

LEGAL, PROFESSIONAL and PRACTICAL
Implications of
Codes of Professional Conduct

An Analysis of Ethical Thinking

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*The Editorial Comments in these Materials
are the Sole Responsibility of the Author/Instructor*

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This material is written from the perspective of two major theses:

- ***SELF-REGULATION** of professional conduct is preferable to governmental regulation.*

However, the need for a "*regulatory safety-net*" is recognized.

- *Regulation of professional conduct is in the best interest of both the regulated professional as well as the public.*

The need for Regulation highlights the importance of this profession and its members to the economic strength of this nation

The presentation is intended to provide understanding and practical guidance regardless of a participant's posture towards the forgoing propositions.

Finally, the value system of any organization or CPA firm will be a reflection of the value system of those individuals who exercise significant influence over those entities, regardless of rules, statutes or codes of conduct.

Actual Performance reflects the Tone at the Top.

CPAs should reflect upon their personal value structure and define clearly the boundaries of their integrity.

This **self-reflection** is necessary to ensure that their judgments and actions will reflect their ethical commitment to all those around them.

***THAT COMMITMENT WILL DISTINGUISH RESPONSIBLE CPAs
FROM OTHERS WHO MERELY HOLD DESIGNATIONS***

This presentation is intended to provide the framework by which that commitment can be dynamically implemented.

SUMMARY

Codes of Professional Conduct are necessary to announce to the public those obligations which the professional assumes in exchange for the public's confidence in the integrity of the professional.

CPAs hold a Public Franchise.

In exchange for that special recognition, CPAs must clearly communicate those obligations that they undertake.

Professional *rules of conduct* and *associated technical standards* are dictated, in part, out of **social responsibility** and in part by **legal necessity**. These proscriptions establish the boundaries of:

- **Public Expectations**
- **Professional Obligations**

Rigid rules of *do's and don'ts* may circumscribe acceptable conduct,
But a dedicated commitment to the public trust
is the **hallmark** of the true professional.

**Sound and Effective Organizational Control Structures
Begin with Public Commitment**

DO PUBLIC EXPECTATIONS OR STANDARDS COME FIRST ?

Persons entrusted with public responsibilities must be held accountable to the public. Professionals clearly have public responsibilities by virtue of their public franchise.

PROFESSIONAL STANDARDS MUST BE RESPONSIVE to PUBLIC EXPECTATIONS

Questionable, Improper, Fraudulent and/or Illegal behavior of private sector management, public officials and independent accountants has been highly publicized.

These circumstances have had two results pertinent to this presentation:

➤ *Renewed inquiry into the role of professional accountants in the process of sustaining public confidence in the Captains of Industry and Government as well as the Accounting Profession,*

and

➤ *Recognition that the Publics' understanding of the professional obligations of accountants differs significantly from the accountants' responsibilities acknowledged in professional standards.*

In the author's view
**management of this dilemma rests on
a continual evaluation of our personal value structure.**

A Personal Ethical Focus is the Risk Management Tool!

INTRODUCTION

WHAT ARE ETHICS ?

Academically, ethics might be defined as follows:

*A set of **guidelines** by which to evaluate the **appropriateness** of alternative courses of action.*

Practically speaking, this means behaving in accordance with your
Social Conscience.

*Your **conscience** is that which feels good when all else feels bad*

However, with approximately 300 Million people in the U.S.,
behavior in accordance with our individual conscience' would create
chaos.

Therefore, for persons entrusted with public responsibilities, a
COMMON CONSCIENCE must be established.

*The **Professions' COMMON CONSCIENCE** is
A **CODE** of **PROFESSIONAL CONDUCT***

Mere *awareness* of the professions' standards of responsibility
is **not sufficient**, however.

**The public demands that 'true' professionals evaluate the
appropriateness of norms and 'official' guidance to the particular
circumstance of the specific engagement affected by that**

guidance.

A framework for ethical analysis is outlined on the following page.

FRAMEWORK FOR "ETHICAL" ANALYSIS (*)

1. SPECIFY the **FACTS**
2. IDENTIFY the **AFFECTED PARTIES**
3. EVALUATE the **Influence** of the FACTS on the AFFECTED PARTIES
4. IDENTIFY :
 - **Alternative Courses of Action**
 - **Norms and Official Guidance**
 - **Personal Ethical Considerations**
5. Define **PREFERRED** Courses of Action
 - **Benefit ascribed to each Affected party**
 - **Consistent with Ethical Considerations & the Norms and Official Guidance**
6. **EVALUATE** the consequences of EACH Preferred Response
7. **DISCUSS WITH TRUSTED OTHERS**
8. **CHOOSE**

(*) Adapted from the 8-Step method described by **Mary Beth Armstrong, Professional Ethics and Accounting Education : A Critique of the 8-Step Method** (*Business & Professional Ethics Journal, Spring-Summer, 1990*)

In applying the forgoing model keep the following points in mind:

- *In many cases, you only have an extremely brief period of time to make the ethical decision, and*
- *Your personal value system is as important as any other consideration!*

Research shows some very interesting influences on *ethical behavior*:

- ✓ In the business environment, **responsibility** is perceived to *rest in the organization as often as with individuals, and*
- ✓ **Work-Life Balance** has a strong relationship to *Ethical Behavior*

If we accept those conclusions,

- **WHY** do these different perceptions arise?
 - Influence of **Laws and Regulations?**
 - **Lack of Confidence** *in the judgment of individuals?*
 - A **Social Need for “One-Size” fits All?**
 - We, as individuals, **prefer to relegate our judgment to others?**
- **How** do we, as individuals, **resolve** those dilemmas?

Let’s first identify the influences on our individual judgment.

WHY DO WE NEED A CODE of CONDUCT

If we are truly professional and our personal value systems are as important as other considerations:

- *Why do we need a list of rules to tell us how to behave or perform our functions ?*
- *Shouldn't responsible behavior be implicit in the context of being a professional?*
- *Why can't we let our **individual conscience** be our guide ?*

LET'S EXAMINE THAT ISSUE

PROFESSIONALS are generally distinguished from other trades people because their **special knowledge** results in the public's reliance upon the **integrity** of the professional to determine what action is in the **best interest of the public segment served**

In recognition of these characteristics, a general principle of **common law** establishes the civil liability of professional persons:



In all those employments where peculiar skill is requisite, if one offers his services, he is understood as holding himself out to the public as possessing the degree of skill commonly possessed by others in the same employment, and if his pretensions are unfounded, he commits a species of fraud upon every man who employs him in reliance on his public profession....

This **principle of common law** measures the adequacy of performance against “... **the degree of skill commonly possessed by others in the same employment...**” and, therefore, establishes the *right* and *obligation* of a profession to establish appropriate **standards of performance.**

- **Behavioral Standards**
- **Technical Standards**

However,
a “**push-pull**” dynamic exists between
professional standards and legal standards.

Both sets of criteria, conceptually, respond to public expectations.

The Common Link
is the exercise
Due Professional Care

The **legal liability** of CPAs to reliant parties may result and damages may be assessed against the CPA if each of the following **four conditions are proven by the plaintiff:**

1. *The CPA had an **implied or contractual duty** to the plaintiff that was not limited by the engagement contract;*
2. *The CPA **breached** that duty;*
3. *The Plaintiff was **injured**, and*
4. *There was a **causal relationship** between the **injury** and the CPA's **breach of duty**.*

Due Care requires that judgment is exercised in the application of the technical standards to assure that the *objectives* of the standards *are achieved*
Consistent with the Publics' Understanding and Expectations

**Mere adherence to TECHNICAL SPECIFICITY does
NOT ensure outputs will meet the
LEGAL STANDARD of DUE PROFESSIONAL CARE**

For example, in an audit engagement, the auditor's responsibility is to obtain evidence to form the basis for a report on the extent to which management met its financial reporting responsibility. If an auditor assumes a certain amount of that responsibility by performing functions that entity personnel are neither capable nor interested in performing, the auditor might violate either the independence or due care standard.

**Departure from Professional Standards is, however, one of the
Elements in a Malpractice Action**

The requirement for *sufficient, relevant data* upon which to base any conclusions or recommendations is a requirement inherent in the nature of a *Professional's Activities*.

Sufficient, relevant data is also the basis for a CPA's defense in a malpractice action under common law. *Common Law liability* is limited to acts of:



- 3 *Negligence*
- 3 *Bad Faith, or*
- 3 *Dishonesty*

A diagram of the foundation for Common Law

- Innocent - Genuine Belief/*Sufficient, Competent Evidence*
- Error of Judgment - Genuine Belief/*Competent Evidence; Sufficiency Debatable*
- Negligence - Genuine Belief/*Lack of Sufficient Competent evidence*
- Gross Negligence - *Lack of Belief/Certain Evidence*
- Fraud - *Knowing Misrepresentation*

As noted above,
DOCUMENTATION of the *Sufficiency* and *Competency* of evidence is a critical element in sustaining a legal defense in a malpractice action.

DOCUMENTATION
constitutes the *body of evidence* upon which *expert testimony* must be based.

Documentation should be *evaluated* from the perspective of an *Expert Witness*:

➤ **Does the Documentation:**

- *Document engagement circumstances sufficiently clear to allow Risks and Responses to be evaluated solely upon the conditions set forth in the W/P;*
- *Demonstrate planning and supervision;*
- *Demonstrate that the planned staffing and the strategy was responsive to the requirements of the engagement as perceived at the time the engagement was being planned;*
- *Demonstrate that actual supervision was responsive to the demands of the engagement;*
- *Contain evidence which is clearly relevant to engagement objectives;*
- *Contain sufficient (but not excessive or extraneous) evidence to support the conclusions or recommendations expressed or decisions reached.*

➤ **Could the reviewer testify, based solely upon the documentation, that:**

- *All relevant matters, of significance, were considered;*
- *The staffing and strategy were appropriate in the circumstances;*
- *Sufficient, competent (relevant) evidence was obtained.*
- *The conclusions/decisions are based solely on the documented evidence, and the logic applied consistent with public expectations.*

Professional Codes of Conduct, therefore, are necessary to establish the benchmark against which to measure:

- *The level of common skill required under common law, and*
- *The degree of care with which the CPA should apply those common skills in any particular set of circumstances.*

A **PROFESSION**, therefore, is:

- *A self-assessing discipline*
- *Guided by a notions of:*
 - *Public Responsibility*
 - *Technical Competency*
- *Subject to **Regulatory Oversight***

Accordingly, all recognized professionals have developed voluntary associations to promote professional objectives consistent with the public responsibilities of its membership.

Professional Rules of Conduct and the associated technical standards codify the profession's voluntary assumption of responsibility for self-discipline consistent with legal and regulatory requirements

These Codes of Conduct announce to the public that, *in exchange for the public's confidence*, the professional membership voluntarily accepts the obligation to *promote responsible conduct* within its ranks and to *discipline members* who fail to responsibly discharge their professional obligations.

Federal and state governments also have statutes and regulations to govern the conduct and performance of professionals.

The potential for government intervention should not be viewed negatively.

The government's interest can be viewed as tacit recognition that the professional's skills & behavior are of utmost importance

To responsibly **self-regulate**, a profession must:

- **Proactively enforce** *its adopted standards, and*
- **Communicate** *the results of that enforcement activity*

This **enforcement/communication** link is *essential* to provide the public benchmark against which the need for governmental intervention can be evaluated.

The **Audit Process**, the **Practice Monitoring programs** of the AICPA and State Boards of Accountancy, and **Internal Control Structure Reporting** for commercial and governmental organizations are the mechanisms to *Monitor & Report that Commitment*.

THE Control Structure CONCEPT

Control Structure development and operation should **NOT** be approached as a *Mechanical Process* i.e. a scientific process whereby step 1 leads to step 2 etc., which will assuredly achieve the proper result.

**The adequacy of control structure denotes an attitude,
*A commitment to meet or exceed public expectations***

The Effectiveness of any Control Structure is dependent upon the **COMMITMENT and QUALITY** of the **PEOPLE** who are involved in the process.

An effective **CONTROL ENVIRONMENT** requires:

- *Thoughtful Evaluation of RISKs & EXPECTATIONS to avoid unnecessary pressure and exposures;*
- *Effective PERSONNEL and SUPERVISORY PRACTICES to ensure that the ORGNIZATION'S personnel are up to the task;*
- *Effective MONITORING to ensure that the OUTCOMES are consistent with the demands of the business and professional environment and expectations of the public.*

TONE
established by
OWNER/MANAGERS

Checklists, FASB/ASB pronouncements, etc.
are merely "tools" to influence our
professional judgment

Mere adherence to technical specificity does not
necessarily demonstrate the application of
Due Professional Care

However, **comprehensive documentation**, developed in an understandable format, are a prudent means to demonstrate that significant, relevant issues were given proper consideration consistent with the cost/benefit considerations inherent in the nature of the engagement.

This approach requires **TEAMWORK** among members of a **TEAM** built upon **mutual respect, confidence and commitment** visa vis organizational structure and/or rule-based philosophy.

The **COSO Framework** defines a suitable control structure:

*A Process,
Effected by an Entity's People,
Designed to Accomplish
Specified Objectives*

**MANAGEMENT Involvement at *each operating level*
is ESSENTIAL to a sound control structure**

A "RISK MANAGEMENT" Plan

ENTERPRISE

- **OBJECTIVES :**

•• *Operational*

•• *Reporting*

•• *Compliance*

COMPONENTS:

- *Control Environment*
- *Risk Assessment*
- *Control (Implementing) Activities*
- *Information & Communication*
- *Monitoring*

At Each
UNIT/ACTIVITY

CONSTRAINTS

- **PEOPLE**

- .. *Understanding*
- .. *Training*
- .. *Commitment*
- .. *Pressures*

- **Cost Effectiveness**

- .. *Risk Assessments*
- .. *Prevention*
- .. *Detection*

- **The Economic & Social Dynamics of Business**

- .. *Individual & Collective Behavior*
- .. *Ethical Decision Making*

SUMMARY

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But a dedicated commitment to the public trust
is the **hallmark** of the true professional.

**Sound and Effective Organizational Control Structures
Begin with Public Commitment**

When Public Expectations conflict with the current performance of professionals, ***regulatory inquiry begins***. A profession may respond by modifying its professional standards to conform more closely to the publics' expectations. Such has certainly been the case recently

- *Federal legislation addressed **Tort Reform** by replacing **Joint and Several Liability** with **Proportionate Liability**.*
- ***Sarbanes-Oxley (SOX)** enactment*
- *Formation and Authority of the **PCOAB***
- ***Treasury Department, Circular 230**, prescribing regulations governing **practice before the IRS**, has been in continual revision*
- ***State Activities** in response to **SOX***

State SOX Activities

As we are all aware Congress enacted the Sarbanes-Oxley Act after Enron.

The AICPA announced concern about the effect that this might have on small business enterprises because SOX contained language directing State Boards to evaluate the implications of this federal legislation to state regulation of auditors and other financial and legal advisors.

A review of recent state legislative activity resulted in the following observations:

1. In 2003, **16 states** proposed legislation related to incorporating all or some of the provisions of SOX into their Accountancy Acts, and/or Corporate/Not-for-Profit/ Government Governance Acts.
2. In 2004, **only 6 states** proposed such legislation, much of which was carried over from 2003.
3. The most aggressive states in attempting to closely mirror SOX have been:
 - New York
 - California, and
 - New Jersey

For example, in 2003, the State of New Jersey, proposed to adopt Sarbanes-Oxley carte- blanc. *That effort was defeated, however.* Several other states by legislation to *totally prohibit concurrent non-audit services but those efforts failed.*

4. Texas, in 2003, enacted legislation requiring disclosure by outside financial advisors/service providers to governmental entities/agencies that manage or invest state funds.

SOX activity at the State Level (continued):

5. In 2003, *the Independence Task Force* formed by the **Washington State Board of Accountancy** recommended to the Board (and ultimately to the Governor) to *not adopt SOX* in Washington State.

That recommendation was influenced significantly by input from the 7 public members of that task force.

These folks were concerned about the effect on small business enterprises.

Furthermore, The **Washington State Board** accepted the task force recommendation to:

- *Define Independence*, and
- Obligate the *licensee to make the independence determination*.

6. In 2004, Illinois enacted significant legislation:

- Requiring the *CPA to communicate*, and *CEO or CFO of the auditee to approve* the concurrent performance of audit and non-audit services for privately-owned business with 500 or more employees or over \$50Mil in annual revenues and,
- Making it a *class 4 felony* to:
 - a. Fraudulently deceive, influence, or coerce an auditor and
 - b. For an auditor to mislead an auditee by falsifying records created by the auditor during the audit.

This does not appear to be the end of the state legislative road.

- The Attorney Generals for the states of New York and California continue to press for legislative reform and harsh discipline for CPAs and corporate execs.
- Several states have either enacted or continue to press for corporate governance statutes affecting privately-owned businesses and not-for-profits to establish audit committees with protocols similar to SOX.
- States continue to enact legislation requiring *CPE* to include *4 hours of Professional Ethics*.

SOX Activity at the Standards Setting and Reporting Levels

1. FASB continues to emphasize a *fair value balance sheet* with *transparency*:

- *Asset Retirement Obligations*
- *Liabilities with characteristics of Equity*
- *Business Combinations and Consolidations*
- *FIN 45*
- *Fins 46 and 46(R)*

2. Attestation Guidance by PCOAB, GAO, and AICPA reemphasizes the importance of:

- *Auditor **Independence***
- ***Internal Control** over Financial Reporting*
- ***Fraud Detection and Prevention***

*GAO exploring **mandatory attestation on IC** under the Yellow Book*

Where do we go from Here ?

Be prepared for
Continual Change

1. **Privatization**, *likely accompanied by:*

- *Enhanced regulation at the state level.*
- *Fewer nonpublic GAAP standards exceptions*
- *Enhanced Professional Standards, e.g. Comp & Review, Tax, Consulting, Forensic Services*

A limited number of states have broken with the AICPA on
Internal Use Only Statements

2. Continued reorganization and/or consolidation within the **CPA firm community**.
3. Increased **documentation** requirements for both CPAs and enterprises.
4. Enhanced ***Peer Review/Oversight*** activities by regulators.
5. ***Continued modification*** and/or ***interpretation*** of SEC, PCOAB, and GAO Guidance

What can YOU do ?

- **Adopt a public perspective** vs. an organizational or professionally defensive posture.
- **Be *proactive*** politically, professionally, and organizationally.
- **Emphasize *People*** vs. processes in the design and operation of control structures.
- **Allocate *your time*** and ***organizational resources*** appropriately.

Responsibilities and Performance Standards

*Continue to be reemphasized and, in some cases, redefined
emphasizing Accountability*

These separate responsibilities are outlined below:

Managers and Public Officials

- *Establish an atmosphere supportive of responsible performance*
- *Commit sufficient resources to accomplish responsible, well-defined objectives*

Operating Personnel

- *Operate in accordance with enterprise policy;*
- *Utilize resources in an **efficient** manner;*
- ***Communicate** informational needs;*
- *Provide an output of **reliable data** on a **timely** basis*

Preparers of Financial and Performance Reports

- *Ensure that the control structure is adequate to accomplish enterprise objectives, and*
- *Ensure that reports are reliably presented in accordance with stated or established criteria and meet users' needs*

Auditors

- *Objectively Report on implied Assertions made by Others*
- *Perform with Due Professional Care, i.e. meet Public Expectations*

The separateness of these responsibilities were emphasized in the report by the Committee of Sponsoring Organizations entitled "*Internal Control : An Integrated Framework*" (COSO; September, 1992)

COSO
promotes a thought process

Participants should observe that the *public interest* is

A MOVING TARGET

This is evident from the changes in the Internal Revenue Code, the changing attitude in the Congress of the United States as to what constitutes "permissible behavior", the volume of activities of the FASB and GASB, etc.

THE RESTRUCTURED CODE OF PROFESSIONAL CONDUCT of the AICPA WAS INTENDED TO PUT ORDER INTO THAT CHAOTIC ENVIRONMENT

Restructured Codes of conduct are generally:

- **Goal Oriented and Positively Stated**
- **Founded upon explicit Principles**

Principles provide the basis for *Enforceable Rules*

The **Importance of the Principles** should not be **Understated**:

To the extent that the rules do not reflect current public sentiment, practitioners and the courts may look to the principles for guidance.

*As a practical matter,
the Principles provide a frame of reference
for both practitioners and others to evaluate responsibilities
when the interest of the 'professional'
conflicts with the interests of 'reliant parties'.*

The PRINCIPLES established by the AICPA

There are six Principles:

v **Responsibilities** - Social Obligations

*Professional responsibility requires the exercise of sensitive **moral** as well as **professional judgments**.*

v **The Public Interest** - 3rd Party 'Liability'

The mutual interests of clients and employers of CPAs are best served when CPAs place primary emphasis on a commitment to the public trust.

v **Integrity** - Necessary *Personal Characteristics*

*CPAs must be **honest** and **candid** when performing their services but must **respect confidentiality**.*

CPAs must observe the spirit as well as the form of ethical and technical standards.

v **Objectivity and Independence** - Fact & Perceptions

*CPAs should be **impartial, intellectually honest, and free from conflicts of interest** regardless of employment or capacity.*

*When a CPA provides **attest services**, the CPA should be **independent** in appearance as well as independent in fact.*

v **Due Care** - The Basis for Self-Regulation

*CPAs must discharge their professional responsibilities with **Diligence** as well as **Competence**.*

Diligence requires performance to be:

- 1. Timely*
- 2. Thorough*

v *Based upon 'Technical Standards,'* **Scope and Nature of Services (Decisions) - Public Confidence**

A careful evaluation is required when considering whether or not to take specific actions.

Matters to be considered are:

- 1. Adequacy of an organization's Control Structures;*
- 2. Potential for **Personal Bias (Conflicts of Interest)**, and*
- 3. Potential effects of the Appearance of Bias' on the 'Image' of **Professionalism and Legal Liability**.*

SUMMARY

Philosophical principles of behavior *generally* do not provide either a basis for a 'malpractice' defense or a 'malpractice' claim because such matters are stated in terms of **broad objectives** rather than specific proscriptions intended to protect defined classes of individuals.

However, because responsible behavior requires a responsiveness to *public expectations (a moving target)* attention to the **Principles** is prudent practice.

As a practical matter,
the Principles provide a frame of reference
for both practitioners and others to evaluate responsibilities
when the interest of the 'professional'
conflicts with the interests of 'reliant parties'.

However, to be effective for the benefit of
both the *professional* and the *public*,
lines of communication must be established to promote
timely understanding of
public expectations and recognized professional obligations.

**Broadly stated Principles, effectively communicated,
can serve as that forum.**

QUESTIONS

TO WHICH PUBLIC IS THE CPA OBLIGATED

CPAs are clearly obligated to the *engaging client* under both common law and contract law.

However, CPAs may be distinguished from other professionals because the CPA's product i.e. report, tax return, etc., is generally provided for the benefit of a party or parties other than the client.

The CPA, in effect, concurrently serves more than one reliant party

This situation imposes upon the accounting profession the unique obligation to establish an **order of responsibilities**. The *relative priority* among reliant parties must be clearly established.

Furthermore, the CPA is periodically faced with conflicting obligations among reliant parties which must be responsibly resolved to avoid legal liability.

The restructured Code of the AICPA suggests a *general priority* for all members of the AICPA as follows:

- **Public**
- *Client/Employer*
- *Profession*
- *Self-Interest*

PUBLIC is defined to include
"...the collective well-being of the community of people and institutions the profession serves."

The IRS broadly asserts that this includes the *Internal Revenue Service*

QUESTIONS

What are your ethical considerations in the following situations and how do YOU resolve them?

- You receive **return address labels** in the mail seeking a voluntary contribution.
- You are the **spokesperson in a class action lawsuit** against X company for distributing a faulty, injurious product. You are asked to give a very important speech at a national business conference to be attended by 500 attendees and shown on TV unrelated to the class action suit. Upon arriving at the conference site and 10 minutes before your presentation you determine that the CEO of the company being sued is to receive an award as the “most socially responsible CEO in the U.S..
- You are a **State Auditor** responsible for auditing every governmental entity in your state. Certain entity types are audited by several independent CPA firms and you want to rely on their work as part of your audit report. However, **the CPA firms cannot agree on the accounting treatment for a common transaction that would affect 400 of the public entities in several different ways.**
- Implementation of **Fair Value Accounting** under SFAS No. 157 and 159?