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 INTERPRETATION 101:9 UNDER RULE 101: The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence [Definition of Member or Member's Firm]
- PROPOSED REVISION OF INTERPRETATION 501:1 UNDER RULE 501: Retention of Client Records
- PROPOSED REVISION TO RULING 41 UNDER RULE 101: Member as Auditor of a Financial Services Company that Manages Member's Assets
- PROPOSED REVISION TO RULING 109 UNDER RULE 101: Member's Investment in Financial Services Products That Invest in Clients
- PROPOSED RULING UNDER RULE 101: Employee Benefit Plan Sponsored by Client

August 2, 1999

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 October 1, 1999, and addressed to Lisa A. Snyder, Director, Professional Ethics Division, AICPA, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or lsnyder@aicpa.org
August 2, 1999

This exposure draft contains five 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 kind 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 October 1, 1999. 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 November 1, 1999, 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 Lisa A. Snyder, Director, AICPA Professional Ethics Division, Harborside Financial Center, 201 Plaza Three, Jersey City, NJ 07311-3881 or lsnyder@aicpa.org.

Sincerely,

Frank J. Pearlman  
Chair  
AICPA Professional Ethics Executive Committee

Lisa A. Snyder  
Director  
AICPA Professional Ethics Division

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PROPOSED REVISION OF INTERPRETATION 101-9
UNDER RULE 101

[Explanation]

The Professional Ethics Executive Committee is proposing a revision to the definition of Member or Member’s Firm in Interpretation 101-9 under rule 101, Independence [AICPA, Professional Standards, vol. 2, ET sec. 101.11]. The proposed revision provides guidance to individuals when disassociating from a firm client to become a member of the firm so that the individual and the firm’s independence would not be impaired.

[Text of Proposed Revision of Interpretation 101-9, Definition of “Member or Member’s Firm”]

The Meaning of Certain Independence Terminology and the Effect of Family Relationships on Independence

This Interpretation defines certain terms used in Interpretation 101-1 [ET section 101.02] and, in doing so, also explains how independence may be impaired through certain family relationships.

Member or Member’s Firm

A member (as used in rule 101 [ET section 101.01]) and a member or a member’s firm (as used in interpretation 101-1 [ET section 101.02]) include—

1. The member’s firm and its proprietors, partners, or shareholders. A member’s firm is defined as a form of organization permitted by state law or regulation whose characteristics conform to resolutions of Council that is engaged in the practice of public accounting, including the individual owners thereof.

2. All individuals³ participating in the engagement, except those who perform only routine clerical functions, such as typing and photocopying.

3. All individuals³ with a managerial position located in an office participating in a significant portion of the engagement.

4. Any entity (for example, a partnership, corporation, trust, joint venture, or pool) whose operating, financial, or accounting policies can be controlled (see definition of control for consolidation purposes in Financial Accounting Standards Board [FASB] Statement No. 94 [AC section C51]) by one or more of the persons described in (1) through (3) or by two or more such persons if they choose to act together.

³ Strike-through denotes proposed deletions to current text. Proposed new language is in italic.

³ Refers to all employees of the member and all contractors retained by the member, except specialists as discussed in SAS No. 3 [AU section 336], irrespective of their functional classification (for example, audit, tax, or management consulting services).
A member or a member’s firm does not include an individual solely because he or she was formerly associated with the client in any capacity described in interpretation 101-1B [ET section 101.02], if such individual has disassociated himself or herself from the client and does not participate in the engagement for the client covering any period of his or her association with the client.

5. A member or a member’s firm includes all individuals who provide services to clients and are associated with the client in any capacity described in interpretation 101-1B [ET section 101.02], if the individuals are located in an office participating in a significant portion of the engagement.

A member or a member’s firm does not include an individual solely because he or she was formerly associated with the client in any capacity described in interpretation 101-1B [ET section 101.02], if the individual has disassociated himself or herself from the client and does not participate in the engagement requiring independence for the client covering any period of his or her association with the client. For all other firm clients, such individuals should immediately comply with rule 101 and its interpretations and rulings in the performance of any services requiring independence.

The following actions should be taken by an individual to disassociate from the client prior to becoming a member through employment, ownership, or merger so that the member or member’s firm’s independence will not be impaired with respect to such client.

1. Terminate any relationship with the client as described under Interpretation 101-1-B [ET section 101.02].

2. Dispose of any direct or material indirect financial interest in the client.

3. Collect or repay all loans to or from the client unless specifically permitted or grandfathered under Interpretation 101-5.

4. Cease active participation in and withdraw from health or welfare plans sponsored by the client, unless the client is legally required to allow the member to participate in the plan (for example, COBRA) and the member pays 100 percent of the premiums on a current basis.

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3 Refers to all employees of the member and all contractors retained by the member, except specialists as discussed in SAS No. 73, AU sec. 336, irrespective of their functional classification (for example, audit, tax, or management consulting services).

4 For example, see Ethics Ruling No. 66, Member’s Retirement or Savings Plan Has Financial Interest in Client [ET section 191.132 through .133]

5 See Ethics Ruling No. 107, “Participation in Health and Welfare Plan of Client,” [ET section 191.214 through .215] for instances in which participation was the result of permitted employment by the member’s spouse or cohabitant.
5. Cease making contributions to any benefit plans sponsored by the client, other than those identified in item 4 above, and terminate any management or trustee relationships with any of the benefit plans sponsored the client.

6. Liquidate or transfer all vested benefits in the client's defined benefit plans, defined contribution plans, and deferred compensation arrangements where the liability is reflected in the client's financial statements, at the earliest possible date. When the right of possession does not exist and the indirect financial interest in the client through plan investments is immaterial to the member, independence of the member's firm would not be considered to be impaired, provided that the member does not participate in the engagement. The right of possession is not considered to exist if either of the following occur.

- A penalty significant to the benefits is imposed upon liquidation or transfer.⁶

- The member is unable to complete a timely liquidation or transfer due solely to the administrative requirements of the plan (for example, certain plans may only permit payments on a quarterly or semiannual basis, or upon attaining a certain age).

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⁶ Participation in the engagement includes any partner or staff member directly involved with providing services requiring independence to the client, as well as those likely to influence the engagement(s).

⁷ A penalty does not include income taxes that would be owed or market losses that may be incurred as a result of the liquidation or transfer.
PROPOSED REVISION OF INTERPRETATION 501-1
UNDER RULE 501

[Explanation]

The Professional Ethics Executive Committee is proposing a revision to Interpretation 501-1 under Rule 501, Acts Discreditable [AICPA, Professional Standards, vol. 2, ET sec. 501.02], to update this guidance to reflect today's electronic environment. The committee believes that a member should provide a client or former client with required information in the format that it is requested (for example, electronic or hard copy) provided it exists in that form. The committee also believes that if the information is requested in a form that does not currently exist, the rules do not prohibit a member from charging a client for the time and cost incurred to convert the information into the requested format.

[Text of Proposed Revision of Interpretation 501-1]

Retention of Client Records

Retention of client records after a demand is made for them is an act discreditable to the profession in violation of rule 501 [ET section 501.01]. The fact that the statutes of the state in which a member practices may grant the member a lien on certain records in his or her possession does not change this ethical standard.

A client's records are any accounting or other records belonging to the client that were provided to the member by or on behalf of the client. If an engagement is terminated prior to completion, the member is required to return only client records.

A member's workpapers, including, but not limited to analyses and schedules prepared by the client at the request of the member, are the member's property, not client records, and need not be made available.

In some instances a member's workpapers contain information that is not reflected in the client's books and records, with the result that the client's financial information is incomplete. This would include (1) adjusting, closing, combining, or consolidating journal entries and, (2) information normally contained in books of original entry and general ledgers or subsidiary ledgers, and (3) tax and depreciation carry forward information. In those instances when an engagement has been completed, such information should also be made available to the client upon request. The information should be provided in the medium in which it is requested, provided it exists in that medium. The member is not required to convert information that is not in electronic format to an electronic form. However, the member may require that all fees due the member, with respect to such completed engagements including the fees for the above services, be paid before such information is provided.

Once the member has complied with the foregoing requirements, he or she need not comply with any subsequent requests to again provide such information.
The Professional Ethics Executive Committee is proposing a revision to ruling no. 41 under Rule 101, *Independence* ([AICPA, Professional Standards, vol. 2, ET sec. 101.11]), to broaden the ruling to apply to all types of financial services companies that provide asset management services for the member or member’s firm. The committee believes that the member’s independence would not be impaired with respect to the financial services company provided the member’s assets are not part of the general assets of the company and all services are provided under the company’s normal terms, procedures, and requirements.

**Text of Proposed Revision to Ruling Under Rule 101**

**Member as Auditor of Insurance a Financial Services Company that Manages Member’s Assets**

**Question**—Contributions made by a member for a member’s assets, including retirement plan for a member and the member’s employees assets are invested and managed by an insurance company (for example, a pooled separate account) and are not part of the general assets of the insurance company (for example, a pooled separate account). For this and similar contracts, would the independence of the member or member’s firm be considered impaired with respect to the financial services company?

**Answer**—Independence of the member or member’s firm would not be considered to be impaired as a result of the member’s investment in the pooled separate account with respect to the financial services company, provided the services are provided under the company’s normal terms, procedures, and requirements and the member is given no special consideration as a result of his or her professional services relationship with the company.

See Ethics Ruling No. 109 under rule 101 [ET section 191.218 -.219] for guidance with respect to a member’s investment in a financial services product that invests in a client.
PROPOSED REVISION TO RULING NO. 109 UNDER RULE 101

[Explanation]

The Professional Ethics Executive Committee is proposing a revision to ruling no. 109 under Rule 101, Independence [AICPA, Professional Standards, vol. 2, ET sec. 101.11], to make it consistent with the proposed revision to ruling no. 41, Member as Auditor of Insurance Company that Manages Member’s Assets. The proposed revision would permit a financial services company client to invest or manage a member’s assets, provided the arrangement is entered into under the same terms as those offered to others.

[Text of Proposed Revision to Ruling Under Rule 101]

Member’s Investment in Financial Services Products That Invest in Clients

Question—Amounts contributed by a member or a member’s firm (member) for investment purposes, including retirement plans, are invested or managed by a non-client financial services company that offers financial services products, for example, insurance contracts and other investment arrangements, which allow the member to direct his or her investment into debt or equity securities. Under what circumstances would the independence of the member be considered to be impaired?

Answer—If the financial services company offering the financial services product is a client, independence would not be considered to be impaired with respect to that client provided that the financial services product is entered into by the member under terms that are the same as those offered to others. (See ethics ruling no. 41 under rule 101 [ET section 191.081-.082] for guidance on a similar arrangement.)

If the member has the ability to direct and does direct his or her investment through a the financial services product into a client, the independence of the member would be considered to be impaired with respect to that client because such an investment is considered to be a direct financial interest in the client as defined under Interpretation 101-1 [ET section 101.02]. If the member does not exercise his or her ability to direct the investment but the financial services product were to invest in a client, such investment would be a direct financial interest in the client and independence would be considered to be impaired.

If the member does not have the ability to direct the investment and the financial services product invests in a client, the member is considered to have an indirect financial interest in the client. If the indirect financial interest becomes material to the member, the member’s independence would be considered to be impaired. (See ethics ruling no. 35 under rule 101 [ET section 191.069-.070] for additional guidance with respect to investments in mutual funds).

Further, an investment in a financial services product that invests only in clients of the member is considered to be a direct financial interest in such client, and the independence would be considered to be impaired.
PROPOSED RULING UNDER RULE 101

[Explanation]

The Professional Ethics Executive Committee proposes the following ethics ruling under Rule 101, Independence [AICPA, Professional Standards, vol. 2, ET sec. 101.11], to provide guidance to AICPA members who provide professional services, such as asset management or investment services, to employee benefit plans sponsored by attest clients. The committee believes that such services generally would impair a member's independence with respect to the benefit plan, however, would only impair independence with respect to the client sponsor in certain circumstances. The committee also believes it is appropriate to differentiate between defined benefit and contribution plans, as defined benefit plans may have a material impact on the sponsor's financial statements.

[Text of Proposed Ruling Under Rule 101]

Employee Benefit Plan Sponsored by Client

Question--A member or member's firm (member) provides asset management or investment services that may include having custody of assets, performing management functions, or making management decisions for an employee benefit plan (the Plan) sponsored by a client. Would the independence of the member be considered to be impaired with respect to the Plan and client sponsor?

Answer--The performance of investment management or custodial services for a Plan sponsored by a client would impair the independence of the member with respect to the Plan. The member's independence would also be considered impaired with respect to the client sponsor of a defined benefit plan if the Plan could have a material impact on the client sponsor's financial statements, unless the assets under management or in the custody of the member are not material to the Plan.

The member's independence would not be considered impaired with respect to the client sponsor of a defined contribution plan provided the member does not make any management decisions or perform management functions on behalf of the client sponsor or have custody of the sponsor's assets.