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What You *Do* Know *Can* Hurt You: An Instructional Case Requiring Application of Professional Standards to an Ethical Dilemma Facing an Auditor and Tax Preparer

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SUMMARY: This instructional case, based on a real-life experience, introduces students/professionals to an ethical dilemma faced by a CPA who serves as both an auditor and a tax preparer for related parties. The CPA becomes aware of a large amount of gambling activity undertaken by an individual income tax client who is employed as the executive director of the local branch of a national charitable organization. The local branch also happens to be an audit client of the CPA. Through the case, students/professionals gain an understanding of and appreciation for a realistic ethical dilemma faced by a CPA who also prepares personal income tax returns for related parties. To help the CPA resolve the issues in this case, students/professionals must understand and apply relevant professional standards, including the AICPA Code of Professional Conduct, AU-C Section 240 "Consideration of Fraud in a Financial Statement Audit," and IRS Circular 230 "Regulations Governing Practice Before the Internal Revenue Service." A survey questionnaire administered to students who completed the case during an upper-level accounting course suggests that students found the case to be an enjoyable and valuable learning experience that helped them to recognize personal and professional ethical issues facing auditors and tax professionals, as well as to access and apply professional standards to such ethical issues.

Keywords: professional standards; ethical issues; auditing; consideration of fraud.

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INTRODUCTION

Practicing accountants face ethical challenges throughout their professional careers, and there have been many recent calls for accounting educators to incorporate coverage of ethical issues in accounting curricula (Haas 2005; Low, Davey, and Hooper 2008; Massey and Van Hise 2009). Indeed, there is evidence that integration of ethics content into accounting and auditing courses improves the ability of students to make ethical judgments (Eynon, Hill, and Stevens 1997; Saat, Porter, and Woodbine 2011). Not only is ethics training important, but having an understanding of professional standards also plays a role in ethical behavior. In an experimental study of 304 practicing auditors, Douglas, Davidson, and Schwartz (2001) found that ethical judgments in situations of high moral intensity are affected by both ethics training in college and an understanding of the profession's code of conduct, which led the authors to suggest that better ethical judgments might be achieved by increasing instruction in both ethics and the professional code of conduct at the college level.

Researchers have cited a lack of available materials as one important impediment to including ethics instruction in accounting curricula. Mintz (1990) surveyed American Accounting Association members and found that the second biggest challenge to integrating ethics content into accounting courses was a lack of materials—second only to curriculum/time constraints. In a more recent study, Blanthorne, Kovar, and Fisher (2007) also found that for instructors who did not incorporate ethics into their courses, the lack of adequate materials was the second-most important reason for not doing so, following lack of time.

Cases are an appropriate tool for introducing realistic ethical dilemmas into the classroom as they give students exposure to real-life practical experiences that they have likely not yet had the opportunity to obtain (Liu, Yao, and Hu 2012). Cases are also considered by accounting educators to be the most effective means of ethics instruction (Blanthorne et al. 2007). The case presented in this paper provides instructors in auditing, tax, and other advanced accounting elective courses an opportunity to present students with a real and increasingly common issue, gambling addiction (Skolnik 2011), and its possible impact on management integrity. The case could also be used as an in-house CPE session for young auditors and tax professionals. By working through the case, students/professionals will gain a better understanding of the types of personal and professional ethical issues that face accounting professionals, and how to apply relevant professional and ethical standards to resolve those issues.

THE CASE

Mark Martin[1] is the executive director for the local branch of a national charitable organization, and is well regarded in the community. As the executive director, he oversees all operating and financial activities of the branch. Daniel Doyle, CPA, is president of Doyle and Associates, a small practice made up of four CPAs and one business manager. Doyle and Associates performs the financial statement audit of Martin's local branch and has done so for the past five years. Doyle and Associates focuses on individual and business taxation with a complementary, off-tax-season service of auditing small not-for-profit entities. In addition to performing yearly audits for the branch of the local charitable organization for which Mark Martin serves as executive director, Daniel Doyle also prepares the joint personal individual income tax return for Mark Martin and his wife, which is billed separately to the Martins.

[1] All names used in this case, including the name of the CPA firm, are fictional.

Having prepared the Martins' personal income tax return for the past five years, Daniel has not encountered any technical or recordkeeping problems with the return. Mark Martin is married and has two school-aged children. His annual total compensation is approximately $80,000 and his wife earns around $35,000 annually as a business professional. Mark provides quality documentation for all items on the return and does not take aggressive income tax positions. It is a tax return that Daniel likes to prepare.

During Daniel's preparation of the current year income tax return in February, however, Mark presented documents reflecting a very high level of gambling activity that did not exist in previous years. Mark's records from the local casino show $372,000 of winnings and $400,000 of losses. While these transactions are easy to report on the return and have no significant income tax impact (positively or negatively), Mark expresses personal embarrassment at having to disclose such a high level of gambling activity. He implies a personal concern about the possibility of a gambling addiction, but never directly acknowledges one. In fact, he expresses both a desire and intention to stop gambling, in order to benefit his family. Daniel observes that $28,000 of after-tax losses seems to be a very large amount for someone of Mark's income level and family responsibilities. Because net gambling losses are not deductible for income tax purposes, this $28,000 was an after-tax loss from take-home pay. Assuming a 30 percent marginal tax rate paid by the family, Mark essentially lost $40,000 of his gross pay (or half of his salary) due to his gambling activity.

Upon completing the Martins' personal income tax return, Daniel becomes concerned about how the Martin family's budget could absorb a $28,000 loss. He knows from preparing their tax return that, as a young family, they have insignificant savings, a large mortgage on the family home, make basic pension contributions, and are not funding any personal IRA accounts. Daniel wonders what could possibly be the source of the lost money.

Two months after completing the Martins' personal tax return, Doyle and Associates starts gearing up for the not-for-profit auditing season. Mark Martin's branch will be audited in May. Daniel Doyle begins to consider how his knowledge of Martin's gambling situation will affect the audit process.

Case Questions

Daniel Doyle begins to prepare for his firm's brainstorming/planning session regarding the audit of Mark Martin's branch. Recognizing Mark Martin's role as executive director of the local branch of the national charitable organization, the significant cash contributions that result from the branch's fundraising efforts, and Martin's significant personal gambling losses, Daniel cannot help but think about the risk of fraud posed by Martin's gambling losses.

1. Define fraud.
2. What are the three components of the fraud triangle?
3. Is gambling an incentive/pressure?
4. Is gambling different from a gambling addiction?
5. Can incentive/pressure alone create a material risk of fraud?
6. Does the executive director's involvement with gambling impact Doyle's audit?
7. Must Doyle disclose his knowledge of the gambling activity during his firm's brainstorming/planning session for the audit?

In addition to his concerns regarding the risk of fraud, Doyle also recognizes that his role as Martin's income tax preparer presents issues of confidentiality.

8. What is confidential client information?
9. What procedure must Doyle undertake, as a CPA, prior to disclosing confidential client information?
10. As a tax professional and CPA, does Doyle violate Martin's confidentiality if he uses information obtained in preparing Martin's personal income tax return when planning the audit of the local charity branch?
11. As an auditor, is Doyle required to communicate his knowledge of Martin's personal gambling activity to the local branch's board of directors?
12. Can Doyle disclose an individual's confidential personal information to a business entity client without that individual's consent?
13. Should Doyle consult legal counsel?
14. If Doyle chooses to keep his knowledge of the executive director's gambling activity confidential and the audited financial statements are subsequently found to be fraudulent, can Doyle support his compliance with AU-C Section 240?
15. If Doyle chooses to violate Martin's confidentiality rights and share his knowledge with the board of directors and the board of directors chooses to terminate Martin as the executive director as a result of this information, how might Doyle stand as a defendant in a personal lawsuit brought against him by Martin for lost wages and personal damages?

Doyle knows that violations of the "Regulations Governing Professional Practice Before the IRS" and the CPA professional standards can result in sanctions. He reflects on his dual role as a tax preparer and an auditor, and thinks about how to handle the situation.

16. Since the AICPA is a voluntary membership organization, what sanctions can the AICPA impose on members who violate the Code of Professional Conduct?
17. What sanctions are assessed against a tax preparer who willfully violates a taxpayer's confidentiality rights?
18. Can Doyle prepare Martin's personal tax return and also serve as auditor of Martin's branch? Does this dual relationship pose a significant threat to independence?
19. Can Doyle simply resign from the engagement? What should Doyle tell the board of directors when they inquire as to why? What should Doyle tell the successor auditor?
20. How should Doyle respond to this situation? Why should he respond in this way? What are the ramifications of his decision?

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CASE LEARNING OBJECTIVES AND IMPLEMENTATION GUIDANCE

Learning Objectives

1. Students/professionals identify and understand professional and personal ethical issues facing auditors and tax preparers.
2. Students/professionals locate and understand ethical, professional, and regulatory standards and guidance.
3. Students/professionals apply ethical standards to a real-life fact pattern.
4. Students/professionals apply professional standards (including those provided by a government body such as the IRS) to a real-life fact pattern.

Implementation Guidance

This case would be applicable to an auditing course, an income tax course, or an upper-level accounting course when there is a desire to add an ethics or professional research component. It would also be useful as an in-house CPE session for young auditors and tax professionals.

The lead author successfully implemented the case in an upper-level financial accounting elective course. The case was covered in three 50-minute class sessions. The purpose of Class Session 1 was to introduce the case, help the students identify the professional references, and provide the timeline. Following this introduction, students were assigned the question sets as homework and then given two weeks to access the relevant professional standards and prepare their responses to the questions. Class Session 2 encompassed a discussion on the questions related to IRS Circular 230 and the AICPA Code of Professional Conduct. Finally, Class Session 3 was another discussion, this time on the questions related to AU-C 240 and overall conclusions.

Other options for implementing the case include the following:

- Individual Paper: Each student is assigned to write a paper recommending a course of action.
- Competing Teams: One or more student teams are assigned to support the need to *violate the confidentiality requirement* to meet professional standards, and one or more student teams are assigned to support the need to *maintain the confidentiality requirement* to meet professional standards.
- Group Paper and Presentation: Groups of students write a paper recommending a course of action and present their papers in class.
- Group Discussion: Groups of students can be assigned to take whatever position they wish, and then come to class prepared to support their position in a discussion or presentation. The instructor may choose to introduce or argue alternate positions.
- Group Presentations Tied to Standards: Form a group or groups for each of the key professional standards (Code of Professional Conduct, Regulations Governing Practice Before the Internal Revenue Service, Generally Accepted Auditing Standards). Each group is assigned to present what *must* happen in order to maintain compliance with the professional standard for which they have been assigned to advocate.

An alternative use for the case would be as an in-house CPE session for young auditors and tax professionals. The training would require staff members to learn how to access the firm's

TABLE 1
Recommended CPE Hours for the Case

Task	CPE Hours
Review AICPA Code of Professional Conduct	1
Review IRS Circular 230	1
Review AU-C Section 240	2
Answer Case Questions	2
Review Firm's Quality Control Documents	1
Prepare Written Conclusion	1

professional literature, document their research findings in a fashion consistent with the firm's systems of quality control, and offer a conclusion for upper management's consideration and use.

A reasonable estimate of CPE hours needed to complete the assignment is 8 hours, allocated as shown in Table 1.

Key Issues to Review in Class Discussion

Following is a list of key issues in IRS Circular 230, the AICPA Code of Professional Conduct, and the Generally Accepted Auditing Standards that are particularly relevant to the case. The instructor should ensure that these key issues are addressed at some point during the discussion of the case.

Confidentiality Rules for Preparing Individual Income Tax Returns

1. IRS Circular 230 ("Regulations Governing Practice Before the IRS")
   a. Willfully disclosing tax return information is an example of incompetence and disreputable conduct [Section 10.51 (15)]
   b. Sanctions for incompetent and disreputable conduct are [Section 10.50 (a) and (c)]:
      i. Censure (public reprimand)
      ii. Suspend CPA's ability to practice before the IRS
      iii. Monetary penalty

2. AICPA Code of Professional Conduct
   a. Unless the particular client information is available to the public, such information should be considered confidential client information [0.400.09]
   b. A CPA in public practice shall not disclose any confidential client information without the specific consent of the client [1.700.001]
   c. In providing professional services to a company's executives, disclosure of confidential client information without the consent of the applicable executive would be a violation [1.700.030]
   d. Failure to comply with the AICPA Code of Professional Conduct considerations:
      i. Membership in the AICPA is voluntary [0.300.030.01]
      ii. Violation of the Code of Conduct can result in expulsion from the AICPA and censure (public reprimand)
      iii. The state board of accountancy will also enforce the AICPA Code of Professional

Conduct; penalties at the state level generally include censure (public reprimand), loss of CPA license, and monetary penalties

Consideration of Fraud in a Financial Statement Audit

1. AU-C Section 240 (“Consideration of Fraud in a Financial Statement Audit”)
   a. Fraud is defined as an intentional act that *materially* misstates a financial statement (AU-C 240.11)
   b. Fraud triangle of incentive/pressure, opportunity, and attitude/rationalization; the greater the incentive/pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud (AU-C 240.11)
   c. Management has a unique ability to perpetrate fraud because it is frequently in a position to manipulate accounting records; management override of controls can occur in unpredictable ways (AU-C 240.07)
   d. In the audit brainstorming session, the discussion should include a consideration of known external and internal factors affecting the entity that may create incentives for management or others to commit fraud (AU-C 240.15)
   e. An entity’s audit committee sometimes assumes an active role in oversight of the entity’s assessment of the risk of fraud (AU-C 240.A21)
   f. The auditor should (should means must) address the risk of management override apart from any conclusions regarding the existence of more specifically identifiable risks (AU-C 240.32)
   g. If a particular asset (e.g., loose cash) is highly susceptible to misappropriation, then extended testing of that account may be warranted (AU-C 240.A13)
   h. Whenever an auditor has determined that there is evidence that fraud *may* exist, and it involves senior management, it should (should means must) be reported directly to those charged with governance (AU-C 240.39)
   i. The auditor should (should means must) communicate other risks of fraud identified to those charged with governance (AU-C 240.41)
   j. Because potential conflicts between the auditor’s ethical and legal obligations for confidentiality may be complex, the auditor may wish to consult with legal counsel (AU-C 240.A73)
   k. An example of an incentive to misappropriate assets is personal financial obligations, which may create pressure on management with access to cash to misappropriate those assets (AU-C 240.A75)
   l. An example of attitude weakness is a disregard for internal control by management, overriding existing controls, or failing to correct known deficiencies (AU-C 240.A75)

Evidence of Effectiveness

After completing the case, students in the lead author’s upper-level financial accounting class completed a short questionnaire regarding their experience with the case. The results, shown in Table 2, suggest that students found the case to be a valuable and enjoyable learning experience, and that the case was effective in achieving its learning objectives. As indicated in the table, the four case Learning Objectives were directly addressed in items 4–7 on the questionnaire.

TEACHING NOTES AND STUDENT VERSION OF THE CASE

Teaching Notes and the Student Version of the Case are available only to non-student-member subscribers to *Current Issues in Accounting* through the American Accounting Association's electronic publications system at http://www.aaapubs.org/. Non-student-member subscribers should use their usernames and passwords for entry into the system where the Teaching Notes can be reviewed and printed. The "Student Version of the Case" is available as a supplemental file that is posted with the Teaching Notes. Please do not make the Teaching Notes available to students or post them on websites.

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TABLE 2

Student Assessment of the Case

	Percentage of Students Selecting Each Response[a]					
Question	**1 = Strongly Disagree**	**2 = Disagree**	**3 = Neutral**	**4 = Agree**	**5 = Strongly Agree**	**Average Rating**
1. I enjoyed this case.	0%	8%	0%	69%	23%	4.08
2. The case material was clear and understandable.	0%	15%	8%	15%	62%	4.23
3. The case questions were clearly worded and easily understood.	0%	8%	8%	31%	54%	4.31
4. The case increased my knowledge of how to access professional standards and guidance. (Case Learning Objective #2)	0%	8%	31%	15%	46%	4.00
5. The case required me to apply ethical standards to a practical fact situation. (Case Learning Objective #3)	0%	15%	0%	23%	62%	4.31
6. The case required me to apply professional standards to a practical fact situation. (Case Learning Objective #4)	0%	8%	8%	8%	77%	4.54
7. The case helped me recognize personal and professional ethical issues facing auditors and tax professionals. (Case Learning Objective #1)	0%	8%	0%	31%	62%	4.46
8. The time allowed to complete this case [3 weeks] was adequate.	0%	0%	31%	38%	31%	4.00
9. This case was a valuable learning experience.	0%	0%	8%	46%	46%	4.38
10. I recommend this case as a learning tool for future classes.	0%	8%	15%	31%	46%	4.15

[a] Due to rounding error, row totals do not all add up to 100 percent.