

1998

Omnibus proposal of Professional Ethics Division interpretations and rulings

American Institute of Certified Public Accountants. Professional Ethics Executive Committee

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EXPOSURE DRAFT

OMNIBUS PROPOSAL OF PROFESSIONAL ETHICS DIVISION INTERPRETATIONS AND RULINGS

■ PROPOSED REVISION OF THE DEFINITION OF *CLIENT* UNDER ET SECTION 92
■ PROPOSED REVISION OF INTERPRETATION 101-2 UNDER RULE 101: Former
Practitioners and Firm Independence ■ PROPOSED REVISION OF RULING NO. 191
UNDER RULE 501 AND RULING NO. 22 UNDER RULE 301: Member Removing Client
Files From an Accounting Firm ■ PROPOSED INTERPRETATION UNDER RULE 101: The
Effect of Alternative Practice Structures on the Applicability of Independence Rules ■
PROPOSED REVISION OF ET SECTION 91.02, Applicability ■ PROPOSED REVISION
OF INTERPRETATION 505-2 UNDER RULE 505: Application of Rules of Conduct to
Members Who Operate *Own* a Separate Business ■ PROPOSED INTERPRETATION
UNDER RULE 505: Application of Rule 505 to Alternative Practice Structures

APRIL 15, 1998

**Prepared by the AICPA Professional Ethics Executive Committee for comments from
persons interested in independence, behavioral, and technical standards matters**

**Comments should be received by July 15, 1998, and addressed to
Herbert A. Finkston, Director, Professional Ethics Division,
AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.**

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Any individual or organization may obtain one copy of this document without charge until the end of the comment period by writing to the AICPA Order Department, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881.

April 15, 1998

This exposure draft contains seven proposals for review and comment by the AICPA's membership and other interested parties regarding pronouncements to be adopted by the Professional Ethics Executive Committee. The text and an explanation of each proposed pronouncement are included in this exposure draft.

A summary does not accompany this exposure draft; instead, the type of information a summary would contain is included in the "Explanation" preceding each proposal.

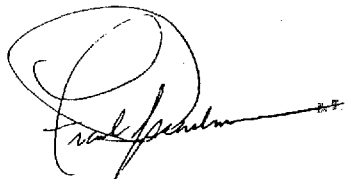
After the exposure period is concluded and the comments have been evaluated by the Professional Ethics Executive Committee, the committee may decide to publish one or more of the proposed pronouncements. Once published, the pronouncements become effective on the last day of the month in which they are published in the *Journal of Accountancy*, except as may otherwise be stated in the pronouncements.

Your comments are an important part of the standard-setting process. Please take this opportunity to comment. Responses must be received at the AICPA by July 15, 1998. All written replies to this exposure draft will become part of the public record of the AICPA and will be available for inspection at the office of the AICPA after August 31, 1998, for a period of one year.

All comments received will be considered by the Professional Ethics Executive Committee at an open meeting. Once scheduled, notice of the meeting will be published in the *CPA Letter* and on the Institute's Web site at <http://www.aicpa.org/members/div/ethics/index.htm>.

Please send comments to Herbert A. Finkston, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or hfinkston@aicpa.org.

Sincerely,



Frank J. Pearlman
Chair
AICPA Professional Ethics
Executive Committee



Herbert A. Finkston
Director
AICPA Professional
Ethics Division

PROPOSED REVISION OF THE DEFINITION OF *CLIENT* UNDER ET SECTION 92

[*Explanation*]

The Professional Ethics Executive Committee is proposing to revise the current definition of the practice of public accounting to include, under certain circumstances, AICPA members who are employed by federal, state, and local governments. To accomplish this, the term “client,” an element of the public practice definition, requires revision (see ET sections 92.01 and 92.09). Should this proposal be adopted, government auditors who are within the proposed criteria listed below would be permitted to issue audit reports under generally accepted auditing standards (GAAS) provided they comply with Rule 101, *Independence*, its interpretations and rulings, and other code rules that apply to AICPA members in public practice.

[*Text of Proposed Revision of the Definition of “Client”*]¹

.01 Client. A client is any person or entity, other than the member’s employer, that engages a member or a member’s firm to perform professional services or a person or entity with respect to which professional services are performed. ~~The term “employer” for these purposes does not include those entities engaged in the practice of public accounting.~~

For purposes of this paragraph, the term “employer” does not include:

- a. *Entities engaged in the practice of public accounting; or*
- b. *Federal, state, and local governments or component units thereof provided the member performing professional services with respect to those entities:*
 - i. *Is directly elected by voters of the government or component unit thereof with respect to which professional services are performed; or*
 - ii. *Is an individual who is (1) appointed by a legislative body, and (2) subject to removal by a legislative body; or*
 - iii. *Is appointed by someone other than the legislative body, so long as the appointment is confirmed by the legislative body and removal is subject to oversight or approval by the legislative body.*

¹Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

PROPOSED REVISION OF INTERPRETATION 101-2 UNDER RULE 101

[*Explanation*]

The Professional Ethics Executive Committee is proposing a revision of Interpretation 101-2 under Rule 101, *Independence* [ET section 101.04], relating to the conditions to be met for a former owner of a firm to no longer be subject to the independence rules. The revision being proposed deals with the circumstances in which amounts due to the former owner for his or her interest in the firm and for unfunded, vested retirement benefits are paid by the firm.

[*Text of Proposed Revision of Interpretation 101-2*]¹

Former Practitioners and Firm Independence

For purposes of this interpretation, a former practitioner is defined as a proprietor, partner, shareholder, or equivalent who leaves by resignation, termination, retirement, or sale of all or part of the practice.

For purposes of determining a firm's compliance with rule 101 and its interpretations, a former practitioner is not included in the term "a member or a member's firm" (see ethics interpretation 101-9, ET section 101.11) provided that

1. ~~A written agreement exists whereby the P~~payments of the amounts due to the former practitioner for his or her interest in the firm and for unfunded, vested retirement benefits ~~according to the payment schedule in effect should be such that they do~~ *are* not cause a ~~substantial doubt about the firm's ability to continue as a going concern for a reasonable period of time; material to the firm, and the underlying formula used to calculate the payments remains fixed during the payout period. In addition, such amounts including all retirement benefits should be fixed, both as to the amount and payment dates. Such amounts due a former practitioner may be paid over a reasonable period of time, and a reasonable rate of interest may be paid on any unpaid balances. Retirement benefits may be adjusted only for inflation.~~
2. The former practitioner does not participate in the firm's business or professional activities whether or not compensated for such participation. This proscription does not apply to consultations on an advisory basis for a reasonable period of time during the transition period upon leaving the firm.

¹Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

3. The former practitioner does not appear to participate in the activities of or be associated with his or her former firm. An appearance of participation or association results from such actions as inclusion of the former practitioner's name under the firm's name in an office building directory, inclusion of the former practitioner's name as a member of the firm in membership lists of business, professional or civic organizations, or inclusion of the former practitioner's name in the firm's internal directory without being designated as retired. The former practitioner will not be considered as participating or associating with his or her former firm solely because the former practitioner is provided an office, either in the firm's suite or in a separate location, and related office amenities such as secretarial and telephone services. (However, see 4. below for restrictions regarding office space and amenities for a former practitioner who accepts a position of significant influence with a client.)

4. A former practitioner in a position of significant influence with the client must no longer be provided with office space and related amenities by his or her former firm.

**PROPOSED REVISION OF RULING NO. 191
UNDER RULE 501 AND RULING NO. 22
UNDER RULE 301**

[Explanation]

The Professional Ethics Executive Committee proposes to revise current ethics ruling no. 191 under rule 501 [ET section 591.381-.382] and ruling no. 22 under rule 301 [ET section 391.043-.044] because the application of the ruling to owners of a firm is a legal issue.

[Text of Proposed Revision of Ruling No. 191 and Ruling No. 22]¹

Member Removing Client Files From an Accounting Firm

Question--If the relationship of a member who is not an owner of a firm is terminated ~~his or her relationship with a firm,~~ may he or she take or retain originals or copies from the firm's client files or proprietary information without the firm's permission?

Answer--No, except where permitted by contractual arrangement. ~~If, upon leaving the firm, the member takes any of the firm's client files or proprietary information without permission, the member would be committing an act discreditable to the profession in violation of rule 501 [ET section 501.01].~~

If the member provides originals or copies of the firm's client files, records, or workpapers to another firm without the prior specific consent of each client, the member would also be in violation of Rule 301, *Confidential Client Information* [ET section 301.01].

¹Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

[*Explanation*]

The following four ethics pronouncements are being proposed by the Professional Ethics Executive Committee to clarify the application of the Code of Professional Conduct to members who choose to practice public accounting in various alternative forms. The pronouncements include interpretations of Rule 101, *Independence*, and Rule 505, *Form of Organization and Name*, and revisions of Interpretation 505-2 and ET section 91, *Applicability*. The revision to Interpretation 505-2 is proposed to ensure that members who practice in an alternative practice structure are not permitted to act in a manner in which members who practice in a traditional structure cannot. The Committee believes that adoption of the proposed pronouncements, together with existing quality control and practice monitoring requirements, would provide adequate safeguards to protect the public interest and the reputation of the profession and ensure the equitable application and enforcement of the Code of Professional Conduct among members.

PROPOSED INTERPRETATION UNDER RULE 101

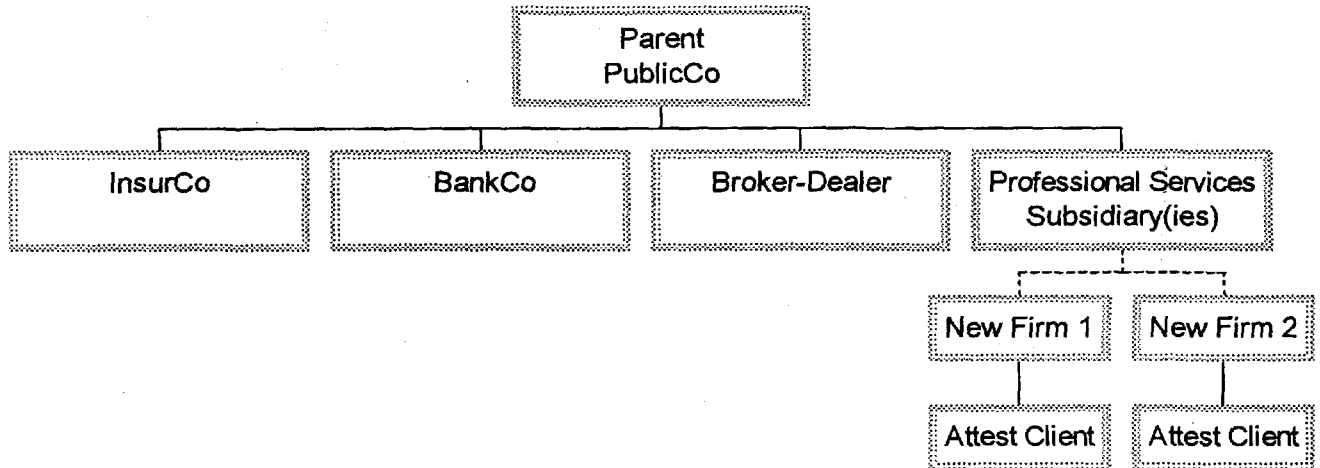
[*Text of Proposed Interpretation Under Rule 101*]

The Effect of Alternative Practice Structures on the Applicability of Independence Rules

Generally, Rule 101, *Independence*, and the related interpretations and rulings (the "independence rules") apply only to a "member or member's firm" as that term is defined in Interpretation 101-9 [ET section 101.11]. This interpretation redefines the term "member or member's firm" for the purpose of an alternative practice structure ("APS") and identifies additional persons and entities to which some of the independence rules apply in an APS.

The APS contemplated by this interpretation is one where an existing CPA firm ("Oldfirm") is sold by its owners to another (possibly public) entity ("PublicCo"). PublicCo has subsidiaries or divisions such as a bank, insurance company, or broker-dealer, and it also has one or more professional services subsidiaries or divisions that offer to clients nonattest services contemplated in the practice of public accounting. Those services are provided by the owners and employees of Oldfirm as employees of one of PublicCo's subsidiaries or divisions. In addition, the owners of Oldfirm form a new CPA firm ("Newfirm") to provide attest services. A majority of Newfirm is owned (as to vote and financial interests) by CPAs, including the former owners of Oldfirm. Attest services are performed by Newfirm and are supervised by its owners. The arrangement between Newfirm and PublicCo (or one of its subsidiaries or divisions) includes the lease of employees, office space, and equipment; the performance of back-office functions such as billing and collections; and advertising. For this, Newfirm pays an amount determined as a percentage of revenues or profits. An example of this arrangement is shown in the chart.

ALTERNATIVE PRACTICE STRUCTURE (APS) MODEL



Application of Independence Rules

1. The term member and member's firm ("Member") in an APS includes any person or entity included in the definition of Member in Interpretation 101-9 [ET section 101.11]. In addition, the definition of Member in an APS also includes the individuals who directly supervise or directly control ("Immediate Superiors") the activities of one or more of (a) the owners of Newfirm or (b) the individuals with a managerial position located in an office participating in a significant portion of an engagement (including leased managerial employees), and the entity or entities within PublicCo in which such Immediate Superiors have a managerial position.
2. Generally, owners of one Newfirm would not be considered Members with respect to the attest clients of another Newfirm except in situations where those owners perform services for the other Newfirm. If, for example, owners of Newfirm 1 perform services in Newfirm 2, such owners would be considered to be owners of both Newfirms for purposes of applying the independence rules. Similarly, individuals with a managerial position (leased or otherwise) in one office (which, for the purpose of this discussion, may be an entire Newfirm) may, at times, be considered to also have a managerial position in another office. Judgment should be applied in determining whether or not an individual should be considered a managerial individual in more than one office. Factors to consider would include the attributes of a managerial position as stated in Interpretation 101-9 and the amount of time the individual devotes to such a role in each office. For example, if the individual spends 90 percent of his or her time in one office performing a managerial role and 10 percent in another, that individual would likely be viewed as having a managerial position in only one office.
3. PublicCo and its subsidiaries and divisions (other than those included in Member) and individuals (other than those included in Member) who indirectly supervise, indirectly control, or could be perceived as influencing the actions of Member:
 - A. May not have a relationship contemplated by Interpretation 101-1.A with an attest client of Newfirm that is material. Further, any investment held by such individual or entity should not allow the investor to exercise significant influence over the attest client. In making the two tests (materiality and significant influence) for investments of an individual, all the investments in an attest client held by the individual should be aggregated and, to determine materiality, assessed in relation to the individual's net worth. In making the two tests for investments of PublicCo and its subsidiaries and divisions, all the investments in an attest client held by such entities should be aggregated and, to determine materiality, assessed in relation to the consolidated financial statements of PublicCo.
 - B. May not be connected with an attest client of Newfirm as a promoter, underwriter, voting trustee, director, or officer.

4. PublicCo and its subsidiaries and divisions and the employees of such entities (other than an entity or individual included in Member) generally are not precluded from providing services to an attest client of Newfirm that would impair independence if performed by Member. For example, trustee and asset custodial services in the ordinary course of business by a bank subsidiary of PublicCo would be acceptable as long as the bank was not included in the definition of Member. Bookkeeping services also would be acceptable by an entity not included in the definition of Member (if such entity issued a report on the financial statements for which it kept the books, it could only be a compilation report indicating a lack of independence).

PROPOSED REVISION OF ET SECTION 91.02, Applicability

[Text of Proposed Revision of ET Section 91.02, Applicability]¹

.02 Interpretation Addressing the Applicability of the AICPA Code of Professional Conduct. For purposes of the applicability section of the Code, a “member” is a member or international associate of the American Institute of CPAs.

1. The Rules of Conduct that follow apply to all professional services performed 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 discipline for departing from any of the rules stated herein as long as the member’s conduct is in accord with the rules of the organized accounting profession in the country in which he or she is practicing. However, where a member’s name is associated with financial statements under circumstances that would entitle the reader to assume that United States practices were followed, the member must comply with the requirements of rules 202 [ET section 202.01] and 203 [ET section 203.01].
2. *A member shall not knowingly permit a person, whom the member has the authority or capacity to control, to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the rules. Further, a member may be held responsible, even without knowledge, for the acts of compliance with the rules by all persons associated with him or her in the practice of public accounting whom the member has the authority or capacity to control who are either under the member’s supervision or are the member’s partners or shareholders in the practice.*
3. ~~A member shall not permit others to carry out on his or her behalf, either with or without compensation, acts which, if carried out by the member, would place the member in violation of the rules.~~

¹Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

PROPOSED REVISION OF INTERPRETATION 505-2 UNDER RULE 505

[Text of Proposed Revision of Interpretation 505-2]¹

Application of Rules of Conduct to Members Who Operate Own a Separate Business

A member in the practice of public accounting may ~~participate in the operation of~~ *own an interest in* a separate business that performs for clients any of the professional services of accounting, tax, personal financial planning, litigation support services, and those services for which standards are promulgated by bodies designated by Council (see ET section 92.09). ~~Such a member~~ *If the member is actively involved in the separate business, he or she* is considered to be in the practice of public accounting in connection with the separate business and must observe all of the Rules of Conduct. *In addition, a determination must be made as to whether the member controls the separate business to determine whether the separate business, its other owners, and its employees are subject to the Rules of Conduct. In general, if the member controls the separate business, the entity, its other owners, and its employees must comply with all of the provisions of the Code (the member will be held accountable under the Applicability section, ET 91). If the member does not control the separate business, the provisions of the Code would not apply to the entity, its other owners, and its employees. For example, the entity could enter into a contingent fee arrangement with an attest client of the member or accept commissions for the referral of products or services to such attest client.*

For the purpose of applying Rule 101, Independence, a determination also must be made as to whether the separate business is included in the definition of "member or member's firm" generally through control as described in item 4 of that definition (see ET section 101.11). If the separate business is included in that definition, rule 101 and all its interpretations and rulings would apply to the separate business, its owners, and its employees the same as prescribed in ET section 101.11 for the member's firm and, if violated, the member's independence would be considered to be impaired.

A member who is not otherwise in the practice of public accounting must observe the Rules of Conduct in the operation of the separate business if the member holds out as a CPA and performs for a client any of the professional services included in the definition of the practice of public accounting (see ET section 92.09).

¹Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

PROPOSED INTERPRETATION UNDER RULE 505

[Text of Proposed Interpretation Under Rule 505]

Application of Rule 505 to Alternative Practice Structures

Rule 505, *Form of Organization and Name*, states, "A member may practice public accounting only in a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council." The Council Resolution (the "Resolution") requires, among other things, that a majority of the financial interests in a firm engaged in attest services (as defined therein) be owned by CPAs. In the context of Alternative Practice Structures ("APS"), questions have arisen as to how the majority of financial interests are owned by CPAs when all or substantially all of its revenues are paid to another entity in return for services and the lease of employees, equipment, and office space. (See Interpretation 101-XX for a description of an APS.)

The overriding focus of the Resolution is that CPAs remain responsible, financially and otherwise, for the attest work performed to protect the public interest. The Resolution contains many requirements that were developed to ensure that responsibility. In addition to the provisions of the Resolution, other requirements of the Code of Professional Conduct and Bylaws ensure that responsibility.

- a. Compliance with all aspects of applicable state law or regulation
- b. Enrollment in an AICPA-approved practice monitoring program
- c. Membership in the SEC Practice Section if the attest work is for SEC clients (as defined by Council)
- d. Compliance with the independence rules prescribed by Rule 101, *Independence*, including the provisions applicable to APSs (see Interpretation 101-XX)
- e. Compliance with applicable standards promulgated by Council-designated bodies (Rule 202, *Compliance With Standards*) and all other provisions of the Code, including ET section 91, *Applicability*

Taken in the context of all the above-mentioned safeguards of the public interest, if the CPAs who own the attest firm remain financially responsible, under applicable state law or regulation, the member is considered to be in compliance with the financial interests provision of the Resolution.