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background
information
on

Restatement of the Code of Professional Ethics

*Membership approval is required for
the enforceable Rules of Conduct
printed on pages 11-18 herein.*

Referendum

November 15, 1972

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666 Fifth Avenue, New York, New York 10019

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Introduction

This booklet provides background on the proposed restatement of the Code of Professional Ethics of the American Institute of Certified Public Accountants.

The proposals have been approved by the Council of the Institute on the recommendation of the Board of Directors. The Code amendments originated with the Division of Professional Ethics.

In accordance with the bylaws, the proposals were included in the call to the annual meeting held in Denver, Colorado, on October 4, 1972, for discussion without action.

The bylaws also provide that following the annual meeting, proposed amendments to the Code shall be submitted to all members for a vote by mail ballot, accompanied by a statement prepared by the Secretary reflecting the arguments advanced for and against them.

This booklet is issued in conformity with these requirements of the bylaws. It contains an explanation of the changes proposed in the enforceable Rules of Conduct of the proposed restatement, the text of the Rules of Conduct which require membership approval and a summary of the questions and arguments. The other parts of the Restated Code of Professional Ethics, Concepts of Professional Ethics and Interpretations of Rules of Conduct, which are not intended to establish enforceable standards and which do not require membership approval are contained in the official Code booklet which is enclosed herewith and which will constitute your copy of the Restated Code upon favorable vote of the membership.

In order to become effective, the proposed amendments must be approved by two-thirds of the members voting. The ballots will be valid and counted only if received by the close of business on the first business day 60 days following the mailing of this ballot on November 15, 1972, as provided in the bylaws. All ballots should be authenticated as provided in the balloting material; unauthenticated ballots will not be counted.

John Lawler
Secretary

Explanation of Major Changes

The following are the major changes of substance from the present Code:

Definitions. This section offers guidance as to the intent with which certain words are used throughout the Code. No similar section is in the present Code and the precise meaning of some terms presently used is ambiguous. While for the most part the definitions reflect traditional meanings, the "practice of public accounting" has been defined as holding oneself out to be a CPA or public accountant and at the same time performing for a client one or more types of services rendered by public accountants. In the past, application of the Code did not depend on whether or not a member held himself out as a CPA.

Applicability of rules. This section is also new and clarifies the application of the rules to members not in public practice and to those practicing outside the United States. It also clarifies a member's responsibility for acts of others on his behalf.

Rule 101—Independence. This rule incorporates the major provisions of the present Rule 1.01 on independence and adds the following conditions which will impair independence:

1. Certain loans with clients.
2. Material joint closely held business investments with clients.
3. Service as a trustee for any pension or profit-sharing trust of an enterprise, or as a trustee or executor for a deceased client where the trust or estate has a direct or material indirect financial interest in a client. A delay of two years in effectiveness permits an orderly transition of client relationships.

Interpretation 101-1 (page 32 of the Code) clarifies the exception for honorary directorships of charities.

Rule 102—Integrity and objectivity. This rule is new and stresses that a member must act truthfully and objectively in performing services and shall not subordinate his judgment to others.

Rule 201—Competence. This rule, providing simply that a member should not undertake any engagement which he or his firm cannot reasonably expect to complete with professional competence, is new.

Rule 202—Auditing standards, and Rule 203—Accounting principles. These two rules would substitute for Rules 2.01 through 2.03 of the present Code. The present rules make no mention of the generally accepted auditing standards or APB Opinions. Proposed Rule 202 would require adherence to the generally accepted auditing standards adopted by the membership in 1948 and 1949 and would clarify the enforceability of Statements on Auditing Procedure issued by the Institute's auditing procedure committee.

Proposed Rule 203 would prohibit a member from expressing his opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements depart in a material respect from an accounting principle established by the body authorized by Council to promulgate such principles unless he can demonstrate that due to unusual circumstances application of the principle would result in misleading statements—in which case his report must describe the departure, the approximate effects thereof; if practicable, and the reasons why compliance with the established principle would result in misleading statements.

Rule 301—Confidential client information. This rule is a restatement and elaboration of the present rule, which provides simply that a member may not "violate the confidential relationship between himself and his client." The restatement makes clear the purpose of the rule and illustrates circumstances in which it would not apply. In addition, it specifically covers the responsibility of the ethics division, Trial Board and quality review personnel to keep confidential the information they receive in the course of their work.

Rule 401—Encroachment. This rule combines and restates the provisions of present Rules 5.01, on encroachment, and 5.02, on referrals, and clarifies the propriety of a member's insistence on auditing any subsidiary, branch or other component of a client as he deems necessary when expressing

an opinion on consolidated statements. (See Interpretation 401-2, page 37 of the Code.)

It also provides that when an audit client of another independent public accountant requests a member to provide professional advice on accounting or auditing matters in connection with an expression of an opinion on financial statements, the member must first consult with the other accountant to be sure he is aware of all the available relevant facts.

Rule 402—Offers of employment. This rule broadens present Rule 5.03 to require notice to a practitioner-employer of offers of employment made on behalf of a client. The present rule is silent on whether it applies to such offers, or is limited only to offers made on behalf of the member himself.

Rule 502—Solicitation and advertising. This rule combines present Rules 3.01, on advertising, and 3.02, on solicitation.

Rule 503—Commissions. This rule would prohibit payment of a commission to anyone to obtain a client, and receipt of a commission from anyone for referral to a client of products or services of others. Present Rule 3.04 permits such payments where other practitioners are involved.

Rule 504—Incompatible occupations. This rule clarifies Rule 4.04, on incompatible occupations, by specifying that a practitioner may not engage in an occupation which impairs his objectivity in rendering professional services or serves as a feeder to his accounting practice.

Rule 505—Form of practice and name. This rule combines Rule 4.06 on practice in corporate form, the substance of Rule 4.02, on practice in the name of another, and Rule 4.01, on designation as "Members of the American Institute of CPAs."

The proposed Code does not contain a rule against competitive bidding because Rule 3.03 has been declared null and void and the Institute has been enjoined from adopting a similar rule by the United States District Court for the District of Columbia in a civil antitrust suit brought by the United States against the Institute. (See Interpretation 502-14, page 42 of the Code.)

Rule 4.03, prohibiting a member from permitting an employee to perform services he himself is not permitted to perform since he is not licensed to do so, has been dropped since such activities are covered by public law and inclusion as a rule is unnecessary.

Rules of Conduct

In the footnotes below, the references to specific rules or numbered Opinions indicate that revised sections are derived therefrom; where modifications have been made to the present rule or Opinion, it is noted. The reference to "prior rulings" indicates a position previously taken by the ethics division in response to a specific complaint or inquiry, but not previously published. The reference to "new" indicates a recommendation of the Code restatement committee not found in the present Code or prior rulings of the ethics division.

Definitions

The following definitions of terminology are applicable whenever such terminology is used in the rules and interpretations.

Client. The person(s) or entity which retains a member or his firm, engaged in the practice of public accounting, for the performance of professional services.

Council. The Council of the American Institute of Certified Public Accountants.

Enterprise. Any person(s) or entity, whether organized for profit or not, for which a CPA provides services.

Firm. A proprietorship, partnership or professional corporation or association engaged in the practice of public accounting, including individual partners or shareholders thereof.

Financial statements. Statements and footnotes related thereto that purport to show financial position which relates to a point in time or changes in financial position which relate

to a period of time, and statements which use a cash or other incomplete basis of accounting. Balance sheets, statements of income, statements of retained earnings, statements of changes in financial position and statements of changes in owners' equity are financial statements.

Incidental financial data included in management advisory services reports to support recommendations to a client, and tax returns and supporting schedules do not, for this purpose, constitute financial statements; and the statement, affidavit or signature of preparers required on tax returns neither constitutes an opinion on financial statements nor requires a disclaimer of such opinion.

Institute. The American Institute of Certified Public Accountants.

Interpretations of Rules of Conduct. Pronouncements issued by the Division of Professional Ethics to provide guidelines as to the scope and application of the Rules of Conduct.

Member. A member, associate member or international associate of the American Institute of Certified Public Accountants.

Practice of public accounting. Holding out to be a CPA or public accountant and at the same time performing for a client one or more types of services rendered by public accountants. The term shall not be limited by a more restrictive definition which might be found in the accountancy law under which a member practices.

Professional services. One or more types of services performed in the practice of public accounting.

Applicability of Rules

The Institute's Code of Professional Ethics derives its authority from the bylaws of the Institute which provide that the Trial Board may, after a hearing, admonish, suspend or expel a member who is found guilty of infringing any of the bylaws or any provisions of the Rules of Conduct.¹

The Rules of Conduct which follow apply to all services performed in the practice of public accounting including tax² and management advisory services³ except (a) where the wording of the rule indicates otherwise and (b) that a member who is practicing outside the United States will not be subject to

¹ Bylaw Section 7.4.

² Opinion No. 13.

³ Opinion No. 14.

discipline for departing from any of the rules stated herein so long as his conduct is in accord with the rules of the organized accounting profession in the country in which he is practicing.⁴ However, where a member's name is associated with financial statements in such a manner as to imply that he is acting as an independent public accountant and under circumstances that would entitle the reader to assume that United States practices were followed, he must comply with the requirements of Rules 202 and 203.⁵

A member may be held responsible for compliance with the Rules of Conduct by all persons associated with him in the practice of public accounting who are either under his supervision or are his partners or shareholders in the practice.⁶

A member engaged in the practice of public accounting must observe all the Rules of Conduct. A member not engaged in the practice of public accounting must observe only Rules 102 and 501 since all other Rules of Conduct relate solely to the practice of public accounting.⁷

A member shall not permit others to carry out on his behalf, either with or without compensation, acts which, if carried out by the member, would place him in violation of the Rules of Conduct.⁸

Independence, integrity and objectivity

Rule 101—Independence. A member or a firm of which he is a partner or shareholder shall not express an opinion on financial statements of an enterprise unless he and his firm are independent with respect to such enterprise.⁹ Independence will be considered to be impaired if, for example:

- A. During the period of his professional engagement, or at the time of expressing his opinion, he or his firm
 - 1. Had or was committed to acquire any direct or material indirect financial interest in the enterprise;¹⁰ or
 - 2. Had any joint closely held business investment with the enterprise or any officer, director or principal stockholder thereof which was material in relation to his or his firm's net worth;¹¹ or
 - 3. Had any loan to or from the enterprise or any officer, director or principal stockholder thereof.¹² This latter proscription does not apply to the following loans

4 Prior ruling.

5 Rules 2.01, 2.02, 2.03 and prior rulings.

6 New.

7 New.

8 Opinion No. 2.

9 Rule 1.01 ("shareholder" added to recognize corporate practice).

10 Rule 1.01.

11 Prior rulings.

12 Prior rulings.

from a financial institution when made under normal lending procedures, terms and requirements:

- (a) Loans obtained by a member or his firm which are not material in relation to the net worth of such borrower.
- (b) Home mortgages.
- (c) Other secured loans, except loans guaranteed by a member's firm which are otherwise unsecured.¹³

B. During the period covered by the financial statements, during the period of the professional engagement or at the time of expressing an opinion, he or his firm

1. Was connected with the enterprise as a promoter, underwriter or voting trustee, a director or officer or in any capacity equivalent to that of a member of management or of an employee;¹⁴ or
2. Was a trustee of any trust or executor or administrator of any estate if such trust or estate had a direct or material indirect financial interest in the enterprise; or was a trustee for any pension or profit-sharing trust of the enterprise.¹⁵

The above examples are not intended to be all-inclusive. (See Interpretations 101-1, 101-2, and 101-3, pages 32-3 of the Code.)

Rule 102—Integrity and objectivity. A member shall not knowingly misrepresent facts, and when engaged in the practice of public accounting, including the rendering of tax and management advisory services, shall not subordinate his judgment to others.¹⁶ In tax practice, a member may resolve doubt in favor of his client as long as there is reasonable support for his position.¹⁷

Competence and technical standards

Rule 201—Competence. A member shall not undertake any engagement which he or his firm cannot reasonably expect to complete with professional competence.¹⁸ (See Interpretation 201-1, page 34 of the Code.)

¹³ Opinion No. 19.

¹⁴ Rule 1.01 (present Rule 1.01 uses the phrase "key employee").

¹⁵ Prior rulings. In order that a member may arrange an orderly transition of his relationship with clients, section B2 of Rule 101 relating to trusteeships and executorships will not become effective until two years following the adoption of these Rules of Conduct.

¹⁶ New.

¹⁷ Opinion No. 13.

¹⁸ New.

Rule 202—Auditing standards. A member shall not permit his name to be associated with financial statements in such a manner as to imply that he is acting as an independent public accountant unless he has complied with the applicable generally accepted auditing standards* promulgated by the Institute. Statements on Auditing Procedure issued by the Institute's committee on auditing procedure are, for purposes of this rule, considered to be interpretations of the generally accepted auditing standards, and departures from such statements must be justified by those who do not follow them.¹⁹

Rule 203—Accounting principles. A member shall not express an opinion that financial statements are presented in conformity with generally accepted accounting principles if such statements contain any departure from an accounting principle promulgated by the body designated by Council to establish such principles which has a material effect on the statements taken as a whole, unless the member can demonstrate that due to unusual circumstances the financial statements would otherwise have been misleading. In such cases his report must describe the departure, the approximate effects thereof, if practicable, and the reasons why compliance with the principle would result in a misleading statement.²⁰ (See Interpretation 203-1, page 35 of the Code.)

Rule 204—Forecasts. A member shall not permit his name to be used in conjunction with any forecast of future transactions in a manner which may lead to the belief that the member vouches for the achievability of the forecast.²¹ (See Interpretation 204-1, page 36 of the Code.)

Responsibilities to clients

Rule 301—Confidential client information. A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client.²²

This rule shall not be construed (a) to relieve a member of his obligation under Rules 202 and 203, (b) to affect in any way his compliance with a validly issued subpoena or summons enforceable by order of a court, (c) to prohibit review of a member's professional practices as a part of voluntary quality review under Institute authorization or (d) to preclude a member from responding to any inquiry made by the ethics

* Ten generally accepted auditing standards are listed in Appendix A, page 26 of the Code.

¹⁹ New (replaces Rules 2.01-2.03).

²⁰ New (replaces Rules 2.01-2.03).

²¹ Restatement of Rule 2.04.

²² Restatement of Rule 1.03.

division or Trial Board of the Institute, by a duly constituted investigative or disciplinary body of a state CPA society, or under state statutes.²³

Members of the ethics division and Trial Board of the Institute and professional practice reviewers under Institute authorization shall not disclose any confidential client information which comes to their attention from members in disciplinary proceedings or otherwise in carrying out their official responsibilities. However, this prohibition shall not restrict the exchange of information with an aforementioned duly constituted investigative or disciplinary body.²⁴ (See Interpretation 301-1, page 36 of the Code.)

Rule 302—Contingent fees.²⁵ Professional services shall not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is attained, or where the fee is otherwise contingent upon the findings or results of such services. However, a member's fees may vary depending, for example, on the complexity of the service rendered.²⁶

Fees are not regarded as being contingent if fixed by courts or other public authorities or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies.²⁷

Responsibilities to colleagues

Rule 401—Encroachment.²⁸ A member shall not endeavor to provide a person or entity with a professional service which is currently provided by another public accountant except:

1. He may respond to a request for a proposal to render services and may furnish service to those who request it.²⁹ However, if an audit client of another independent public accountant requests a member to provide professional advice on accounting or auditing matters in connection with an expression of opinion on financial statements, the member must first consult with the other accountant to ascertain that the member is aware of all the available relevant facts.³⁰

2. Where a member is required to express an opinion on combined or consolidated financial statements which include a subsidiary, branch or other component audited by another in-

²³ Prior rulings.

²⁴ New.

²⁵ Restatement of Rule 1.04.

²⁶ New.

²⁷ Rule 1.04.

²⁸ Restatement of Rule 5.01.

²⁹ Rule 5.01.

³⁰ New.

dependent public accountant, he may insist on auditing any such component which in his judgment is necessary to warrant the expression of his opinion.³¹

A member who receives an engagement for services by referral from another public accountant shall not accept the client's request to extend his service beyond the specific engagement without first notifying the referring accountant, nor shall he seek to obtain any additional engagement from the client.³² (See Interpretations 401-1 and 401-2, page 37 of the Code.)

Rule 402—Offers of employment. A member in public practice shall not make a direct or indirect offer of employment to an employee of another public accountant on his own behalf or that of his client without first informing such accountant. This rule shall not apply if the employee of his own initiative or in response to a public advertisement applies for employment.³³

Other responsibilities and practices

Rule 501—Acts discreditable. A member shall not commit an act discreditable to the profession.³⁴

Rule 502—Solicitation and advertising. A member shall not seek to obtain clients by solicitation.³⁵ Advertising is a form of solicitation and is prohibited.³⁶ (See Interpretations 502-1 to -14, pages 37-42 of the Code.)

Rule 503—Commissions. A member shall not pay a commission to obtain a client, nor shall he accept a commission for a referral to a client of products or services of others.³⁷ This rule shall not prohibit payments for the purchase of an accounting practice³⁸ or retirement payments to individuals formerly engaged in the practice of public accounting or payments to their heirs or estates.³⁹ (See Interpretation 503-1, page 42 of the Code.)

Rule 504—Incompatible occupations. A member who is engaged in the practice of public accounting shall not concurrently engage in any business or occupation which impairs

³¹ Opinion No. 20.

³² Rule 5.02 restated to include prior rulings.

³³ Rule 5.03, "or that of his client" added.

³⁴ Rule 1.02.

³⁵ Rule 3.02.

³⁶ Rule 3.01.

³⁷ Restatement of Rule 3.04.

³⁸ Prior rulings.

³⁹ Opinion No. 6.

his objectivity in rendering professional services or serves as a feeder to his practice.⁴⁰

Rule 505—Form of practice and name. A member may practice public accounting, whether as an owner or employee, only in the form of a proprietorship, a partnership or a professional corporation whose characteristics conform to resolutions of Council.⁴¹ (See Appendix B, page 28 of the Code.)

A member shall not practice under a firm name which includes any fictitious name, indicates specialization or is misleading as to the type of organization (proprietorship, partnership or corporation).⁴² However, names of one or more past partners or shareholders may be included in the firm name of a successor partnership or corporation.⁴³ Also, a partner surviving the death or withdrawal of all other partners may continue to practice under the partnership name for up to two years after becoming a sole practitioner.⁴⁴

A firm may not designate itself as "Members of the American Institute of Certified Public Accountants" unless all of its partners or shareholders are members of the Institute.⁴⁵ (See Interpretation 505-1, page 43 of the Code.)

⁴⁰ Restatement of Rule 4.04.

⁴¹ Rule 4.06.

⁴² Prior rulings.

⁴³ Rule 4.02.

⁴⁴ Prior rulings.

⁴⁵ Rule 4.01.

Discussion of Restated Code

- Q.** Why was it felt necessary to submit the proposed Code as a package, when some members, while favoring the Restatement in principle, might disapprove of one or another proposed rule or section thereof?
- A.** While the proposed restatement has retained substantial parts of the present Code and Opinions of the Ethics Division in reorganized form, it was developed as a unit and consists of interrelated rules. It would be impracticable, therefore, to ask the members to vote on the restatement section by section since the rejection of some key provisions, while other related provisions were approved, would lead to a totally unworkable statement of ethical standards.
- Q.** The proposed rules relating to technical standards incorporate by reference the ten generally accepted auditing standards and pronouncements of the body designated by Council to establish accounting principles. Are not the members being asked to relinquish their rights under Article VIII of the bylaws to vote on any change in the technical standards by which they will be judged?
- A.** Any amendment to the technical standards rules of the Restated Code would have to be submitted to the membership for approval. Although the Restated Code incorporates the profession's technical standards in a more positive way than does the present Code, standard-setting pronouncements are the product of long study by responsible practitioners, and become final only after completion of extensive discussion and exposure through which the membership can influence the final product.
- Q.** Will not the new relationships set out in Rule 101 as impairing independence (material joint closely-held business investments with a client or its management, loans to or from a client or its management, trusteeships of pension or

profit-sharing trusts and certain other trusteeships and executorships) cause unreasonable hardship since they cover activities performed by a number of practitioners?

- A. The independence rule does not prohibit these relationships. It simply provides that a member whose activities fall within the scope of the rule would be considered to be lacking in independence for audit purposes. The proscriptions in the rule have no effect on tax, management advisory or other accounting services. Further, the relationships cited are considered by the Institute's ethics committee and governmental regulatory agencies to impair independence even under the present independence rule.
- Q. Would not the rule on competence deter smaller practitioners from accepting engagements in unfamiliar situations?
- A. Wholly apart from the requirements of the Code, a CPA offering his services to the public is understood as holding himself out as possessing the degree of skill commonly possessed by others in the profession—in other words, that he is competent to perform the service. Proposed Rule 201 and its companion Interpretation 201-1 do not alter this legal responsibility. Interpretation 201-1 makes clear that competence can be gained both before *and during* an engagement through research or consultation.
- Q. Wasn't a rule requiring adherence to APB Opinions rejected by the membership a few years ago? Why is it felt necessary to propose this requirement again?
- A. The proposal in 1967 to require disclosure of departures from APB Opinions failed by only a fraction of a percent to gain the required two-thirds vote. It differed from proposed Rule 203 in several respects: (1) it distinguished between generally accepted accounting principles—those espoused by the APB and others also having substantial authoritative support, (2) it offered no guidance as to when an APB Opinion should be followed and when another treatment having substantial authoritative support should be used—and (3) it gave no indication of how substantial authoritative support was to be determined.

In the restatement committee's view, the time has come for the profession to lend concrete support to the recognized standards-setting bodies. Proposed Rule 203 and Interpretation 203-1 recognize that courts have tested accountants not only by whether they have observed professional standards but also by whether financial statements with which they are associated are misleading. Thus the

proposed rule supports compliance with accounting principles promulgated by the body designated by Council to establish such principles, but provides also for the full exercise of professional judgment as to whether such compliance would result in misleading statements.

- Q.** It has been suggested that the profession become more active in the forecasting of future events. Is not the proposed rule on forecasts inconsistent with the acceptance of a broader responsibility in this area?
- A.** Rule 204 simply prohibits a member from vouching for the achievability of the forecast. Interpretation 204-1 makes clear that the rule does not prohibit a member from preparing forecasts, and offers specific guidelines which must be followed in such an engagement.
- Q.** Does not Rule 401, which permits a member to insist on auditing additional components before expressing his opinion on consolidated financial statements, appear to encourage improper displacement of practitioners?
- A.** The proposed rule was intended as a recognition of existing technical standards and will be interpreted in the light of Statement on Auditing Procedure 45. Paragraph 2 of SAP 45 sets forth the criteria to be considered before the role of principal auditor is assumed and paragraph 10 indicates steps to be taken by the principal auditor who relies on the work of another. Further, Interpretation 401-2 makes clear that insistence on auditing an unreasonably large portion of consolidated financial statements could be held to violate the encroachment rule.
- Q.** Since referral fees are an established practice in many professions, why was it felt necessary to prohibit them in proposed Rule 503?
- A.** The restatement committee's review of codes of other professions indicated that payments to other practitioners for a referral when no service was rendered were uniformly disapproved. Like all other rules in the proposed restatement, Rule 503 must be read in conjunction with the interpretation of the ethics committee. Interpretation 503-1 states clearly that Rule 503 was adopted to avoid a client's having to pay fees for which he does not receive commensurate services and that the rule does not prohibit payment of fees to a referring accountant for services to the successor firm or to the client.