**Chapter 4 Auditing Theory**

Multiple-Choice Questions

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| 1. | Society has attached a special meaning to the term “professional.” A professional is: |
| easy | a. someone who has passed a qualifying exam to enter the job market. |
| b | b. a person who is expected to conduct himself or herself at a higher level than the requirements of society’s laws or regulations. |
|  | c. any person who receives pay for the services performed. |
|  | d. someone who has both an education in the trade and on-the-job experience received under an experienced supervisor. |
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| 2. | The underlying reason for a code of professional conduct for any profession is: |
| easy | a. the need for public confidence in the quality of service of the profession. |
| a | b. that it provides a safeguard to keep unscrupulous people out. |
|  | c. that it is required by federal legislation. |
|  | d. that it allows licensing agencies to have a yardstick to measure deficient behavior. |
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| 3. | A challenge associated with the Ethical Principles stated in the *Code of Professional Conduct* is: |
| easy | a. the emphasis on positive activities. |
| c | b. that they identify ideal conduct. |
|  | c. the difficulty of enforcing principles, or general ideals. |
|  | d. that there are too many to remember. |
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| 4. | For which of the following professional services must CPAs be independent? |
| easy | a. Management advisory services. |
| b | b. Audits of financial statements. |
|  | c. Preparation of tax returns. |
|  | d. All three of the above. |
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| 5. | “Independence” in auditing means: |
| easy | a. maintaining an indirect financial interest. |
| c | b. not being financially dependent on a client. |
|  | c. taking an unbiased and objective viewpoint. |
|  | d. being an advocate for a client. |
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| 6. | When CPAs are able to maintain their actual independence, it is referred to as independence in: |
| easy | a. conduct. |
| c | b. appearance. |
|  | c. fact. |
|  | d. total. |
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| 7. | Which of the following statements is true? The CPA firm will lose its independence if: |
| medium | a. a staff auditor providing audit services to the client acquires stock in that client. |
| a | b. a staff tax preparer who provides 15 hours of non-audit services to the client acquires stock in that client. |
|  | c. an audit manager in an office different than the office providing audit services has a direct, immaterial financial interest in the audit client. |
|  | d. a covered member has an indirect, immaterial financial interest in an audit client. |
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| 8.easy | Interpretations of Rule 101 prohibit covered members from owning any stock or other direct investment in audit clients. Covered members include all but which of the following? |
| a | a. All partners in an office that has no responsibility for the engagement. |
|  | b. The firm and its employee benefit plans. |
|  | c. Individuals on the attest engagement. |
|  | d. All of the above describe covered members. |
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| 9.easyc | In some situations, the interpretations of the Rules of Conduct permit former partners to have relationships with a client of the firm without affecting the firm’s independence. Which of the following situations would not cause a loss of independence? |
|  | a. The former partner invests in a current client of the firm and receives retirement benefits from the CPA firm, which are dependent upon the firm’s financial performance. |
|  | b. The former partner uses the CPA firm’s office space and has significant influence over a client. |
|  | c. The former partner severs relations with the firm and accepts employment with the firm’s client after having been retired for 18 months. |
|  | d. The former partner is held out as an associate of the firm and takes part in the firm’s business activities. |
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| 10.easy | The financial interests of which of the following parties would not be included as a “direct financial interest” of the CPA? |
| d | a. Spouse. |
|  | b. Dependent child. |
|  | c. Relative supported by the CPA. |
|  | d. Sibling living in the same city as the CPA. |
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| 11. | Interpretations of the rules regarding independence allow an auditor to serve as: |
| easy | a. a director or officer of an audit client. |
| d | b. an underwriter for the sale of a client’s securities. |
|  | c. a trustee of a client’s pension fund. |
|  | d. an honorary director for a not-for-profit charitable or religious organization. |
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| 12.easyb | When the question arises whether a CPA firm may do both bookkeeping and auditing services for the same public company client, the Interpretations of the AICPA’s Code of Professional Conduct: |
|  | a. encourage it. |
|  | b. prohibit it. |
|  | c. allow it. |
|  | d. allow each firm to determine the answer on a case-by-case basis. |
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| 13. | The CPA must not subordinate his or her professional judgment to that of others in any: |
| easy | a. engagement. |
| a | b. audit engagement. |
|  | c. engagement excluding tax services. |
|  | d. engagement excluding management advisory services. |
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| 14. | Which of the following would be a violation of the rule requiring “objectivity” by the CPA? |
| easyc | a. The auditor accepts management’s opinion regarding the collection of accounts receivable without an independent evaluation. |
|  | b. In preparing a client’s tax return, the CPA encourages a client to take a deduction which the CPA believes is risky, but unlikely to be found during an IRS audit. |
|  | c. Either a or b would be a violation of the rule. |
|  | d. Neither a nor b would be a violation of the rule. |
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| 15.easyd | Several months after an unqualified audit report was issued, the auditor discovers the financial statements were materially misstated. The client’s CEO agrees that there are misstatements, but refuses to correct them. She claims that “confidentiality” prevents the CPA from informing anyone. |
|  | a. The CEO is correct and the auditor must maintain confidentiality. |
|  | b. The CEO is incorrect, but because the audit report has been issued it is too late. |
|  | c. The CEO is correct, but to be ethically correct the auditor should violate the confidentiality rule and disclose the error. |
|  | d. The CEO is incorrect, and the auditor has an obligation to issue a revised audit report, even if the CEO will not correct the financial statements. |
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| 16.medium | A member in public practice may perform for a contingent fee any professional services for a client for whom the member or member’s firm performs: |
| b | a. an audit. |
|  | b. consulting services. |
|  | c. preparation of an original tax return. |
|  | d. preparation of an amended tax return. |
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| 17. | Which of the following activities is allowed for a CPA firm’s attestation clients? |
| easy | a. Contingent fees based on savings due to implementation of an information system. |
| a | b. Commissions for referring a review client to an insurance agency for insurance coverage. |
|  | c. Preparation of tax returns for which fees are based upon client refunds. |
|  | d. Each of the above is allowed. |
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| 18.Mediumb | A member in public practice shall neither receive from, nor pay to, a client a commission when the member or member’s firm also performs certain services for that client. Are commissions allowed if the CPA performs: |
|  |  | A compilation that will be used by a third party |  | An audit of prospective financial information |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 19.easy | If the board of accountancy in the state in which a CPA firm is licensed has rules that are different than the AICPA’s rules, the CPA firm must follow: |
| b | a. whichever rules are less restrictive. |
|  | b. whichever rules are more restrictive. |
|  | c. the rules of the AICPA. |
|  | d. the rules of the state’s board of accountancy. |
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| 20.easy | Elise, CPA, owns a public accounting firm and wishes to establish a separate partnership to offer data processing services to the public and other public accountants. |
| b | a. Elise cannot be a partner in any separate partnership that offers data processing services. |
|  | b. Elise may form a separate partnership. |
|  | c. Elise may form a separate partnership as long as partners are CPAs. |
|  | d. Elise may form a separate partnership, but must give up the public accounting practice. |
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| 21. (SOX)medium | The Sarbanes-Oxley Act requires which employees of an accounting firm to rotate off the engagement every five years? |
| d |  |  |  |  |
|  |  | In-Charge Auditor |  | Partner responsible for concurring review |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 22.medium | The AICPA’s Code of Professional Conduct states that a CPA should maintain integrity and objectivity. The term “objectivity” in the Code refers to a CPA’s ability to: |
| d | a. choose independently between alternate accounting principles and auditing standards. |
|  | b. distinguish between accounting practices that are acceptable and those that are not. |
|  | c. be unyielding in all matters dealing with auditing procedures. |
|  | d. maintain an impartial attitude on matters that come under the CPA’s review. |
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| 23.medium | Which of the following is required for a firm to designate itself “Member of the American Institute of Certified Public Accountants” on its letterhead? |
| b | a. At least one of the partners must be a member of the AICPA. |
|  | b. All partners must be members of the AICPA. |
|  | c. The partners whose names appear in the firm name must be members of the AICPA. |
|  | d. A majority of the partners must be members of the AICPA. |
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| 24. | CPAs are prohibited from which of the following forms of advertising? |
| medium | a. Self-laudatory advertising. |
| d | b. Celebrity endorsement advertising. |
|  | c. Use of trade names, such as “Awesome Auditors.” |
|  | d. Use of phrases, such as “Guaranteed largest tax refunds in town!” |
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| 25.mediumd | Anna Greer, a CPA in public practice, contacts Blake Sawyers, an employee of Jackson & Jackson, LLP, and makes him an offer of employment without first notifying Jackson & Jackson, LLP. According to the AICPA’s Code of Professional Conduct, Anna’s behavior: |
|  | a. is a violation of the Code of Professional Conduct. |
|  | b. is a violation only if Greer and Sawyers are CPAs. |
|  | c. is a violation only if Jackson & Jackson LLP is a CPA firm. |
|  | d. is not a violation. |
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| 26.mediumb | CPAs may provide bookkeeping services to their non-public audit clients, but there are a number of conditions that must be met if the auditor is to maintain independence. Which of the following conditions is not necessary? |
|  | a. The CPA must not assume a management role or function. |
|  | b. The client must hire an external CPA to approve all of the journal entries prepared by the auditor. |
|  | c. The auditor must comply with GAAS when auditing work prepared by his/her firm. |
|  | d. The client must accept responsibility for the financial statements. |
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| 27. | Which of the following statements is not true with respect to audit committees? |
| medium | a. Individuals not on a firm’s board of directors should comprise the audit committee. |
| d | b. The audit committee generally helps in resolving conflicts between the auditors and company management. |
|  | c. All companies listed on the NYSE are required to have an audit committee. |
|  | d. Audit committees are required for all companies. |
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| 28. | To emphasize auditor independence from management, many corporations: |
| medium | a. appoint a partner of the firm conducting the audit to the corporation’s audit committee. |
| c | b. establish a policy of discouraging social contact between employees of the corporation and the staff of the independent auditor. |
|  | c. have the independent auditor report to an audit committee of outside members of the board of directors. |
|  | d. request that a representative of the independent auditor be on hand at the annual stockholders’ meeting. |
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| 29.medium | Which of the following statements is true when the CPA has been engaged to perform an audit of financial statements? |
| b | a. The CPA firm is engaged and paid by the client; therefore, the firm has primary responsibility to be an advocate for the client. |
|  | b. The CPA firm is engaged and paid by the client, but the primary beneficiaries of the audit are those who rely on the financial statements. |
|  | c. Should a situation arise where there is no convincing authoritative standard available, and there is a choice of actions which could impact a client’s financial statements, the CPA is free to endorse the choice which is in the investors’ interests. |
|  | d. The CPA firm has primary responsibility to the FASB. |
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| 30.medium | Which of the following is not one of the four parts of the AICPA’s Code of Professional Conduct? |
| d | a. Principles. |
|  | b. Rules of Conduct. |
|  | c. Interpretations. |
|  | d. Definitions. |
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| 31.medium | One of the AICPA’s Ethical Principles deals with the public interest. It states that members should accept the obligation to act in a way that will: |
| c |  |  |  |  |
|  |  | Honor the public trust |  | Serve the client’s interest |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 32. | According to the Principles section of the Code of Professional Conduct, all members: |
| medium | a. should be independent in fact and in appearance at all times. |
| c | b. in public practice should be independent in fact and in appearance at all times. |
|  | c. in public practice should be independent in fact and in appearance when providing auditing and other attestations services. |
|  | d. in public practice should be independent in fact and in appearance when providing auditing, tax, and MAS services. |
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| 33. | Of the various parts of the AICPA’s Code of Professional Conduct, the: |
| medium | a. Principles are enforceable. |
| d | b. Ethical Rulings are enforceable. |
|  | c. Interpretations are enforceable. |
|  | d. Rules of Conduct are enforceable. |
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| 34.medium | Which of the following statements best describes the enforceability of the Interpretations of the Rules of Conduct? |
| d | a. The Interpretations are not enforceable. |
|  | b. The Interpretations are enforceable. |
|  | c. The Interpretations may be enforceable if they have been reviewed and approved by the AICPA’s Division of Professional Ethics. |
|  | d. The Interpretations are not enforceable, but a practitioner must justify departure from them. |
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| 35. | Of the four parts of the AICPA’s Code of Professional Conduct, which part is enforceable? |
| medium | a. Ethical Rulings. |
| b | b. Rules of Conduct. |
|  | c. Principles. |
|  | d. Interpretations. |
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| 36. | Ethical Rulings are: |
| medium | a. issued by the AICPA’s Board of Governors. |
| b | b. explanations relating to specific factual circumstances. |
|  | c. explanations relating to broad hypothetical circumstances. |
|  | d. enforceable. |
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| 37. | The AICPA’s Code of Professional Conduct requires independence for all: |
| medium | a. attestation engagements. |
| a | b. services performed by accountants in public practice. |
|  | c. accounting and auditing services performed. |
|  | d. professional work performed by CPAs. |
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| 38.medium | Rules of Conduct contained in the Code of Professional Conduct apply to all AICPA members for all services provided, whether or not the member is in the practice of public accounting: |
| d | a. in all circumstances. |
|  | b. for non-attestation services. |
|  | c. except for the single exception of a tax practice. |
|  | d. unless it is specifically stated otherwise in the Code. |
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| 39.medium | A member firm of the AICPA is not only responsible for its compliance with the Rules of Conduct, but it is also responsible for compliance by its: |
| a |  |  |  |
|  | Employees |  | Shareholders |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 40.medium | An example of an “indirect ownership interest in a client” would be ownership of a client’s stock by a member’s: |
| c | a. dependent child. |
|  | b. spouse. |
|  | c. non-dependent grandfather. |
|  | d. All of the above are examples of indirect ownership. |
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| 41.medium | When determining whether independence is impaired because of an ownership interest in a client company, materiality will affect whether ownership is a violation of Rule 101: |
| c | a. in all circumstances. |
|  | b. only for direct ownership. |
|  | c. only for indirect ownership. |
|  | d. under no circumstances. |
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| 42.medium | Interpretations of Rule 101 regarding a “direct financial interest” have presumed that a violation exists in which of the following circumstances, unless other circumstances offset such a presumption? |
| a | a. When close relatives such as nondependent children, brothers, and sisters have a significant financial interest in the client. |
|  | b. When close relatives such as nondependent children, brothers, and sisters have any financial interest in the client. |
|  | c. When the CPA owns shares in a mutual fund that has an ownership interest in the client. |
|  | d. When close relatives such as brother, sister, or in-laws are employed by client. |
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| 43. | Which of the following circumstances would ordinarily not impair the auditor’s independence? |
| challenging | a. Litigation by a client against an audit firm related to tax services. |
| a | b. Litigation by a client against an audit firm claiming a deficiency in the previous audit. |
|  | c. Litigation by an audit firm against a client claiming management fraud or deceit. |
|  | d. Client’s intent to start a lawsuit at some future date, after the current audit is completed, claiming a deficiency in the previous audit. |
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| 44.medium | Interpretations to the Rules of Conduct permit a CPA firm to do both bookkeeping and auditing for the same client if three criteria are met. Which of the following is not one of those criteria? |
| b | a. The client must accept full responsibility for the financial statements. |
|  | b. The client is required to file an annual report, including audited financial statements, with the Securities and Exchange Commission. |
|  | c. The CPA must not assume the role of employee or of manager. |
|  | d. The CPA must follow applicable auditing standards. |
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| 45.medium | Which of the following services is not prohibited by the SEC whenever a CPA also audits the company? |
| d | a. Internal audit outsourcing. |
|  | b. Legal services unrelated to the audit. |
|  | c. Appraisal or valuation services. |
|  | d. Services related to assessing the effectiveness of internal control over financial reporting. |
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| 46.medium | Which of the following services is not prohibited by the SEC whenever a CPA also audits the company? |
| b | a. Actuarial services. |
|  | b. Assisting the company in preparing certain SEC registration statements (e.g., 10-Q, 10-K). |
|  | c. Investment banker services. |
|  | d. Bookkeeping services. |
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| 47. | The members of a client’s “audit committee” should be: |
| medium | a. members of management. |
| b | b. directors who are not a part of company management. |
|  | c. non-directors and non-managers. |
|  | d. directors and managers. |
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| 48.medium | An increasing number of companies require stockholders to approve the selection of a new CPA firm or the continuation of the existing CPA firm because: |
| a | a. stockholders are presumably more objective than management. |
|  | b. the SEC requires it. |
|  | c. the AICPA requires it. |
|  | d. the stockholders are in a better position to evaluate the performance of previous or potential auditors. |
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| 49.mediumd | Rule 301 of the AICPA’s Code of Professional Conduct requires CPAs to maintain the confidentiality of client information. This rule would be violated if a CPA disclosed information without a client’s consent as a result of a: |
|  | a. subpoena or summons. |
|  | b. peer review. |
|  | c. complaint filed with the trial board of the Institute. |
|  | d. request by a client’s largest stockholder. |
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| 50. | Which one of the following statements is false? |
| mediuma | a. The auditor’s responsibility to follow PCAOB standards is greater than the responsibility for confidentiality. |
|  | b. Information that a CPA obtains from a client is generally not privileged. |
|  | c. When a CPA firm conducts an AICPA-authorized peer review of the quality controls of another CPA firm, permission of the client is not needed to examine audit documentation. |
|  | d. A CPA firm which observes substandard audit documentation of another firm can initiate a complaint of substandard performance with the AICPA Ethics Division trial board notwithstanding the confidentiality rule. |
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| 51. | A CPA is allowed to accept a referral fee for recommending a client to another CPA if: |
| medium | The client pre-approves the transaction |  | Payment of the referral fee is disclosed to the client |
| d | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 52. | Rule 505 of the AICPA’s Code of Professional Conduct permits CPA firms to organize as: |
| medium | a. proprietorships or partnerships only. |
| c | b. proprietorships, partnerships, or professional corporations. |
|  | c. proprietorships, general partnerships, general corporations, professional corporations, limited liability companies, and limited liability partnerships if permitted by state law. |
|  | d. single proprietorships, partnerships, professional corporations if permitted by state law, or regular corporations. |
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| 53.medium | According to the profession’s ethical standards, an auditor would be considered independent in which of the following instances? |
| a | a. The auditor’s checking account, which is fully insured by a federal agency, is held at a client financial institution. |
|  | b. The auditor is also an attorney who advises the client as its general counsel. |
|  | c. An employee of the auditor serves as treasurer of a charitable organization that is a client. |
|  | d. The client owes the auditor fees for two consecutive annual audits. |
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| 54.medium | If a nonpublic company asks an accountant to perform a review engagement, and the accountant has an immaterial direct financial interest in the company, the accountant is: |
| b | a. independent because the financial interest is immaterial and, therefore, may issue a review report. |
|  | b. not independent and, therefore, may not issue a review report. |
|  | c. not independent and, therefore, may not be associated with the financial statements. |
|  | d. not independent and, therefore, may issue a review report, but may not issue an auditor’s opinion. |
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| 55. (SOX)medium | The Sarbanes-Oxley Act requires a cooling off period of how long before a member of an audit team can work for a client in a key management position? |
| b | a. Eighteen months. |
|  | b. Twelve months. |
|  | c. Thirty-six months. |
|  | d. It is not specified; instead it is left to the auditor’s discretion. |
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| 56.medium | In determining independence with respect to any audit engagement, the ultimate decision as to whether or not the auditor is independent must be made by the: |
| a | a. auditor. |
|  | b. client. |
|  | c. audit committee. |
|  | d. public. |
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| 57. | A CPA firm should decline an offer to perform management advisory services engagement if: |
| medium | a. the proposed engagement is not accounting-related. |
| c | b. recommendations made by the CPA firm are to be subject to review by the client. |
|  | c. acceptance would require the CPA firm to make management decisions for an audit client. |
|  | d. any of the above is true. |
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| 58.medium | In which of the following circumstances would a CPA be bound by ethics to refrain from disclosing any confidential information about a client? |
| b | a. The CPA is issued a summons enforceable by a court order which orders the CPA to present confidential information. |
|  | b. A major stockholder of a client company seeks accounting information from the CPA after management declined to disclose the requested information. |
|  | c. Confidential client information is made available as part of a quality review of the CPA’s practice by a peer review team authorized by the AICPA. |
|  | d. An inquiry by a disciplinary body of a state CPA society requests confidential client information. |
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| 59.challengingb | Companies are required to disclose in their proxy statement or annual filings with the SEC the total amount of audit and non-audit fees paid to the audit firm for the two most recent years. Which of the following is **not** one of the categories of fees that must be disclosed?a. “Tax fees”b. “Consulting fees”c. “Audit-related fees”d. “All other fees” |
| 60.challenginga | Four of the six Ethical Principles in the AICPA’s *Code of Professional Conduct* are equally applicable to all members of the AICPA. Which of the following principles applies only to members in public practice? |
|  | a. Scope and Nature of Services. |
|  | b. Integrity. |
|  | c. Due Care. |
|  | d. The Public Interest. |
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| 61. | Interpretations of the *AICPA Code of Professional Conduct* are dominated by the concept of: |
| challenging | a. independence. |
| a | b. compliance with standards. |
|  | c. accounting. |
|  | d. acts discreditable to the profession. |
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| 62.challenging | An audit committee, consisting of members of the client’s board of directors who are not a part of company management, is required for all companies: |
| c | a. that have audits performed by AICPA member firms. |
|  | b. that must file 10-K reports with the SEC. |
|  | c. listed on the New York Stock Exchange. |
|  | d. in all circumstances. |
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| 63.challenging | The Code of Professional Conduct is established by the membership of the AICPA, and the Interpretations of the Rules of Conduct are prepared by the: |
| d | a. Financial Accounting Standards Board. |
|  | b. Securities and Exchange Commission. |
|  | c. CPA licensing agencies within each state. |
|  | d. Professional Ethics Executive Committee of the AICPA. |
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| 64.challenging | Generally, loans between a CPA firm or its members and an audit client are prohibited because they create a financial relationship. Which of the following is not an exception to this rule? |
| d | a. Automobile loans. |
|  | b. Loans fully collateralized by cash deposits at the same financial institution. |
|  | c. Home mortgages. |
|  | d. Unpaid credit card balances not exceeding $15,000. |
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| 65.challengingc | Generally, loans between a CPA firm or its members and an audit client are prohibited because it is a financial relationship. Which of the following, made under normal lending procedures, is not an exception to this rule? |
|  | a. Immaterial loans. |
|  | b. Home mortgages. |
|  | c. Material loans. |
|  | d. Secured loans. |
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| 66. | Rule 101 indicates that materiality is a consideration for: |
| Mediumd | Evaluating direct investments made by the CPA |  | Evaluating indirect ownership investments |
|  | a. | Yes |  | Yes |
|  | b. | No |  | No |
|  | c. | Yes |  | No |
|  | d. | No |  | Yes |
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| 67. | It is not a violation of the AICPA’s Code of Professional Conduct for a CPA to: |
| challenginga | a. charge fees as an expert witness determined by the amount awarded to the plaintiff, even though the CPA also performs a compilation for client use . |
|  | b. base consulting fees on a percentage of a bond issue, even though the CPA performs a review of the client’s financial statements. |
|  | c. base fees for a tax service on the amount of the refund that the client will receive. |
|  | d. base consulting fees on a percentage of a bond issue, even though CPA performs an audit of the client’s financial statements. |
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| 68.medium | Which of the following is not defined as an act discreditable in either the Rules or the Interpretations of the AICPA’s Code of Professional Conduct? |
| d | a. The CPA firm has issued the standard unqualified audit report after auditing a governmental agency, although GAAS was not followed because the government required procedures different from GAAS. |
|  | b. The CPA firm discriminates in its hiring practices based on the age of the applicant. |
|  | c. The CPA retains the client’s books and records to enforce past-due payment of the CPA’s bill, even after the client has demanded they be returned. |
|  | d. The CPA firm’s partner-in-charge was arrested recently on his way home from the firm’s holiday party. He was a passenger in a car driven by his wife and she was charged with “driving while intoxicated.” |
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| 69.challenging | There are a number of offenses for which a CPA may be expelled from membership in the AICPA. Which of the following is not one of these offenses? |
| c | a. The willful failure to file any income tax return that the CPA, as an individual taxpayer, is required by law to file. |
|  | b. The willful filing of a fraudulent income tax return on a client’s behalf. |
|  | c. Conviction of a crime punishable by imprisonment of 6 months. |
|  | d. The willful aiding in the preparation of a false and fraudulent income tax return. |
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| 70. | Which of the following statements regarding professional and regular corporations is not true? |
| challenginga | a. Shareholders in both professional corporations and regular corporations are individually liable in litigation against the CPA firm. |
|  | b. The shareholders, officers, and employees must comply with all Code of Professional Conduct requirements. |
|  | c. Stock in a public accounting corporation must be held by only those CPAs who are qualified to practice. |
|  | d. The firm name must meet the same requirements as those for a single proprietorship and partnership. |
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| 71.challenging | In which of the following instances would the independence of the CPA most likely not be considered to be impaired? The CPA has been retained as the auditor of a: |
| c | a. charitable organization in which an employee of the CPA serves as treasurer. |
|  | b. municipality in which the CPA owns $250,000 of the $2,500,000 indebtedness of the municipality. |
|  | c. cooperative apartment house in which the CPA owns an apartment and is not part of the management. |
|  | d. company in which the CPA’s investment club owns a one-tenth interest. |
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| 72.challenging | Rule 201 - General Standards requires members to comply with certain standards and interpretations. Which of the following is not a standard specifically addressed in Rule 201? |
| a | a. Professional integrity. |
|  | b. Due professional care. |
|  | c. Planning and supervision. |
|  | d. Sufficient relevant data. |
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| 73. (SOX)challengingd | Which of the following statements is correct?a. Non-audit services that are not prohibited by Sarbanes-Oxley or the SEC rules must be approved by management of the client.b. Non-audit services that are not prohibited by Sarbanes-Oxley or the SEC rules must be approved by staff of the PCAOB.c. Non-audit services that are not prohibited by Sarbanes-Oxley or the SEC rules must be approved by staff of the PCAOB and the SEC.d. Non-audit services that are not prohibited by Sarbanes-Oxley or the SEC rules must be approved by the company’s audit committee. |

Essay Questions

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| 74.easy | Explain why there is a special need for ethical conduct in the auditing profession. |
|  | Answer: Since users (e.g., the general public) of services provided by an auditor generally cannot evaluate the quality of the auditor’s performance, it is critical to the auditing profession that the public have a high degree of confidence in the quality of the services provided by the auditor. Public confidence in the quality of professional services is enhanced when the profession encourages high standards of performance and ethical conduct by all its members. If users of auditing services were to lack confidence in the quality of those services, then the value of CPA firms’ audits would be diminished, as would the demand for audits. |
| 75.medium | Discuss the ways the accounting profession and society encourage CPAs to conduct themselves in a professional manner; i.e., the factors that influence the ethical conduct of audit practitioners. |
|  | Answer: There are many factors that encourage CPAs to conduct themselves at a high level, including:* GAAS and interpretations.
* *Code of Professional Conduct*.
* Legal liability.
* Quality control.
* Peer review.
* Continuing professional education requirements.
* CPA examination.
* SEC.
* Division of CPA firms.
* Public Company Accounting Oversight Board.
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| 76.medium | Identify and describe each of the four parts to the AICPA’s *Code of Professional Conduct*. Also discuss which parts are officially enforceable and which are not. |
|  | Answer: The four parts to the *Code* are:1. *Principles.* These establish ideal standards of ethical conduct stated in philosophical terms. They are not officially enforceable.
2. *Rules of conduct.* These are the minimum standards of ethical conduct stated as specific rules. They are officially enforceable.
3. *Interpretations.* Interpretations of rules are intended to clarify the rules of conduct. They are not officially enforceable, but a practitioner must justify any departure.
4. *Ethical rulings.* These are answers to specific questions submitted to the AICPA by practitioners. They are not enforceable, but a practitioner must justify any departure.
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| 77.medium | Briefly describe the advantages and disadvantages of stating a code of conduct using general statements of ideal conduct as opposed to specific rules that define unacceptable behavior. |
|  | Answer: Advantages Disadvantages General statements Emphasis on positive Difficult to enforce. activities encouraging a high level of performance. Specific rules Enforceability of Tendency for rules minimum behavior to be regarded as and performance maximum rather standards. than minimum standards. |
| 78.medium | What are the six Ethical Principles stated in the *Code of Professional Conduct*? Briefly discuss each principle. Are these principles enforceable? |
|  | Answer: The six Ethical Principles of the *Code of Professional Conduct* are:1. *Responsibilities*. Members should exercise sensitive professional and moral judgments.
2. *The Public Interest.* Members should demonstrate commitment to professionalism by serving the public interest and honoring the public trust.
3. *Integrity.* Members should maintain the highest sense of integrity.
4. *Objectivity and Independence.* Members should remain free of conflicts of interest and when providing attestation services be independent in fact and in appearance.
5. *Due Care*. Members should observe standards and continually strive to improve quality of services and discharge of responsibilities.
6. *Scope and Nature of Services.* Members should observe the Principles of the *Code of Professional Conduct* in determining the scope and nature of services to be provided.

The Ethical Principles are not enforceable. |
| 79.medium | Each of the following situations involves a possible violation of the rule on independence. For each situation, (1) decide whether the *Code* *of Professional Conduct* has been violated, and (2) briefly explain how the situation violates (or does not violate) the *Code of Professional Conduct*. |
|  | a. Harry Brown is a partner in the Topeka office of Hedley & Co., CPAs. Harry’s brother is employed in an audit-sensitive position by Jensen Appliances, a publicly held company in Kansas. Jensen Appliances is one of Hedley & Co.’s audit clients. Neither Harry nor personnel from the Topeka office is involved in the audit of Jensen . |
|  |  Violation? Yes No |
|  |  Explanation: |
|  | Answer: No violation. Although partners in a CPA firm are not allowed to have close relatives employed in a position of significant influence by a client, it is acceptable to have a close relative employed in an audit-sensitive position (with no significant influence), as long as the partner does not participate in the engagement. |

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|  | b. John Woods is an audit manager with Calden & Co., CPAs, a one-office CPA firm. John owns 100 shares of common stock in one of the firm’s audit clients, but he does not provide any audit or non-audit services to the company. |
|  |  Violation? Yes No |
|  |  Explanation: |
|  | Answer: No violation. John is not a covered member with respect to the audit client as he has no responsibility for the engagement and is not in a position to influence the engagement.  |
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|  | c. The accounting firm of Fine & Herman, CPAs, provides bookkeeping and tax services for Henderson Corporation, a privately held company. Fine & Herman also performs the annual audit of Henderson Corporation. |
|  |  Violation? Yes No |
|  |  Explanation: |
|  | Answer: No violation. The AICPA does not prohibit CPA firms from providing bookkeeping, tax, and audit services to the same non-public client. |
|  | d. Bob Shelton CPA, is the auditor of Cafe Ecko. A couple of weeks ago, Cafe Ecko’s management expressed an intention to commence litigation against Bob, alleging he was negligent in last year’s audit. Bob believes there is a strong possibility that management will proceed with the litigation. However, Cafe Ecko has not fired Bob as its auditor, and he is now working on the current year’s audit. |
|  |  Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation. When there is a lawsuit or intent to start a lawsuit between a CPA and an audit client’s management related to audit services, independence is impaired. |
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|  | e. Hamilton Appliance has not paid Karen Linwood, CPA, her audit fee for the past two years. Karen is starting work on the current year’s audit of Hamilton. |
|  |  Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation. Independence is impaired if fees remain unpaid for services provided more than one year prior to the date of the report. |
| 80.medium | The following situations involve a possible violation of the AICPA’s *Code of Professional Conduct*. For each situation, (1) determine the applicable rule number or name from the *Code*, (2) decide whether or not the *Code* has been violated, and (3) briefly explain how the situation violates (or does not violate) the *Code*. |

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|  | a. In 2004, Freeman and Johnson, both CPAs, decided to form a CPA practice. In 2007, Freeman and Johnson approached Bill Delaney, a physician and medical expert, and asked him to assist them with their growing medical consulting practice. Delaney agreed, but only after he was given an ownership interest in the firm. Delaney does not intend to quit his private medical practice.  |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #505-Form of Organization and Name. Non-CPA ownership of firms is allowable, however, a non-CPA owner must actively provide services to the firm’s clients as their principal occupation. |
|  | b. Brian DePalie has a successful dentistry practice in Charleston. Brian has recommended one of his patients to Katie Walton, CPA. To show gratitude for the referral, Katie has agreed to pay Brian a token gift of $50. Katie discloses the payment arrangement to her new clients. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: No violation of Rule #503-Commissions and Referral Fees. A CPA may pay a referral fee to a non-CPA as long as the payment is disclosed to the client. |
|  | c. The accounting firm of Bayer & Peng, CPAs, is negotiating a fee with a new audit client. They agree the client will pay $50,000 if Bayer & Peng issues a clean, unqualified opinion, $40,000 if a qualified opinion is issued, and only $20,000 if an adverse opinion is issued. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #302-Contingent Fees. This is a contingent fee agreement and is prohibited by Rule 302. |
|  | d. Don Smith, CPA, is a member of the engagement team that performs the audit of Shaw Corporation. Don’s five-year-old daughter, Precious, received ten shares of Shaw Corporation’s common stock for her fifth birthday. The stock was a gift from Precious’s grandmother. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #101-Independence. Don is a covered member for purposes of Rule 101. Because his daughter is a dependent, her ownership interest in Shaw is treated as a direct financial interest of her father. |
|  | e. Jennifer Harris, CPA, is a partner in the CPA firm that audits Alltech, Inc., a closely held corporation. Jennifer’s sister-in-law is the chief financial officer at Alltech, Inc. |
|  |  Rule # \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: No violation of Rule #101. According to the *Code* a close relative is defined as a parent, sibling, or nondependent child. Thus, a sister-in-law is not considered to be a close relative. |
| 81.medium | The following situations involve a possible violation of the AICPA’s *Code of Professional Conduct*. For each situation, (1) determine the applicable rule from the *Code*, (2) decide whether or not the *Code* has been violated, and (3) briefly explain how the situation violates (or does not violate) the *Code*. |
|  | a. Howard Cunningham & Co., CPAs, designates its firm as “Members of the American Institute of Certified Public Accountants.” All of the partners of the firm are CPAs. However, one of the partners has recently chosen to allow her membership to lapse because of personal reasons. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #505-Form of Organization and Name. A firm may not designate itself as “Members of the American Institute of Certified Public Accountants” unless *all* of its owners are members of the Institute. |
|  | b. Brad Long, CPA, was traveling from Orlando to Miami, Florida when he was pulled over by a police officer on suspicion of driving under the influence. He was convicted in court of driving while under the influence of alcohol. Because of past convictions, Brad was sentenced to 5 years in prison. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #501-Acts Discreditable. Felonies are considered acts discreditable. |
|  | c. Kelley Brent, CPA, is a partner in a one-office CPA firm that audits Dane, Inc., a closely held corporation. Kelley’s sister was recently appointed as the chief financial officer for Dane, Inc. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #101-Independence. According to the *Code*, Kelly’s sister is a “close relative” and she occupies a key position at an audit client. Because Kelly is a partner in the office that provides the audit services to Dane, the firm is not independent. |
|  | d. Sarah Matrin, CPA, is a senior auditor in the San Francisco office of Cooper & Howell, CPAs. Sarah’s father is employed as the controller of Line Electronics, a public company in Detroit, Michigan. Line Electronics is one of the firm’s audit clients. Neither Sarah nor the San Francisco office is involved in the audit of Line Electronics. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |

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|  | Answer: No violation of Rule #101-Independence. While Sarah’s father occupies a key position with an audit client of the firm, there is no independence violation as long as Sarah is not a member of the engagement team. The firm may provide the audit services. |

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|  | e. On August 20, 2006, Hank Anderson, CPA and partner, was offered and accepted the engagement to audit the annual financial statements of Jernigan Corporation for the year ended December 31, 2006. Preliminary work began on the audit on September 15, 2006 and the engagement ended on March 7, 2007. Jernigan is regulated by the SEC. Hank served as controller of Jernigan Corporation from December 1, 2002, until April 10, 2006, at which time he terminated his employment with Jernigan. |
|  |  Rule: \_\_\_\_\_\_\_\_\_\_ Violation? Yes No |
|  |  Explanation: |
|  | Answer: Violation of Rule #101-Independence. Since Hank had an employment relationship with the client during part of the period covered by the financial statements, his independence is impaired. |
| 82.medium | Discuss the AICPA’s *Code of Professional Conduct* rule on advertising and solicitation. Give two examples of permitted advertising or solicitation, and two examples of prohibited advertising or solicitation. |
|  | Answer: The rule on advertising and solicitation prohibits members in public practice from advertising in a manner that is false, misleading, or deceptive. It also prohibits solicitation by the use of coercion, over-reaching, or harassment. Examples of permitted advertising include the use of television, radio, newspapers, and billboards to communicate truthful information about the CPA. Examples of prohibited advertising identified by Interpretation 502-2 of the AICPA’s *Code of Professional Conduct* include any advertisement that creates a false or unjustified expectation of favorable results, and any advertisement that contains statements that would be likely to cause a reasonable person to be deceived. |
| 83.medium | Describe the methods used by the AICPA and State Boards of Accountancy to enforce the rules of conduct. |
|  | Answer: The AICPA uses two levels of disciplinary action. For less serious violations of Rules of Conduct, remedial or corrective action may be required of the violator. For more serious violations, the violator may be suspended or expelled from membership in the AICPA.  Violation of a State Boards’ rules of conduct is punishable by loss of the violator’s CPA certificate and license to practice. |
| 84.challenging | The 200-level rules of the *Code of Professional Conduct* (Rules 201, 202, and 203) are known as the “technical standards.” Summarize each of these three technical standards. |
|  | Answer: Rule 201—General Standards requires the CPA to comply with four standards of conduct:a. undertake only those services for which the CPA has the necessary professional competence.b. exercise due professional care in the performance of professional services.c. adequately plan and supervise the services.d. obtain sufficient relevant data to support conclusions.Rule 202—Compliance with Standards requires CPAs to perform professional services in compliance with standards promulgated by bodies designated by the AICPA. Rule 203—Accounting Principles requires that if a CPA expresses an opinion that financial statements are presented in conformity with generally accepted accounting principles, those statements must not contain any departure from an accounting principle promulgated by bodies designated by the AICPA to establish such principles. |
| 85.challenging | Describe an ethical dilemma that an auditor or an accountant might face in his or her business career, then illustrate how the auditor or accountant might use the six-step approach presented in the text to resolve that dilemma. Be specific. |
|  | Answer: Although students’ answers will vary depending on the dilemma, their answer should list the following six steps, along with a discussion of how each step relates to their particular dilemma:1. *Obtain the relevant facts.* Students should list the key facts from their dilemma.
2. *Identify the ethical issues from the facts.* Students should identify the key ethical issue(s) in their dilemma.
3. *Determine who is affected by the outcome of the dilemma and how each person or group is affected.* Students should identify who is involved and how each person is affected by the dilemma.
4. *Identify the alternatives available to the person who must resolve the dilemma*. Students should list the alternatives available to the auditor or accountant.
5. *Identify the likely consequence of each alternative*. Students should identify both the short- and long-term effects of each alternative.
6. *Decide the appropriate action*.
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| 86.challenging | Discuss Rule 301—Confidential Client Information, including the four exceptions to the rule. |
|  | Answer: Rule 301 prohibits a member from disclosing any confidential client information without permission from the client. However, there are four conditions when client permission is not required:1. Obligations related to technical standards; i.e., when Rule 202 or Rule 203 requires the disclosure.
2. In response to a valid subpoena or summons.
3. A peer review is being conducted under AICPA, state CPA Society, or State Board of Accountancy authorization.
4. The CPA is initiating or responding to an inquiry from a recognized investigative body or the professional ethics division.
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Other Objective Answer Format Questions

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| 87.easya | An advantage of specific rules in the *Code of Professional Conduct* is the enforceability of minimum behavior and performance standards.a. Trueb. False |

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| 88. (SOX)easyb | The Sarbanes-Oxley Act permits the auditor to perform a wide variety of non-audit services for audit clients.a. Trueb. False |
| 89. (SOX)easyb | A company may purchase internal audit services from their financial statement auditor if they are approved by the company’s audit committee.a. Trueb. False |
| 90.easya | The audit committee of a private committee need not approve all non-audit services provided by the company’s financial statement auditor.a. Trueb. False |
| 91.easyb | An advantage of the principles of professional conduct in the *Code of Professional Conduct* is that they are more easily enforced than are the specific rules of conduct.a. Trueb. False |
| 92.easya | Rule 101, Independence, prohibits a CPA from performing both audit services and bookkeeping services for the same public company in the same year.a. Trueb. False |
| 93.easyb | Under Rule 101, Independence, independence is considered to be impaired if fees remain unpaid for professional services provided more than six months before the date of the current year’s report.a. Trueb. False |
| 94.easyb | Imprisonment for a period of six months or longer will result in automatic expulsion from the AICPA.a. Trueb. False |
| 95.easyb | Rule 505, Form of Organization and Name, prohibits CPA firms from practicing as limited liability partnerships.a. Trueb. False |
| 96.easya | Under Rule 505, Form of Organization and Name, a CPA firm may use any name as long as it is not misleading.a. Trueb. False |
| 97.mediumb | A CPA firm may practice public accounting only in a form of organization permitted by federal law or regulation whose characteristics conform to resolutions of Council.a. Trueb. False |
| 98.mediumb | In the *AICPA Code of Professional Conduct*, ethical rulings are less specific than rules of conduct.a. Trueb. False |
| 99.mediumb | Interpretations of rules of conduct in the *Code of Professional Conduct* are not officially enforceable and practitioners need not justify departure from them.a. Trueb. False |
| 100. (SOX)mediumb | The Sarbanes-Oxley Act does not require audit committee approval of all non-audit services prior to their performance by the company’s external auditor.a. Trueb. False |
| 101.mediumb | In the *AICPA Code of Professional Conduct*, interpretations of rules are more specific than ethical rulings.a. Trueb. False |
| 102.mediumb | In the *AICPA Code of Professional Conduct*, the second principle of professional conduct, entitled “The Public Interest,” applies only to members of the AICPA in public practice and not to members who work as accountants in business, government, or education.a. Trueb. False |
| 103.mediumb | In the *AICPA Code of Professional Conduct*, the sixth principle of professional conduct, entitled “Scope and Nature of Services,” applies to members of the AICPA who work in public practice, business, government, or education.a. Trueb. False |
| 104.mediuma | Auditors are allowed to have an indirect financial interest in an audit client, such as ownership of stock in a client’s company by the auditor’s brother, as long as the amount of the financial interest is immaterial to the brother.a. Trueb. False |
| 105.mediumb | Rule 101, Independence, applies to members of the AICPA when performing any professional service.a. Trueb. False |
| 106.mediuma | Rule 101, Independence, applies to covered members in a position to influence an attest engagement.a. Trueb. False |
| 107.mediuma | Under Rule 301, Confidential Client Information, permission is not required from the client to use the audit documentation relating to that client during an AICPA-authorized peer review program with another CPA firm.a. Trueb. False |
| 108.mediumb | Information obtained by a CPA from a client is legally privileged in federal court.a. Trueb. False |

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| 109.mediumb | Rule 502, Advertising and Other Forms of Solicitation, prohibits members of the AICPA in public practice from performing comparative advertising.a. Trueb. False |
| 110.mediumb | Under Rule 505, Form of Organization and Name, a CPA firm may not designate itself as “Members of the American Institute of Certified Public Accountants” unless a majority of its owners are members of the Institute.a. Trueb. False |
| 111.mediumb | Expulsion from the AICPA for failing to follow the rules of conduct is, by itself, sufficient to prevent a CPA from practicing public accounting.a. Trueb. False |
| 112.mediumb | Under the *AICPA’s Code of Professional Conduct*, CPAs are prohibited from offering audit clients a discount for referring a prospective client even if they are disclosed.a. Trueb. False |
| 113.mediumb | All owners of a CPA firm must be CPAs who are qualified to practice.a. Trueb. False |
| 114.mediuma | The Independence Standards Board was formed to provide a conceptual framework for independence issues related to audits of public companies.a. Trueb. False |