Ethics and Professional Judgment in Accounting

Chapter 4

Questions for Consideration

- What are the underlying behavioral characteristics of good judgment?
- What is the link between moral reasoning methods and making professional judgments?
- How does cognitive dissonance influence professional judgment?
- What is the role of professional judgment in making ethical decisions?
- How does the AICPA Code address issues of professional judgment?

Public Watchdog Function

- Public responsibility transcending any employment responsibility with the client
- Ultimate allegiance to the corporation’s creditors and stockholders, as well as to the investing public
- Accountant must maintain total independence from the client at all times and requires complete fidelity to the public trust
- Overriding duty to put the interests of investors first
- Need for professional skepticism in making professional judgments
- Need for objectivity and due care in making judgments given the increasing complexity in financial reporting
- Only profession where one’s public obligation supersedes that to a client

Professional Judgment in Accounting

- Professional judgment is influenced by personal behavioral traits
  - Attitudes
  - Ethical values
- Personal values link to ethical sensitivity and judgment
- Ethical awareness of an ethical dilemma is a mediator of the personal factors and ethical judgment relationship
- Objectivity and due care are attitudes and behaviors that enable professional judgment
- Professional skepticism is essential in making professional judgments; helps frame auditors' mindset of independent thought

KPMG Professional Judgment Framework

- Judgment is the process of reaching a decision or drawing a conclusion where there are a number of possible alternative solutions
- Judgment occurs in a setting of uncertainty, risk, and often conflicts of interest
- Components revolve around ones' mindset
  - Clarify issues and objectives
  - Consider alternatives
  - Gather and evaluate information
  - Reach conclusion
  - Articulate and document rationale
- Prescriptive framework is used but pressures, time constraints, and limited capacity may cause deviations
- Auditor should approach matters with objectivity and independence, with inquiring mind and critical assessment of audit evidence

Link between KPMG Framework and Cognitive Processes

- Auditors need to use System 2 thought process
  - Ethical awareness
  - Application of ethical reasoning, ethical analysis of harms and benefits and stakeholder rights; and professional obligations
- Judgments can fall prey to cognitive traps and biases that negatively influence judgments
  - Group-think
  - Rush to solve problems
  - Judgment triggers
- Judgment triggers – can lead to accepting a solution before it is properly identified and evaluated
  - Availability tendency
  - Confirmation tendency
  - Overconfidence tendency
  - Anchoring tendency

CIFiR and Role of Professional Skepticism

- CIFiR is the SEC's Advisory Committee on Improvements to Financial Reporting; framework for accounting judgments
  - A critical and good faith thought process
  - Documentation
- Greek word skeptikos, meaning "inquiring or reflective"
- Professional skepticism links to professional judgment through the ethical standards of independent thought, objectivity and due care, which are incorporated in AICPA Code of Professional Conduct
- CPA firm management should set an appropriate tone that emphasizes a questioning mind throughout the audit and the exercise of professional skepticism in gathering and evaluating evidence

Public Interest in Accounting

- When professional judgment is compromised by taking shortcuts or allowing pressures and biases imposed by others to taint decision making, the public looses trust in the accounting profession
- The profession must rebuild its reputation on its historical foundation of ethics and integrity
- IFAC's Policy Position Paper #4, A Public Interest Framework for the Accounting Profession
  - A distinguishing mark of the accounting profession is the acceptance of its responsibility to act in the public interest.
- International Ethics Standards Board for Accountants (IESBA) include integrity, objectivity, professional competence and due care, confidentiality, and compliance with laws and regulations
- AICPA public interest includes clients, credit grantors, governments, employers, investors, the business and financial community, and others who rely on the objectivity and integrity of CPAs

Professionalism versus Commercialism

- In 2013 PwC acquired the consulting giant Booz & Company.
- In 2014 KPMG brought Zanett Commercial Solutions and in 2015 acquired all the assets of Beacon Partners, Inc.
- Unlike audits that are conducted primarily to satisfy the public interest, consulting services satisfy the client's interest and does not require independence from the client.
- Lynn Turner, former SEC chief accountant asked, "Are the auditors going to serve management, or are they going to serve the best interests of the investing public?"
- As long as the appearance of independence has been tainted by the consulting relationship, the Independence standard would be compromised.

Investigations of the Profession

- High profile frauds in the 1970s, 1980s, 2000s
- Congressional concern of auditors' ethical and professional responsibilities
- Themes of investigations
  - Nonaudit services impairing auditor independence
  - Management to report on internal controls
  - Prevention and detection of fraud
  - Role of audit committee and communication between them and auditors
  - Peer reviews/inspections

Metcalf (Moss) Committee

- First investigation of profession since 1930s
- Conducted between 1975-1977
- Some recommendations
  - Establish self-regulatory organization of firms
  - Led to AICPA two-tier voluntary peer review program
    - Public company clients (assumed by PCAOB in 2004)
    - Private companies
  - Limitation of management service to those directly related to accounting
- Report didn’t lead to any new legislation at the time

Cohen Commission

- Examined issues:
  - Auditor's responsibility for detecting fraud
  - Expectation gap between public expectations and profession's goals for the audit
- Recommendations:
  - Management should report on its internal controls
  - Auditors should evaluate management's report
  - Both enacted as part of Sarbanes-Oxley Act of 2002
- Importance of Cohen Commission:
  - Demonstrated conflicts of providing nonauditing services for an audit client
  - Lowballing fees
    - Deliberately underbidding for an audit; Less prevalent after SOX
  - Opinion shopping
    - Client seeks auditor who will go along with accounting treatment

Early 1980s

- Fraud failure with ESM Government Securities, Continental Illinois National Bank and Trust, and Penn Square Bank
- Rep. Wyden authored 1986 bill to hold auditors responsible for fraud detection
- Rep. Shad modified bill
  - Internal control reports
  - Detection of material illegalities or irregularities
  - Bill did not pass
- ZZZZ Best Co.
  - Created fictitious revenue that amounted to 80% of total revenue; Rep. Dingell chaired investigation; auditors did not disclose fraud to authorities

Savings and Loan Failures

- Deloitte & Touche audits
  - Beverly Hills Savings and Loan
  - Sunrise Savings
- Arthur Young audit
  - Western Savings Association
  - Lincoln Savings and Loan
  - If Arthur Young had not merged with Ernst & Whinney to form EY, the firm may have been forced out of business
- Greatest collapse of U.S. financial institutions since the Great Depression
- Accounting issues in failed S&Ls centered on three issues:
  - Inadequate allowances for loan losses
  - Non-disclosure of related party transactions
  - Inadequate internal controls

Treadway Commission Report

- National Commission on Fraudulent Financial Reporting
- 1985 study and report on factors leading to fraudulent financial reporting
- Established Committee of Sponsoring Organizations (COSO)
  - Need to change the corporate culture
  - Establish systems to prevent fraudulent reporting
  - Tone at the Top – sets ethical tone of organization
  - Importance of strong control environment
  - Internal auditors must have direct and unrestricted access to Audit Committee of BOD
- COSO Enterprise Risk Management – Integrated Framework

2007 – 2008 Financial Crisis

- Excessive risk taking
- Mortgage meltdown
- Moral Hazard – Incentive for risk taking -- --to put own interests first especially when perceived sanctions for inappropriate behavior not enforced
- Concern over independence, objectivity, and audit quality
- Growing personal and business relationships between auditing firms, the client, and client management
- Emphasis on marketing of professional services
- Lehman Brothers

Failure of Lehman Brothers

- Insufficient liquidity to meet its current obligations and loss of confidence of its lenders
- CEO, CFOs, and external auditors all failed to meet professional responsibilities
- Lehman used “Repo 105”, did not disclose its use
- Shares dropped 94% over 8 months; U.S. refused to fund a solution for Lehman
- Auditors play a critical role in the proper functioning of public companies and financial markets
- The public has every right to conclude that auditors who hold themselves out as independent will stand up to management and not succumb to pressure
- External auditors need to recommit to their watchdog/gatekeeper function

AICPA Revised Code: Independence for Members in Public Practice

- Conceptual framework incorporates a "threats and safeguards" approach
- New section on "Ethical Conflicts"
- Violation of the rules for a CPA to permit others acting on his behalf to engage in behavior that would have been a violation for the CPA
- When differences exist between AICPA and those of the licensing state board of accountancy, the CPA should follow the state board's rules

Conceptual Framework for Independence Standards

- Independence required for audit and other attestation services; in fact and in appearance
- AICPA uses risk based approach for analyzing threats using the following steps:
  - Identifying and evaluating threats to independence
  - Determining whether safeguards already eliminate or sufficiently mitigate identified threats and whether threats that have not yet been mitigated can be eliminated or sufficiently mitigated by safeguards
  - If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired

Threats to Independence

- Independence must be in fact and appearance
- Threats include:
  - Self review threat
  - Advocacy threat
  - Adverse interest threat
  - Familiarity threat
  - Undue influence threat
  - Financial self-interest threat
  - Management participation threat
- Safeguards to counteract threats:
  - Safeguards created by the profession, legislation, or regulation
  - Safeguards implemented by the attest client
  - Safeguards implemented by the firm

Threats to Independence

Exhibit 4.2 Examples of Threats to Independence	
Threat	Example
Self-Review Threat	Preparing source documents used to generate the client's financial statements.
Advocacy Threat	Promoting the client's securities as part of an initial public offering or representing a client in U.S. tax court.
Adverse Interest Threat	Commencing, or the expressed intention to commence, litigation by either the client or the CPA against the other.
Familiarity Threat	A CPA on the attest engagement team whose spouse is the client's CEO.
Undue Influence Threat	A threat to replace the CPA or CPA firm because of a disagreement with the client over the application of an accounting principle.
Financial Self-Interest Threat	Having a loan from the client, from an officer or director of the client, or from an individual who owns 10 percent or more of the client's outstanding equity securities.
Management Participation Threat	Establishing and maintaining internal controls for the client.

Safeguards

Source of the Safeguard	Examples of Safeguards
Created by the profession, legislation, or regulation	Professional resources, such as hotlines, for consultation on ethical issues.
Implemented by the client	• The client has personnel with suitable skill, knowledge, or experience who make managerial decisions about the delivery of professional services and makes use of third-party resources for consultation as needed. • The tone at the top emphasizes the client’s commitment to fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies. • Policies and procedures are in place to achieve fair financial reporting and compliance with the applicable laws, rules, regulations, and corporate governance policies. • Policies and procedures are in place to address ethical conduct. • Policies are in place that bar the entity from hiring a firm to provide services that do not serve the public interest or that would cause the firm’s independence or objectivity to be considered impaired.
Implemented by the firm	Policies and procedures addressing ethical conduct and compliance with laws and regulations.

Global Code of Ethics

- International Ethics Standards Board for Accountants (IESBA)
- Code of Ethics for Professional Accountants (IFAC Code)
- Principles
  - Integrity
  - Objectivity
  - Professional Competence and Due Care
  - Confidentiality
  - Professional Behavior

Financial Relationships that impair Independence

- Direct or material indirect financial interest in a client
- Loans to or from a client
  - Example: Alexander Grant and ESM: CPA accepted loans from a financial institution client.
  - Led to changes in independence rules to prohibit such loans and
  - Permitted Loans
    - Automobiles loans collateralized by the car
    - Loans fully collateralized by cash deposits at the same financial institution (passbook loans)
    - Credit cards and overdraft accounts of $10,000 or less

Other Relationships

- Family Relationships
  - Immediate family members
    - Spouse or spouse equivalent, or dependents
  - Close relatives in financial sensitive position with the client or material financial interest
    - Parent, sibling, or nondependent child
  - Subject to independence rule if CPA knows member has material financial interest
- Business Relationships
  - Partner or manager who provides more than 10 hours of nonattest services to the attest client
  - Partnerships or joint ventures with attest client

Employment or Association with Attest Clients

- Independence may be impaired when a partner or professional employee leaves the firm and is subsequently employed by the client in a key position unless following met:
  - Amounts due to the former professional are not material to the firm
  - The former professional is not in a position to influence the accounting firm's operations or financial policies
  - The former professional employee does not participate in or appear to participate in or is not associated with the firm once the relationship with the client begins
- Participating in the firm may be continuing to consult for it or have one's name included in firm literature

Providing Nonattest Services to an Attest Client

- Certain lucrative nonattest services create a conflict of interests
- A CPA should not perform management functions or make management decisions for an attest client
- Client must agree to perform the following functions:
  - Assume all management responsibilities
  - Designate competent overseer of these services
  - Evaluate adequacy and results of services performed
  - Accept responsibility for the results of the services

Nontraditional Forms of Ownership

- A traditional CPA firm may be acquired by a public company that will provide nonattest services to clients while, at the same time, a spin-off of the original firm provides the attest services.
- Only firms that are majority owned by CPAs can perform attest services.
- Concerns whether managers of the public companies (or alternative practice structures) may attempt to exert pressure over those in the CPA firm and cause ethical problems.
- The appearance may be that the audit work could be tainted by the relationship.

SEC Position on Independence

- Emphasizes independence in fact and appearance in 3 ways:
  - Proscribing certain financial interests and business relationships with the audit client
  - Restricting certain nonauditing services to audit clients
  - Subjecting all auditor conduct to a general standard of independence
- Three principles that underlie auditor independence:
  - An auditor cannot function in the role of management
  - An auditor cannot audit her own work
  - An auditor cannot serve in an advocacy role for her client

General Standard of Independence

- Judged by a reasonable investor with knowledge of all relevant facts and circumstances
- Auditor must be capable of exercising objective and impartial judgment on all issues within the engagement
- Principles
  - Situations which impair independence
  - Creates a mutual or conflicting interest between an accountant and his audit client
  - Places an accountant in the position of auditing his own work
  - Results in an accountant acting as management or employee of the audit client
  - Places an accountant in position of being an advocate for the audit client

SEC Independence Actions Against Big 4

- Deloitte
  - Violated independence rules when its consulting affiliate kept a business relationship with a trustee serving on boards/audit committees of three funds Deloitte audited
- EY
  - PeopleSoft – joint sales, marketing, license fees and royalty with client (mutuality of interests)
- KPMG
  - Violated independence rules by providing certain nonaudit services to affiliates of companies whose books KPMG was auditing
- PwC
  - Avon hired PwC for IT system; terminated project; did not write down full cost of project, approved by PwC
  - Pinnacle – PwC approved improper treatment of $8.5M as capital expenses and reserves
- Cases raise red flags about consulting services and impairment of audit independence

Insider Trading Cases

- Deloitte
  - Thomas P. Flanagan, former management advisory partner and vice chair
  - Traded in the securities of multiple clients (including Best Buy, Motorola, Sears, and Option Care) from information learned in his partner duties
  - Tipped his son, Patrick so he could also trade on that information
- KPMG
  - Scott London, former partner of the KPMG's Southern California's regional audit practice
  - Leaked confidential information to Brian Shaw, about Skechers and Herbalife
  - Shaw repaid London with $50,000 in cash and a Rolex watch
  - Audit opinions signed by London on Skechers and Herbalife had to be withdrawn
- Cases show the risk to audit independence when audit engagement team members trade on information that is not publicly available

AICPA Code: Ethical Conflicts

- Assess whether an ethical conflict exists
- Ethical conflicts create challenges to ethical decision making because they present barriers to meeting the requirements of the rules of conduct
- Consider whether any departures exist to the rules, laws, or regulations and how they will be justified in order to ensure that conflicts are resolved in a way that permits compliance with these requirement
- Any unresolved conflicts can lead to a violation of the rules of conduct which should focus the CPA’s attention on any continuing relationship with the engagement team, specific assignment, client, firm, or employer

Integrity and Objectivity

- Conflicts of interest for public practice occur when a professional service, relationship, or specific matter creates a situation that might impair objective judgment
- A conflict of interest creates adverse and self-adverse threats to integrity and objectivity
- Safeguards include
  - Implementing mechanisms to prevent disclosure or violation of confidentiality
  - Senior individual not involved in the engagement regularly reviewing safeguards
  - Member of the firm not involved in the conflict review the work performed to assess whether key judgments and conclusions are appropriate, and
  - Consulting with third parties, such as professional body, legal counsel, or another CPA
- The CPA should disclose the nature of the conflict to clients and obtain their consent to perform professional services
- If consent is not received, then the CPA should either cease performing the services or take action to eliminate or reduce the threat to an acceptable level

Subordination of Judgment

- Integrity rule prohibits a CPA from knowingly misrepresenting facts or subordinating one's judgments when performing professional services for a client or employer
  - Addresses differences of opinion between a CPA accountant/auditor and that person's supervisor or others in the organization including top management on material accounting issues
- CPA should consider any threats to integrity and objectivity, and assess their significance whenever there is a material misrepresentation of fact
- CPA should assess if threats are at an acceptable level; if not, evaluate significance of safeguards to prevent impairment to independence/objectivity
- Follow prescribed process to protect against subordination of judgment (see Exhibit 3.13)

AICPA Code: Conceptual Framework for Members in Business

- The conceptual framework for members in business applies to integrity and objectivity, as well as other rules of conduct, but not independence
- Threats
  - Adverse interest threat
  - Advocacy threat
  - Familiarity threat
  - Self-interest threat
  - Self-review threat
  - Undue influence threat

Safeguards to Mitigate Risk

- Safeguards include
  - Tone at the top
  - Policies, procedures, implementation, and monitoring addressing ethical conduct and compliance with laws and regulations
  - Internal policies and procedures for disclosure of interests and relationships
  - Whistle-blower hotlines
  - Internal auditors not allowed to audit areas where they have operational responsibilities
  - Policies for promotion, rewards and enforcement of a culture of high ethics and integrity
  - Use of third-party resources for consultation as needed.

SOX: Nonaudit Services

- Financial information systems design and implementation
- Appraisal or valuation services, fairness opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions or human resources
- Broker or dealer services, investment adviser, or investment banking services
- Legal services and expert services unrelated to the audit
- Any other service prohibited by BOD
- Tax services must be preapproved by the audit committee

Rules of Professional Practice

- The General Standards rule establishes requirements for competence, compliance with professional standards, and adherence to accounting principles
- Acts Discreditable covers a broad number of actions that may bring discredit to the profession including
  - Discrimination and harassment
  - Solicitation or disclosure of CPA examination questions and answers
  - Failure of a CPA/CPA firm to file and pay taxes
  - Negligence in preparation of financial statements or records
  - Standards relating to governmental accounting and auditing
- Confidentiality of information gained through employment, except in specified situations
- Records Request governing what is client-provided records, member-prepared records, member’s work products, and member’s working papers

Contingent Fees, Commissions, and Referral Fees

- Contingent fees and commissions are permitted when performing advisory-type services for a nonattest client
- Contingent fees are prohibited from an attest (audit) client
  - Prohibits acceptance of contingent fees if CPA or firm performs any of the following:
    1. an audit or review of a financial statement
    2. compilation of financial statement that third party may use
    3. examination of prospective financial information
    4. prepares original/amended tax return
  - Permits acceptance of contingent fee based upon initiation by and findings of governmental agencies (i.e., IRS-initiated investigation of income taxes paid)
- Commissions and Referral Fees
  - Rule is similar to that for contingent fees; cannot accept commissions or referral fees from audit client
  - Commissions and referral fees require disclosures by CPAs when recommending or referring a service or product to which the commission relates

Advertising and Solicitation

- Advertising and solicitation permitted
  - Requires that advertising not be false, deceptive or misleading
  - Imply ability to influence official bodies
  - Contain a representation that specific services will be performed for a stated fee, when such fees would be substantially increased
  - Prohibits solicitation by use of coercion, over-reaching, or harassing conduct
  - Contain any representation that would be likely to cause a reasonable person to misunderstand or be deceived

Confidentiality

- Confidential information
  - CPA should not disclose confidential client information without specific consent of the client
  - Internal whistle blowing allowed; external may violate confidentiality; consult legal counsel
  - Permitted disclosure of confidential client information
    - Response to validly issued subpoena or summons
    - Adherence to applicable laws and regulations (i.e., Dodd-Frank whistle-blowing provisions)
    - Compliance with peer review of CPA practice under PCAOB, AICPA, state CPA society, or board of accountancy authorization
    - Defense in an investigation of the CPA

Ethics and Tax Services

- Tax services include tax compliance, where much of the service is derived from audited financial records, tax consulting, tax planning, and tax shelters
- AICPA explicitly recognizes the tax professional’s dual obligations to the client to act as advocate and to foster integrity in the tax system by honesty and fairly administering the tax laws
- The tax accountant remains obligated to act objectively, with integrity, exercise due care, and follow the Statements on Standards for Tax Services (SSTS)
- The CPA must place the public interest ahead of client and self-interests
- When auditing tax client’s financial statements: The tax CPA is expected to consider whether any threats to independence exist that cannot be reduced or eliminated by safeguards and how such matters will be handled to avoid a violation of audit independence

SSTS

- 7 statements explain CPAs' responsibilities to their clients and the tax systems
- SSTS No.1, Tax Return Positions
  - A tax return position is a position reflected on a tax return on which a CPA has specifically advised a taxpayer, or a position about which a CPA has knowledge of all material facts and, based on those facts, has concluded whether the position is appropriate
  - A taxpayer is a client, a CPA's employer, or any other third-party recipient of tax services
  - CPA's obligation to advise a taxpayer of relevant tax return disclosure responsibilities and potential penalties
  - CPA should not recommend a tax return position or sign a tax return unless she has a good-faith belief that the position has at least a "realistic possibility of success"
  - CPA cannot recommend a tax return position that he knows exploits the audit selection process of a taxing authority
- SSTS Interpretation No. 1-1 - Realistic Possibility Standard
  - Includes establishing the relevant facts, consider the reasonableness of the assumptions and representations, apply the pertinent authorities to the facts, consider the business purpose and economic substance of the transaction, and arrive at a conclusion supported by the authorities

Tax Shelters

- Sometimes called tax avoidance transactions
- “Prohibited tax shelter transaction" means listed transactions, transactions with contractual protection, or confidential transactions
- Investments to help wealthy clients avoid paying taxes
- In KPMG case, the firm prepared false documents to deceive regulators (fraud)
  - KPMG shelters broke the law: no economic risk and designed solely to minimize taxes
  - KPMG shelters generated $11 billion in fraudulent losses and $2.5 billion in tax evaded
  - KPMG settled criminal tax case for $456 million
- More recent tax shelter scandal: BDO failed to register various tax shelters as required by law

PCAOB Rules

- Variety of standards that pertain to ethics and independence:
  - Rule 3520: Auditor Independence
  - Rule 3521: Contingent Fees; mirrors rules of AICPA code
  - Rule 3522: Tax Transactions; "aggressive tax position" transaction
  - Rule 3523: Tax Services for Persons in Financial Reporting Oversight Roles; not independent if firm provides tax services to persons who serve in financial reporting oversight roles at an audit client unless:
    - Person only serves as member of BOD
    - If member serves in an affiliate of audit company and has non material financial statements
    - Person was not in role when audit began
  - Rule 3524: Audit Committee Pre-Approval of Certain Tax Services
  - Rule 3525: Audit Committee Pre-Approval of Nonaudit Services Related to Internal Control Over Financial Reporting
  - Rule 3526: Communication With Audit Committees Concerning Independence

Concluding Thoughts

- Technical skills are important in accounting but so are ethical reasoning abilities
- Virtue-based decision making is an important component because it depends on “practical wisdom,” or the ability to see the right thing to do in circumstances
- The process in the Code is a conceptual framework to assess whether independence, integrity and objectivity may be compromised as a result of threats that exist
- Safeguards can be put into place to reduce or eliminate such threats, although nothing can substitute for ethical intent and ethical action
- The accounting profession is in danger of losing sight of its mandate to protect the public interest because of increased commercial tendencies

Video Links

- Insider Trading: Scott London
  - https://www.youtube.com/watch?v=4qUo4nexfQM
- Insider Trading: Scott London
  - https://www.youtube.com/watch?v=eUz4rl-k_LE

- Case 4-7: HealthSouth
- Aaron Beam: HealthSouth
  - https://www.youtube.com/watch?v=FeGZmtXZtVA