noncompliance causes the company to restate its financials, the CEO and CFO forfeit any bonuses and other incentives received during the 12-month period following the first filing of the erroneous financials.

- **CEOs & CFOs Must Enact Internal Controls.** CEOs and CFOs will be responsible for establishing and maintaining internal controls to ensure they are notified of material information.

- **Penalties for Fraud.** The Act also has stiffened penalties for corporate and criminal fraud by company insiders. The law makes it a crime to destroy, alter or falsify records in a federal investigation or if a company declares bankruptcy. The penalty for those found guilty includes fines, or up to 20 years imprisonment, or both.

- **Companies Affected by the Act.** Publicly traded companies affected by the Act are those defined as an "issuer" under Section 3 of the Securities Exchange Act of 1934, whose securities are registered under Section 12 of the 1934 Act. An issuer also is considered a company that is required to file reports under Section 15(d) of the Act, or that files or has filed a registration statement that has not yet become effective under the Securities Act of 1933.

- **Debts Not Dischargeable in Bankruptcy.** Amends federal bankruptcy law to make non-dischargeable in bankruptcy certain debts that result from a violation relating to federal or state securities law, or of common law fraud pertaining to securities sales or purchases.

- **Expanded Statute of Limitations for Securities Fraud.** For a civil action brought by a non-government entity or individual, an action involving a claim of securities fraud, deceit or manipulation may be brought not later than the earlier of two years after discovery or five years after the violation.

- **No Listing on National Exchanges for Violators.** The SEC will direct national securities exchanges and associations to prohibit the listing of securities of a noncompliant company.

- **No Insider Trading.** No insider trading is permitted during pension fund blackout periods. The insider must forfeit any profit during this period to the company.

- **SEC Rules on Enhanced Financial Disclosures.**
(a) Off-Balance Sheet Transactions: All quarterly and annual financial reports filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations (including contingent obligations), and other relationships of the issuer with unconsolidated entities. Disclosure must be made on significant aspects relating to financial condition, liquidity, capital expenditures, resources, and components of revenue and expenses.
(b) Pro Forma Figures: Pro forma financial information in any report filed with the SEC or in any public release cannot contain false or misleading statements or omit material facts necessary to make the financial information not misleading.

- **No Personal Loans.** No personal loans or extensions of credit to company executives either directly or through a subsidiary, except for certain extensions of credit under an open-ended credit plan or charge card, home improvement and manufactured home loans, or extensions of credit by a broker or dealer to its employee to buy, trade or carry securities.
(a) The terms of permitted loans cannot be more favorable than those offered to the general public.

Criminal Penalties Enhanced*

BEHAVIOR	SENTENCE

The alteration, destruction, concealment of any records with the intent of obstructing a federal investigation.	Fine and/or up to 10 years imprisonment.
Failure to maintain audit or review "workpapers" for at least five years.	Fine and/or up to 5 years imprisonment.
Anyone who "knowingly executes, or attempts to execute, a scheme" to defraud a purchaser of securities.	Fine and/or up to 10 years imprisonment.
Any CEO or CFO who "recklessly" violates his or her certification of the company's financial statements. If violation is willful.	Fine of up to $1,000,000 and/or up to 10 years imprisonment. Fine of up to $5 million and/or up to 20 years imprisonment.
Two or more persons who conspire to commit any offense against or to defraud the U.S. or its agencies.	Fine and/or up to 10 years imprisonment.
Any person who "corruptly" alters, destroys, conceals, etc., any records or documents with the intent of impairing the integrity of the record or document for use in an official proceeding.	Fine and/or up to 20 years imprisonment.
Mail and wire fraud. Violating applicable Employee Retirement Income Security Act (ERISA) provisions.	Increase from 5 to 20 years imprisonment. Various lengths depending on violation.

* Source: Sarbanes-Oxley Act of 2002 and New York City Office of the Comptroller.

CHAPTER 3
STANDARDS OF ETHICAL CONDUCT FOR PRACTITIONERS OF MANAGEMENT ACCOUNTING AND FINANCIAL MANAGEMENT FOR CERTIFIED MANAGERIAL ACCOUNTANTS (CMA) AND THE CERTIFIED IN FINANCIAL MANAGEMENT (CFM)

LEARNING OBJECTIVES:

After studying this chapter you will be able to:

1. Describe the level of competence required by accountants (CMAs) and financial managers (CFMs).
2. Distinguish between the concepts of confidentiality and integrity.
3. Outline and clarify a method of resolution of ethical conflict.

Practitioners of management accounting and financial management have an obligation to the public, their profession, the organizations they serve, and themselves, to maintain the highest standards of ethical conduct. In recognition of this obligation, the Institute of Management Accountants (IMA) has promulgated the following standards of ethical conduct for practitioners of management accounting and financial management. Adherence to these standards, both domestically and internationally, is integral to achieving the *Objectives of Management Accounting*. Practitioners of management accounting and financial management shall not commit acts contrary to these standards nor shall they condone the commission of such acts by others within their organizations.

Competence
Practitioners of management accounting and financial management have a responsibility to:

- Maintain an appropriate level of professional competence by ongoing development of their knowledge and skills.
- Perform their professional duties in accordance with relevant laws, regulations, and technical standards.
- Prepare complete and clear reports and recommendations after appropriate analyses of relevant and reliable information.

Confidentiality
Practitioners of management accounting and financial management have a responsibility to:

- Refrain from disclosing confidential information acquired in the course of their work except when authorized, unless legally obligated to do so.
- Inform subordinates as appropriate regarding the confidentiality of information acquired in the course of their work and monitor their activities to assure the maintenance of that

confidentiality.
- Refrain from using or appearing to use confidential information acquired in the course of their work for unethical or illegal advantage, either personally or through third parties.

Integrity
Practitioners of management accounting and financial management have a responsibility to:

- Avoid actual or apparent conflicts of interest and advise all appropriate parties of any potential conflict.
- Refrain from engaging in any activity that would prejudice their ability to carry out their duties ethically.
- Refuse any gift, favor, or hospitality that would influence or would appear to influence their actions.
- Refrain from either actively or passively subverting the attainment of the organization's legitimate and ethical objectives.
- Recognize and communicate professional limitations or other constraints that would preclude responsible judgment or successful performance of an activity.
- Communicate unfavorable as well as favorable information and professional judgments or opinions.
- Refrain from engaging in or supporting any activity that would discredit the profession.

Objectivity
Practitioners of management accounting and financial management have a responsibility to:

- Communicate information fairly and objectively.
- Disclose fully all relevant information that could reasonably be expected to influence an intended user's understanding of the reports, comments, and recommendations presented.

Resolution of Ethical Conflict
In applying the standards of ethical conduct, practitioners of management accounting and financial management may encounter problems in identifying unethical behavior or in resolving an ethical conflict. When faced with significant ethical issues, practitioners of management accounting and financial management should follow the established policies of the organization bearing on the resolution of such conflict. If these policies do not resolve the ethical conflict, such practitioners should consider the following courses of action:

- Discuss such problems with the immediate superior except when it appears that the superior is involved, in which case the problem should be presented initially to the next higher managerial level. If satisfactory resolution cannot be achieved when the problem is initially presented, submit the issues to the next higher managerial level. If the immediate superior is the chief executive officer, or equivalent, the acceptable reviewing authority may be a group such as the audit committee, executive committee, board of directors, board of trustees, or owners. Contact with levels above the immediate superior should be initiated only with the superior's knowledge, assuming the superior is not involved. Except where legally prescribed, communication of such problems to authorities or individuals not employed or engaged by the organization is not considered appropriate.

- Clarify relevant ethical issues by confidential discussion with an objective advisor (e.g., IMA Ethics Counseling Service) to obtain a better understanding of possible courses of action.

- Consult your own attorney as to legal obligations and rights concerning the ethical conflict.

- If the ethical conflict still exists after exhausting all levels of internal review, there may be no other recourse on significant matters than to resign from the organization and to submit an informative memorandum to an appropriate representative of the organization. After resignation, depending on the nature of the ethical conflict, it may also be appropriate to notify other parties.

(*Source:* Statement on Management Accounting 1C (Revised), Objectives: Standards of Ethical Conduct for Practitioners of Management Accounting and Financial Management, April 1997, pp. 69-70).

CORPORATE GOVERNANCE The system of checks and balances designed to ensure that corporate managers are just as vigilant on behalf of long-term shareholder value as they would be if it was their own money at risk. It is also the process whereby shareholders—the actual owners of any publicly traded firm—assert their ownership rights, through an elected board of directors and the CEO and other officers and managers they appoint and oversee.

DEONTOLOGY (KANTIAN ETHICS) the concept of duty and the rightness of acts. It emphasizes maxims, duties, rules, and principles that are so important that they should be followed whatever the consequences.

ETHICS: standards of professional conduct and business practices adhered to by professionals in order to enhance their profession and maximize idealism, justice and fairness when dealing with the public, clients and other members of their profession.

LAWS: bodies of rules governing members of a community, state, organization, professional, etc ... and enforced by authority or compelling legislation.

MORAL: an accepted rule or standard of human behavior.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD (PCAOB) (**www.pcaobus.com**) established in 2002 as a result of the Sarbanes-Oxley Act, a private sector, non-profit corporation set up to oversee the audits of public companies and ensure that accountancy firms should no longer derive non-audit revenue streams, such as consultancy, from their audit clients.

SARBANES-OXLEY (SOX) ACT wide-ranging U.S. corporate reform legislation, coauthored by the Democrat in charge of the Senate Banking Committee, Paul Sarbanes, and Republican Congressman Michael Oxley. The Act, which became law in July 2002, lays down stringent procedures regarding the accuracy and reliability of corporate disclosures, places restrictions on auditors providing non-audit services and obliges top executives to verify their accounts personally. Section 409 is especially tough and requires that companies must disclose information on material changes in the financial condition or operations of the issuer on a rapid and current basis.

UTILITARIANISM (TELEOLOGICAL ETHICS) the promotion that the best long-term interest of everyone concerned should be the moral standard. One should take those actions that lead to the greatest balance of good versus bad consequences.