Independence and ethics developments - 2014/15; Audit risk alerts

American Institute of Certified Public Accountants (AICPA)
Independence and Ethics Developments

2014/15

Independence and Ethics Developments

STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING
Strengthening Audit Integrity
Safeguarding Financial Reporting
Independence and Ethics
Developments

2014/15

Independence and Ethics
Developments

A L E R T

AICPA
STRENGTHENING AUDIT INTEGRITY
SAFEGUARDING FINANCIAL REPORTING
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Recognition

Author
Frank X. Bochanski

AICPA Staff
Liese Faircloth
Technical Manager
Accounting and Auditing Publications

Ellen Goria
Senior Technical Manager
Professional Ethics Division

Feedback

Any comments you have about the alert would be appreciated. You may e-mail these comments to A&APublications@aicpa.org.
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How This Alert Helps You

01 This alert informs you of recent developments in the important areas of independence and ethics for accountants—an area that continues to receive increased attention from regulators, investors, analysts, the news media, and others. This alert helps you understand your professional responsibilities under the AICPA Code of Professional Conduct (the code) and, as applicable, other rule-making and standard-setting bodies.

Current Practice Environment

02 The practice environment continues to be one where regulators, users of financial statements, the business community, and the profession itself have placed increasing emphasis on ethics and independence. Though the SEC and the PCAOB have not issued any specific independence rule changes or guidance in the last few years, they have nonetheless had auditor independence and objectivity clearly in their sights.

03 At the international level, securities regulators, including the SEC, are exchanging ideas on ethics and independence topics through the International Organization of Securities Commissioners. In addition, the International Federation of Accountants (IFAC) through its ethics and independence standards setting body—the International Ethics Standards Board for Accountants (IESBA)—continues to enhance its code. The AICPA participates in the IESBA standard-setting process through its representative on the IESBA and the Professional Ethics Executive Committee (PEEC) closely monitors all standard-setting projects and comments on all IESBA proposals. In such capacity, the AICPA is able to stay abreast of international ethics standard-setting activities, provide thought leadership, and when appropriate, lead convergence projects that are believed to benefit the U.S. accounting profession.

New and Revised AICPA Ethics and Independence Requirements

AICPA Ethics Codification Project—The Revised Code

04 At its January 2014 meeting, the PEEC adopted its final version of the revised AICPA Code of Professional Conduct. This project, which commenced in November 2008, was one of the longest in the PEEC’s recent history, spanning more than six years and consuming a significant amount of resources. The result however is something that AICPA members will find to be extremely useful. PEEC restructured and codified the code so that members and other users of the code can apply the rules and reach appropriate conclusions more easily and intuitively. This effort is referred to as the AICPA Ethics Codification Project.

05 Similar to the recent FASB Codification Project and the Auditing Standards Board’s Clarity Project, the goals of the Ethics Codification Project were to reorganize and reformat the code into a structure that is easier for members and others to use, and will also allow them to reach correct conclusions more quickly and intuitively. In addition, in order to enhance the user's understanding of the code's requirements, the PEEC decided to link certain
nonauthoritative information issued by the AICPA Professional Ethics Division to the related topic in the code.

.06 While the intent of the project was not specifically to revise the code, a substantial amount of the code's content was redrafted using consistent drafting and style conventions in order to clarify the existing guidance as part of the reformatting process. In some cases, the PEEC concluded that the existing guidance should be expanded to make it broader or more understandable. Consequently, some changes to prior guidance were identified in the PEEC exposure draft as substantive changes. These revisions are also specifically noted in the revised code. One of the PEEC's intentional changes was the redrafting of all preexisting ethics rulings as ethics interpretations. Such rulings had historically been drafted in a question and answer format, which typically covered a very narrow and specific set of facts and usually focused on one particular issue. In the revised code, all rulings were redrafted as interpretations and are now codified under their appropriate topics. Furthermore, these new interpretations (or revised rulings) have often been broadened in scope, and thus, will likely be more informative to members. Additionally, the revised code distinguishes rules from interpretations. The following are examples:

- Rule 101, Independence [ET sec. 101.01] is referred to as the "Independence Rule" [ET sec. 1.200.001] in the revised code.
- The content from the ethics ruling entitled "Financial Services Company Client Has Custody of a Member's Assets" [ET sec. 191.081–.082] is incorporated into the "Brokerage and Other Accounts" interpretation [ET sec. 1.255.020] found under the subtopic "Depository, Brokerage, and Other Accounts" [ET sec. 1.255] of the "Independence" topic [ET sec. 1.200].

NOTE: In this alert, referenced rules and interpretations found in both the current code and the version that becomes effective December 15, 2014, will be presented with citations for both versions as follows: "ET sec. XXX; as of December 15, 2014, ET sec. X.XXX." All ET section references are from AICPA, Professional Standards.

.07 The most significant change brought about by the Ethics Codification Project is the incorporation of two new conceptual frameworks, which are discussed in a separate section.

.08 The reformatted code is organized in a manner that allows users to quickly find those requirements that apply to them. It now has four sections, organized by type of user:

- Preface—Provides general information about the code and its structure, contains the broad principles of professional conduct and definitions, and has new guidance on changes to the code and the related effective dates. This section is applicable to all users.
- Part 1: "Members in Public Practice"—Contains all guidance applicable to members in public practice.
- Part 2: "Members in Business"—Contains all guidance applicable to members in business.
Part 3: "Other Members"—Contains all guidance applicable to all other members, such as individuals who are retired or not currently in the workforce.

.09 Similar to the other recent codifications projects mentioned previously, parts 1, 2, and 3 each use an organizational structure that starts with topics, which are then typically broken down by subtopic, which are then broken down by sections, with each subsequent level providing more specific information to the user. After this material, any nonauthoritative information that is applicable to the topic, subtopic, or section is shown in boxed text at the end of the applicable standard. The reformatted code uses a numerical hierarchy similar to that of the FASB Accounting Standards Codification® (ASC), which allows a user to easily locate relevant information. The AICPA's Professional Ethics Division staff has developed a mapping document that will assist members' understanding of where to find various matters in the revised code by showing cross references to the current code.1 This mapping document will also be reproduced in the code for a period.

.10 The effective date of the revised code is December 15, 2014; however, the effective date of the new conceptual frameworks is one year later—December 15, 2015. Members are permitted to implement both the revised code and the conceptual frameworks prior to their effective dates; however, the PEEC decided that members should not implement the relevant conceptual framework prior to implementing the revised code. The revised code will be issued in its electronic format and will be free of charge to all users. It is located at pub.aicpa.org/codeofconduct.

.11 As noted previously, one of the major reasons for undertaking the project was to make the code easier for members to understand and use. Even though that goal has been accomplished, transitioning to the revised code will present some challenges to members. Because the layout and format of the revised code is so different from what members are used to, there will be a learning curve for even the most experienced members. Therefore, members should take steps to become familiar with and test their use of the code prior to the effective dates. It may be advantageous to attend a seminar or take a continuing professional education (CPE) course to enhance your understanding of the code and the conceptual frameworks. Because members in business have not yet had to apply the threats and safeguards approach utilized in the conceptual frameworks, it will be very important for these members to begin to learn how to understand and use the revised code as soon as possible. Please see the "Resource Central" section of this publication for more information on transitioning to the revised code.

Changes to the Conceptual Framework

.12 Since 2006, the Code of Professional Conduct has included a "Conceptual Framework for AICPA Independence Standards,"2 which is used by members when considering independence matters that are not specifically addressed in the code. Please note that the existing conceptual framework should be used only for independence related matters and it does not apply to other

1 www.aicpa.org/InterestAreas/ProfessionalEthics/Community/Pages/ethics-codification-implementation-tools.aspx.
2 ET section 100-1; as of December 15, 2014, ET section 0.400.01.
parts of the code. The existing conceptual framework was based on the risk-based approach that the PEEC and other standard setters typically apply in developing independence standards. The risk-based approach entails evaluating the risk that the member would not be independent, or that the member would be perceived as not independent by a reasonable and informed third party with knowledge of all relevant information. It requires the following three steps:

1. Identify and evaluate potential threats to independence and determine whether those threats are at an acceptable level.
2. Where such threats are not at an acceptable level, the member must consider and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level.
3. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, independence would be considered impaired.

The existing conceptual framework describes and defines seven threats to independence:

- **Self-review threat.** Members reviewing as part of an attest engagement evidence that results from their own or their firm's nonattest work such as, preparing source documents used to generate the client's financial statements.
- **Advocacy threat.** Actions promoting an attest client's interests or position such as promoting the client's securities as part of an initial public offering or representing a client in U.S. tax court.
- **Adverse interest threat.** Actions or interests between the member and the client that are in opposition, such as, commencing, or the expressed intention to commence, litigation by either the client or the member against the other.
- **Familiarity threat.** Members having a close or longstanding relationship with an attest client or knowing individuals or entities (including by reputation) who performed nonattest services for the client, such as a member who performs insufficient audit procedures when reviewing the results of a nonattest service because the service was performed by the member's firm, or a member of the attest engagement team whose close friend is in a key position at the client
- **Undue influence threat.** Attempts by an attest client's management or other interested parties to coerce the member or exercise excessive influence over the member, such as a client's threat to replace the member or the member's firm over a disagreement with client management on the application of an accounting principle, or pressure from the client to reduce necessary audit procedures for the purpose of reducing audit fees
- **Financial self-interest threat.** Potential benefit to a member from a financial interest in, or from some other financial relationship with, an attest client, such as excessive reliance on revenue from a single attest client, or having a material joint venture or other material joint business arrangement with the client
- **Management participation threat.** Taking on the role of client management or otherwise performing management functions on
behalf of an attest client, such as establishing and maintaining internal controls for the client, or hiring, supervising, or terminating the client’s employees.

.14 The existing conceptual framework defines safeguards as "controls that eliminate or reduce threats to independence," and it includes a discussion on the effectiveness of safeguards, as well as an expansive (but not all-inclusive) listing of safeguards that the member may consider applying in the circumstances.

.15 In connection with the Ethics Codification Project discussed above, the PEEC decided that it would be helpful if the code contained guidance on how to address relationships or circumstances that are not addressed in the code but that give rise to threats to rules other than independence. As a result, the PEEC developed two new conceptual frameworks, one for members in business, and another for members in public practice. Both of the new conceptual frameworks are to be used only in situations for which the revised code does not contain a specific rule or requirement; however, failure of a member to apply the conceptual framework in those circumstances will be considered a failure of the member to comply with the code.

.16 The PEEC used an existing nonauthoritative document, the Guide for Complying With Rules 102–505 (the guide), and the existing "Conceptual Framework for AICPA Independence Standards" as starting points when developing these conceptual frameworks for the revised code:

- "Conceptual Framework for Members in Public Practice"3
- "Conceptual Framework for Members in Business"4

.17 The guide outlines a threats and safeguard approach that members can use when evaluating relationships or circumstances that could cause a member to violate the following rules:

- Integrity and Objectivity (Rule 102)
- General Standards (Rule 201)
- Compliance With Standards (Rule 202)
- Accounting Principles (Rule 203)
- Confidential Client Information (Rule 301)
- Contingent Fees (Rule 302)
- Acts Discreditable (Rule 501)
- Advertising and Other Forms of Solicitation (Rule 502)
- Commissions and Referral Fees (Rule 503)
- Form of Organization and Name (Rule 505)

.18 The new "Conceptual Framework for Members in Business" contains six threats as opposed to the seven threats outlined in "Conceptual Framework for Members in Public Practice" because the PEEC determined that the management participation threat would not be relevant to members in business for

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3 ET sec. 1.000.010.
4 ET sec. 2.000.010.
obvious reasons. The new frameworks describe and define those six threats to compliance with the ethics rules, as follows:

- **Adverse interest threat.** The threat that a member will not act with objectivity because the member's interests are opposed to the interests of the employing organization.
- **Advocacy threat.** The threat that a member will promote an employing organization's interests or position to the point that his or her objectivity is compromised.
- **Familiarity threat.** The threat that, due to a long or close relationship with a person or an employing organization, a member will become too sympathetic to their interests or too accepting of the person's work or employing organization's product or service.
- **Self-interest threat.** The threat that a member could benefit, financially or otherwise, from an interest in, or relationship with, the employing organization or persons associated with the employing organization.
- **Self-review threat.** The threat that a member will not evaluate the results of a previous judgment made or service performed or supervised by the member, or an individual in the employing organization, and that the member will rely on that service in forming a judgment as part of another service.
- **Undue influence threat.** The threat that a member will subordinate judgment to that of an individual associated with the employing organization or any relevant third party due to that individual's position, reputation or expertise, aggressive or dominant personality, or attempts to coerce or exercise excessive influence over the member.

.19 Once again, a risk-based approach entails evaluating the risk that the member would not be in compliance with the rules, or would be perceived by a reasonable and informed third party having knowledge of all relevant information as not being in compliance with the rules. The process of applying the new "Conceptual Framework for Members in Business" is the same that is described previously in the three-step process used for independence matters. The member should work through the following steps:

1. Identify and evaluate potential threats to compliance with respect to the relevant rule (Integrity and Objectivity, for example) which result from a specific relationship or circumstance and determine whether those threats are at an acceptable level.
2. Where such threats are not at an acceptable level, the member must consider and apply appropriate safeguards to eliminate the threats or reduce them to an acceptable level.
3. If no safeguards are available to eliminate an unacceptable threat or reduce it to an acceptable level, the rule will be violated, and the member should decline or discontinue the professional services, or resign from the engagement, or in the case of a member in business, resign from the employing organization.

.20 The PEEC has recognized that using the conceptual frameworks may be unfamiliar to many members, especially those in business who may never
have had to use the threats and safeguards approach before. As a result, members have been given an additional year before they will be required to implement the new conceptual frameworks. Furthermore, the AICPA is developing a conceptual frameworks toolkit that will assist members in understanding and applying the conceptual framework concepts to their specific situations. The toolkit is expected to contain checklists, flowcharts, case summaries, and frequently asked questions. It will include examples and materials relevant to members both in public practice and in business. The toolkit is expected to be available in 2015. Check the Ethics Codification Project page for updates at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/Pages/aicpa-ethics-codification-project.aspx.

New Definition—"Partner Equivalent" Under ET Section 92, Definitions

.21 In March 2013, the PEEC adopted a new definition of "partner equivalent" that will be effective for engagements covering periods beginning on or after December 15, 2014. The new definition extends to partner equivalents the independence requirements that are applicable to partners. It was adopted because the PEEC believed that certain individuals who did not meet the definition of partner of a firm (as defined in the code) may have duties, responsibilities or powers with respect to attest engagements that effectively permit them to act as a partner while not legally being a partner.

.22 Under the new definition, a partner equivalent is a professional employee who is not a partner of the firm but who either

a. has the authority to bind the firm to conduct an attest engagement without a partner's approval (for example, the professional employee has the authority to sign or to affix the firm's name to an attest engagement letter or contract to conduct an attest engagement without partner approval), or

b. has the ultimate responsibility for the conduct of an attest engagement, including the authority to sign or affix the firm's name to an attest report or issue, or authorize others to issue, an attest report on behalf of the firm without partner approval.

.23 In adopting the definition, the PEEC indicated its belief that having the authority to bind the firm to a professional service engagement is a partner level responsibility and therefore individuals having such authority are equivalent to partners. The PEEC made a distinction between individuals having partner level powers for attestation engagements versus those who may have such powers with respect to other types of engagements (for example, tax or consulting) because they believed that the risks associated with such engagements were higher.

.24 Members in public practice should consider whether they or other individuals in their firms meet the above definition, and if so, ensure that those individuals are compliant with all AICPA independence requirements that apply to a partner of the firm.

5 The Code of Professional Conduct defines a partner as "a proprietor, shareholder, equity or nonequity partner or any individual who assumes the risks and benefits of firm ownership or is otherwise held out by the firm to be the equivalent of any of the aforementioned."
Revisions to Interpretation No. 101-3—Nonattest Services

Cumulative Effect on Independence When Providing Nonattest Services

.25 The "Nonattest Services" interpretation has provided guidance for many years now to members in public practice concerning the performance of certain services that could be considered to impair independence. It has also been revised numerous times to address new or changing practice issues. Though the guidance in this interpretation has focused on various types of engagements and activities, it has not contained any requirements or specific guidance on the effect that multiple nonattest engagements might have on independence.

.26 In August 2013, the PEEC approved a significant change to the interpretation that will now require a member in public practice to consider the cumulative effect on independence that arises from a member, or a member's firm, performing multiple permitted nonattest services or engagements. The new requirement is effective for engagements covering periods beginning on or after December 15, 2014.

.27 The PEEC has determined that performing multiple nonattest services can increase the significance of the self-review and the management participation threats, as well as other threats to independence. Under the new requirements, it is not sufficient for a member to consider only the threats to independence at the time an engagement to perform a nonattest service begins. Rather, a member is now required to evaluate whether the performance of multiple nonattest services in the aggregate creates a significant threat to the member's independence that cannot be reduced to an acceptable level by the application of the safeguards outlined in the interpretation's general requirements section. In cases where threats are not at an acceptable level, the interpretation requires the member to apply additional safeguards to eliminate the threats, or reduce them to an acceptable level. If the threats cannot be eliminated or reduced to an acceptable level, the member's independence will be impaired.

.28 Under the new guidance, a member is not required to consider the possible independence threats created by any nonattest services that are provided to the member's attest client by other network firms within the member's firm's network.

Certain Services Performed in Connection With an Attest Engagement

.29 The AICPA's Professional Ethics Division has noted for several years now that there has been confusion among members in public practice concerning services that are typically performed in conjunction with an attest engagement, such as preparation of financial statements, cash to accrual conversions, reconciliations, and similar activities. Many members viewed these services as part of the attest engagement because they were often enumerated in the audit, review, or compilation engagement letter. More specifically, members were seeking clarity regarding whether such services are simply a part of the attest engagement or whether they are actually a separate engagement that would be subject to the general requirements of the "Nonattest Services" interpretation.

6 ET sec. 101 par. .05; as of December 15, 2014, ET sec. 1.295.
PEEC recently clarified these situations and added guidance to the "Nonattest Services" interpretation in the "Activities Related to Attest Services" section as follows:

"...activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are considered outside the scope of the attest engagement and, therefore, constitute a nonattest service. Such activities would not impair independence provided the requirements of this interpretation are met."

The requirements referenced in the PEEC revision in paragraph .30 are those in the "General Requirements for Performing Nonattest Services" section of the interpretation. These requirements include determining that the client has assumed all management responsibilities (and the member has not assumed any such responsibilities), determining that the client properly oversees the service, determining that the client evaluates the adequacy and results of the service, and determining that the client accepts responsibility for the service. These matters are often outlined specifically in an engagement letter, which may also cover the attest engagement.

The requirement to treat the above services, as well as any other services of a similar nature, as nonattest services is effective for engagements covering periods beginning on or after December 15, 2014.

Revisions to Interpretation No. 102-4—Subordination of Judgment by a Member

At its May 2013 meeting, the PEEC approved significant revisions to the "Subordination of Judgment by a Member" interpretation, which became effective on August 31, 2013. Before the revisions, this interpretation, which requires that the member take specific steps to ensure that a situation does not constitute a subordination of judgment, had only one example involving circumstances in which a member and the member's supervisor have a disagreement or dispute relating to the preparation of financial statements or the recording of transactions. The PEEC believed that the example was too narrow and that it applied primarily to members in business. The PEEC therefore decided to clarify that the interpretation applies to all members, and to broaden it to cover differences of opinion with a supervisor related to the application of accounting principles, auditing standards, or other relevant professional standards, including standards applicable to tax and consulting services, or applicable laws or regulations. In addition, the PEEC has clarified that the guidance applies when performing professional services for a client, an employer, or on a volunteer basis.

In making its revisions, the PEEC took a threats-and-safeguards approach because it believed that such differences of opinion could result in self-interest, familiarity, and undue influence threats to the member's compliance with the Integrity and Objectivity rule.
The key revisions are as follows:

- The interpretation clarifies that the guidance is addressing internal firm and company disagreements and not differences of opinion between a member and client.

- Requires members to assess any identified threats and form a conclusion about whether the result of the position taken by the supervisor fails to comply with professional standards, when applicable; creates a material misrepresentation of facts; or may violate applicable laws or regulations.

- In circumstances whereby the member concludes that the position taken by the supervisor results in a material misrepresentation of facts or a violation of applicable laws or regulations, then threats to the member's compliance with the Integrity and Objectivity rule would be considered significant. In such circumstances, the member should discuss his or her concerns with the supervisor, and if the difference of opinion is not resolved with the supervisor, the member should discuss his or her concerns with the appropriate higher level(s) of management within the organization.

- In circumstances whereby the member concludes that appropriate action has not been taken by the supervisor or appropriate higher level(s) of management within the organization, the member should consider applying safeguards to eliminate or reduce the threats to an acceptable level (specific examples of safeguards for the member to consider are presented in the interpretation). If the member concludes that no safeguards can eliminate or reduce the threats to an acceptable level or if the member concludes that appropriate action was not taken, he or she should consider his or her continuing relationship with the organization and take appropriate steps to eliminate his or her exposure to subordination of judgment.

**New Definition—"Those Charged With Governance" Under ET Section 92, Definitions**

.36 The AICPA code had several references to the term "those charged with governance" even though the term was not defined. Additionally other standard setters, including the international level, are increasingly using the term and establishing requirements related to those charged with governance. In an effort to assist members in their understanding of the term, at its January 2014 meeting, the PEEC approved a new definition, "those charged with governance," which became effective on May 31, 2014.

.37 The new definition is as follows:

**Those charged with governance.** The person(s) or organization(s) (for example, a corporate trustee) with responsibility for overseeing the strategic direction of the entity and the obligations related to the accountability of the entity. This includes overseeing the financial reporting process. Those charged with governance may include management personnel (for example, executive members of a governance board or an owner-manager).
When an interpretation requires communicating with those charged with governance, the member should determine, considering the nature and importance of the particular circumstances and matter to be communicated, the appropriate person(s) within the entity's governance structure with whom to communicate. If the member communicates with a subgroup of those charged with governance (for example, an audit committee or an individual), the member should determine whether communication with all of those charged with governance is also necessary, so that they are adequately informed.

Conflicts of Interest

.38 The currently effective Interpretation No. 102-2 is applicable to members both in public practice and in business. Due to the unique circumstances facing members in public practice and members in business, the PEEC felt that it would be more appropriate to have two separate interpretations in which the guidance is tailored to address conflicts of interest that might arise when providing professional services to clients (for members in public practice) and those that may arise when providing professional services for the member's employing organization (for members in business).

.39 In May 2014, the PEEC adopted a revised Interpretation No. 102-2, "Conflicts of Interest for Members in Public Practice,"9 and new Interpretation No. 102-7, "Conflicts of Interest for Members in Business."10 Both interpretations are based on the newly adopted guidance concerning conflicts of interest issued by the IESBA. (See the previous discussion.)

.40 Both interpretations are effective September 30, 2014.

.41 In an effort to clarify what would be considered a conflict of interest, the newly adopted interpretations contain a description of a conflict of interest and additional examples of situations that may result in a conflict of interest. The PEEC believes including the description and additional examples in the interpretations will assist members in identifying the types of relationships and interests that may give rise to a conflict of interest.

.42 Similar to the IESBA requirements, the interpretations require the member to take reasonable steps to identify circumstances that might create a conflict of interest. Where a conflict of interest has been identified, the member is required to evaluate the significance of the threats created by the conflict of interest. If threats are not at an acceptable level, the member is required to apply safeguards to eliminate threats or reduce them to an acceptable level. Even for situations in which threats are considered to be at an acceptable level, members are required to disclose the conflict of interest to the client (for members in public practice) or to appropriate levels within the employing organization (for members in business) as well as any other appropriate parties, and obtain their consent to perform the professional services. The interpretations also encourage, but do not require, the member to document such disclosure and consent.

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9 ET sec. 102 par. .03; as of December 15, 2014, ET sec. 1.110.010.
10 ET sec. 102 par. .08; as of December 15, 2014, ET sec. 2.110.010.
Recently Effective AICPA Ethics and Independence Requirements

Application of the Independence Rules to Affiliates—Interpretation No. 101-18

.43 In August 2011, the PEEC approved new interpretation, "Application of the Independence Rules to Affiliates," which added an affiliates definition to the AICPA code. The PEEC gave the interpretation a significantly delayed effective date because it represented a substantial change from prior independence requirements and implementation was expected to be difficult for many members. The new requirement to apply independence requirements to certain affiliates of a financial statement attest client became effective for engagements covering periods beginning on or after January 1, 2014.

.44 This interpretation requires members to be independent of certain affiliates of a financial statement attest client (specifically, audits and reviews of financial statements and compilations of financial statements in which the member's compilation report does not disclose a lack of independence). Under the definition, the following entities are considered affiliates of a financial statement attest client:

- An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.
- An entity in which a financial statement attest client, or an entity controlled by the financial statement attest client, has a direct financial interest that gives the financial statement attest client significant influence over such entity and that is material to the financial statement attest client.
- An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.
- An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.
- A sister entity of a financial statement attest client, if the financial statement attest client and sister entity are each material to the entity that controls both.
- A trustee that is deemed to control a trust financial statement attest client that is not an investment company.
- The sponsor of a single-employer employee benefit plan financial statement attest client.
- Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.
- An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an

11 ET sec. 101 par. .20; as of December 15, 2014, 0.400.02.
employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.

j. An investment adviser, general partner, or trustee of an investment company financial statement attest client (fund), if the fund is material to the investment adviser general partner or trustee, and he or she is deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

.45 Members should apply the independence rules to the affiliates of their financial statement attest clients unless they meet one of four exceptions. Broadly, the exceptions relate to the following:

- Certain loans to or from an individual who is an officer, director, or 10 percent or more owner of an affiliate
- Nonattest services provided to certain affiliates that do not threaten independence with respect to the financial statement attest client under the "Conceptual Framework for AICPA Independence Standards" for example, self-review or management participation threats
- A covered member's subsequent employment with certain affiliates provided the former employee is not in a key position with respect to the financial statement attest client; and
- Employment of a covered member's close relatives or immediate family members by certain affiliates, when their position does not put them in a key position with respect to the financial statement attest client

.46 Recently, the Professional Ethics Division issued a nonauthoritative staff FAQ document to help members better understand how the definitions and guidance provided in Interpretation No. 101-18, "Application of the independence rules to affiliates," apply to affiliates of employee benefit plans subject to the Employee Retirement Income Security Act. Please note that the questions and answers should not be used for governmental employee benefit plan financial statement attest clients except for governmental employee benefit plans that are subject to GASB standards.

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12 ET sec. 101 par. .20.
New and Revised IFAC Ethics and Independence Requirements

Informational Note: IFAC is the global organization for the accounting profession dedicated to serving the public interest by strengthening the profession and contributing to the development of strong international economies. IFAC has several standard-setting boards one of which is the IESBA. IESBA develops and issues ethical standards and other pronouncements for professional accountants worldwide. As a member body of IFAC, the AICPA (through the PEEC) has agreed to maintain ethics standards that, at a minimum, meet the IESBA ethics standards.

Breaches of the IESBA Code of Ethics for Professional Accountants

.47 At its December 2012 meeting, the IESBA approved the changes to the IESBA code addressing Breaches of a Requirement of the Code as a final standard, which was released in March 2013 and is effective on April 1, 2014 (early application is permitted). The amendments resulted from an exposure draft published in October 2011 and stemmed from the existing code at that time, which contained several provisions that addressed an inadvertent violation of a provision of the code indicating that such a violation would not compromise compliance with the fundamental principles, or independence, provided certain conditions are met. The IESBA decided to reconsider such provisions believing that they could be misread as implying that all inadvertent violations can be corrected by applying necessary safeguards.

.48 The revised code has new requirements relating to when a breach of an independence requirement of the code has occurred. The code now requires a firm to undertake various actions, which may include terminating the relationship causing the breach, evaluating the significance of the breach, communicating the breach, and documentation requirements. Among other things, the code specifies that depending on the significance of the breach, it may be necessary to terminate the audit engagement, or it may be possible to take action that satisfactorily addresses the consequences of the breach.

.49 In considering what actions may be necessary, the guidance indicates that the firm should exercise professional judgment and take into consideration whether a reasonable and informed third party, weighing the significance of the breach, the action to be taken, and all the specific facts and circumstances, would be likely to conclude that the firm’s objectivity has been compromised, and therefore the firm would be unable to issue an audit report. It also provides examples of other actions the firm might consider, as follows:

- Removing the relevant individual from the audit team
- Conducting an additional review of the affected audit work or re-performing that work to the extent necessary and in either case using different personnel
- Recommending that the audit client engage another firm to review or re-perform the affected audit work to the extent necessary
Independence and Ethics Developments—2014/15

- Where the breach relates to a non-assurance service that affects the accounting records or an amount that is recorded in the financial statements, engaging another firm to evaluate the results of the non-assurance service or having another firm re-perform the non-assurance service to the extent necessary to enable it to take responsibility for the service.

.50 Regarding the requirements to communicate breaches, the IESBA concluded the following:

- The firm shall discuss all breaches and the action it has taken, or proposes to take, with those charged with governance. The communication shall be as soon as possible, unless those charged with governance have specified an alternative timing for less significant breaches.
- The firm shall communicate the breach in writing to those charged with governance.
- In addition to complying with any legal or regulatory requirements, the firm shall consider reporting a breach to a member body, relevant regulator, or oversight authority when such reporting is common practice or encouraged in the particular jurisdiction by the member body, regulator, or oversight authority.

Changes to the IESBA Code of Ethics for Professional Accountants Addressing Conflicts of Interest

.51 At its December 2012 meeting, the IESBA approved the changes to the IESBA code addressing conflicts of interest as a final pronouncement, which was released in March 2013 and is effective on July 1, 2014.

.52 The changes establish additional specific requirements around conflicts of interests, and provide more comprehensive guidance to support professional accountants in identifying, evaluating, and managing conflicts of interest. The requirements apply to accountants both in public practice and in business, taking into account the different circumstances in which they work.

.53 The IESBA pronouncement

- contains a description of circumstances that might create a conflict of interest;
- requires professional accountants to consider whether or not a reasonable and informed third party, weighing all the specific facts and circumstances available to the accountant at that time, would be likely to conclude that compliance with the fundamental principles is compromised; and
- contains guidance on the nature of safeguards that may be available to manage conflicts of interest.

New and Revised Ethics and Independence Requirements of the SEC and PCAOB

.54 Neither the SEC nor the PCAOB has released new rules, regulations, or guidance regarding ethics or independence matters during the past two years. However, in speeches and other more informal communications,
commissioners and staff members of both organizations have continued to emphasize the importance of auditor independence and objectivity to the public markets.

.55 More information regarding these communications and the status of the PCAOB's concept release on firm rotation is located in the next section, "Trending Ethics and Independence Topics."

**Trending Ethics and Independence Topics**

**Nonattest Services**

.56 Both members in public practice and their clients (who are often members in business) need to continue to carefully monitor the changing requirements regarding nonattest services prohibitions.

.57 On the public company front, the SEC has continued to express its concerns—in speeches and otherwise—about the potential that providing certain nonaudit services to audit clients may compromise auditor independence. In recent years, the PEEC has revised the "Nonattest Services" interpretation several times in an effort to make the guidance more useful for members.

.58 For instance, the PEEC rolled out additional guidance concerning "management responsibilities" in response to concerns that members might not fully understand the types of activities encompassed within that phrase. The PEEC clarified that management responsibilities involve leading and directing an entity, including making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. If a member in public practice assumes a management responsibility for an attest client, the management participation threat created would be so significant that no safeguards could reduce that threat to an acceptable level. For this reason, assumption of management responsibilities would impair independence. The PEEC has added helpful examples of activities that would be considered a management responsibility to the "Nonattest Services" interpretation.

.59 Another area of concern is the provision of internal audit assistance services (sometimes referred to as "internal audit outsourcing"), since the requirements have been modified in recent years. Assisting the client in performing financial and operational internal audit activities would impair independence, unless the member takes appropriate steps to be satisfied that the client accepts its responsibility for designing, implementing, and maintaining internal control and directing the internal audit function, including the management thereof.

.60 The PEEC has also made changes to the internal audit services guidance to clarify what the term *monitoring activities* means and how such activities may affect independence. The guidance indicates that monitoring activities can be performed through either ongoing evaluations, or separate evaluations, or some combination of the two. To help clarify the differences between ongoing and separate evaluations, descriptions of both have been incorporated into the "Nonattest Services" interpretation and the descriptions align with COSO's internal control framework.¹⁴

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¹⁴ Issued by COSO (Committee of Sponsoring Organizations of the Treadway Commission), *Internal Control–Integrated Framework* was revised in 2013.
The revised independence guidance indicates that separate evaluations generally do not create a significant threat independently, whereas ongoing evaluations create a significant management participation threat that would impair independence. The revised guidance also requires that members use judgment in determining whether otherwise permitted internal audit services that are normally permitted may result in a significant management participation threat. Members can make this determination by considering other factors, such as the significance of the controls being tested, the scope or extent of the controls being tested in relation to the overall financial statements of the client, and the frequency of the internal audit services.

The Peer Review Board has also identified nonattest services as an area of focus for peer reviews conducted in 2015. There will be a new requirement that reviewed firms list on the engagement profile any nonattest services performed for the attest client during the period of the professional engagement or the period covered by the financial statements. Peer reviewers will then determine whether the reviewed firm has met the requirements of the "Nonattest Services" interpretation for the listed nonattest services. The requirements that peer reviewers will consider include the following:

- Whether the auditor determined that such a service would not impair independence before performing the nonattest service.
- Whether the member established and documented in writing his or her understanding with the client with regard to the following:
  - The objectives of the nonattest service engagement
  - The nonattest services to be performed
  - The client's acceptance of its responsibilities relative to the nonattest service
  - The auditor's responsibilities
  - Any limitations of the nonattest service engagement.
- The reviewer will also specifically focus on whether any nonattest services provided to the client resulted in the auditor assuming management responsibilities for the client and whether, in connection with the nonattest services provided, that client management performed all of the following functions:
  - Assumed all management responsibilities,
  - Oversaw the nonattest services by designating an individual, preferably within senior management, who possessed suitable skill, knowledge, or experience, or all
  - Evaluated the adequacy and results of the services performed
  - Accepted responsibility for the results of the nonattest services.

Audit Firm Rotation Proposals

Recently, a number of regulators have proposed mandatory auditor rotation requirements, or announced that they were considering such requirements. The activity included the European Commission issuing a proposed rule that would require European public companies and their audit firms to
limit the period that an outside auditing firm can perform audits of a company to six years, while companies that opt for a voluntary joint audit would be allowed a nine-year window;

impose a cooling-off period of four years before a firm could audit again for the same client.

Recently the European Union moved a step closer to a mandatory audit firm rotation requirement when the member states' Permanent Representatives Committee approved new audit regulations. The new regulations and amendments approved include a requirement that public-interest entities rotate engagements with audit firms every 10 years—with provisions for longer periods when engagements are put out for bid or joint audits are performed. Public-interest entities include banks, insurance firms, and listed companies. However, to take effect, the new regulations must still be approved by the European Parliament and the council of national governments.

Regulations and amendments approved include the following:

- A 10-year maximum period during which a member state may allow an audit firm to continue auditing the same public-interest entity. If the engagement is put out for public bid, the member state may allow the engagement to continue for a maximum of 20 years. In cases of joint audits, where multiple audit firms share the engagement, the maximum period is 24 years.

- A prohibition on the provision of certain nonaudit services by audit firms to the public-interest entities they audit. Member states will have the right to allow firms to provide some tax and valuation services to their audit clients, provided they are immaterial and have no direct effect on the audited financial statements.

- A requirement that fees from permitted nonaudit services to an audit client cannot exceed 70 percent of the audit fees.

In August 2011, the PCAOB issued a concept release on the topic of mandatory audit firm rotation, suggesting that it would enhance auditor independence, objectivity, and professional skepticism. It then held a number of public meetings to solicit the views of interested parties. In response to the release, the PCAOB received hundreds of letters, the vast majority of which opposed the idea for a variety of reasons, including the SEC's existing mandatory audit partner rotation rules. Similarly, the public meetings indicated that there was significant resistance to the idea, especially from publicly listed companies, their officers, and boards.

However, during February 2014, it was widely reported that the PCAOB had abandoned its plans with respect to mandatory audit firm rotation. PCAOB Chairman James Doty apparently told the SEC that the PCAOB no longer has an active project or on-going work within the board to move forward with an auditor rotation rule. This came on the heels of activity on Capitol Hill, where in July 2013, the U.S. House of Representatives passed bipartisan legislation that prevents PCAOB from implementing a system of mandatory rotation for audit firms.

United Kingdom regulators have also been weighing the idea of mandatory auditor rotation, and in 2013, the UK Competition Committee decided to forego mandatory rotation, suggesting instead that FTSE 350
companies should put their audit out to tender every five years. Also in 2013, another UK regulator, the Financial Reporting Council introduced a mandatory retendering every 10 years.

**Recent PEEC Enforcement Actions**

.69 The AICPA Professional Ethics Division enforces members' compliance with the AICPA Code of Professional Conduct via the Joint Ethics Enforcement Program, which is conducted in concert with participating state CPA societies. Investigations of violations of the code are performed by two subcommittees: the Technical Standards Subcommittee (TNS) and the Independence and Behavioral Standards Subcommittee (IND/BHS). The TNS investigates violations of all technical standards, whereas the IND/BHS investigates independence and behavioral standards, including tax standards.

.70 The following are examples of common disciplinary findings and the rules in the code to which they relate:15

* General Standards (Rule 201)
  
  - Lack of due professional care when providing professional services, such as a balance sheet number not agreeing to a note

* Compliance with Standards (Rule 202)
  
  - Failure to obtain sufficient competent evidential matter for one or more audit areas to support his or her opinion on the financial statements (AU-C section 500, Audit Evidence [AICPA, Professional Standards])16
  
  - Failure to adequately document audit procedures performed (AU-C section 230, Audit Documentation [AICPA, Professional Standards])
  
  - Failure to dual date or redate a reissued report (Paragraph .41 of AU-C section 700, Forming and Opinion and Reporting on Financial Statements; paragraphs .12–.14 of AU-C section 560, Subsequent Events and Subsequently Discovered Facts; and paragraphs .13–.15 of AU-C section 720, Other Information in Documents Containing Audited Financial Statements [AICPA, Professional Standards])
  
  - Failure to identify and test all major programs in accordance with the Office of Management and Budget Circular A-133, Audits of States, Local Governments and Non-Profit Organizations Section .520, "Major Program Determination"

  - Overall compliance with clarified auditing standards, such as the auditor's opinion

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15 Note: References to ethics rules and interpretations are to the code as it exists before the December 2014 effective date of the revised code.
16 All AU-C sections are from AICPA Professional Standards.
• **Accounting Principles** (Rule 203)
  – Failure to make required fair value disclosures (FASB ASC 820, *Fair Value Measurements*)
  – Failure of the subsequent events note to comply with generally accepted accounting principles (GAAP) (FASB ASC 450-2-50, FASB ASC 855-10-50)

• **Acts Discreditable** (Rule 501)
  – Inappropriate or no peer review being performed due to misrepresentation of a firm’s practice (Peer reviewers are encouraged to check the Federal Audit Clearing House and the Department of Labor’s [DOL’s] EFAST2 websites to verify representations made by their peer review clients regarding their audit practice.)
  – Failure to return client records and respond to request for records (supported by the "Response to requests by clients and former clients for records" interpretation\(^{17}\))
  – Failure to file tax returns (supported by the "Failure to file tax return or pay tax liability"\(^{18}\))

• **Advertising and Other Forms of Solicitation** (Rule 502)
  – Providing false or misleading information in advertising and soliciting (supported by the "False, misleading or deceptive acts in advertising or solicitation" interpretation\(^{19}\))

.71 TNS finds that a majority of the technical violations can be attributed to a lack of adequate education. More detailed lists of the most frequent violations of the professional standards are available in two documents on aicpa.org:

• For investigations related to employee benefit plan audits, visit www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/EmployeeBenefitPlanReport.pdf.

• For investigations related to government and not-for-profit entities, visit www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/EthicsEnforcement/DownloadableDocuments/GovernmentNotForProfitReport.pdf.

.72 The Professional Ethics Division educates members and promotes the understanding of ethical standards contained in the AICPA code by responding to member inquiries on the application of the AICPA code to specific areas of practice. If you have questions, e-mail them to ethics@aicpa.org or call 888.777.7077. When prompted, select "6" on your keypad, followed by "1." If you are unable to make a selection on your keypad, a service representative will connect you to the Ethics Hotline. The Ethics Hotline fields more than 3,000 calls annually. The bulk of the calls are related to independence questions, and

\(^{17}\) ET sec. 501 par. .02.
\(^{18}\) ET sec. 501 par. .08.
\(^{19}\) ET sec. 502 par. .03.
a large percentage of such calls concern the independence requirements when performing nonattest services.

**Ongoing AICPA PEEC Projects**

**Loans and Leases**

.73 When FASB commenced its Leases Project several years ago, the PEEC established a task force to consider the impact that changes in the accounting for leases might have on the code and to propose related new or revised guidance.

.74 As the FASB has not yet completed its project, the PEEC task force is currently monitoring the FASB's progress. Once the project is finalized, the task force will consider the potential impact on the related guidance in the code.

**Breaches of the Code—IFAC Convergence**

.75 This IFAC Convergence Breaches of the Code Task Force is considering the IESBA standard on breaches of the code and whether such guidance would be appropriate for the AICPA Code of Professional Conduct. As a part of this project, the task force is looking at the AICPA Private Companies Practice Section (PCPS) informal guidance entitled "Inadvertent Independence Violations Practice Tool." The Ethics Division will issue an exposure draft on this topic during the summer of 2014.

**Suspected Fraud or Illegal Acts—IFAC Convergence**

.76 A PEEC task force was also charged with the responsibility to respond to IESBA's exposure draft "Responding to a Suspected Illegal Act" and to make recommendations to the PEEC on any changes to the code in this area.

**Definition of Client**

.77 The Client Task Force is assessing what, if any, revisions are necessary to the definition of client to conform to the organizational independence requirements in the U.S. Government Accounting Office's (GAO's) *Government Auditing Standards* (the Yellow Book), and related issues.

**Merged Firms**

.78 The Merged Firm Task Force is considering whether additional independence guidance is needed for members when firms merge and a partner or professional employee of one firm is associated with an attest client of the other firm. The Task Force is also considering whether additional independence guidance is needed when one of the merged firms provided nonattest services that would impair independence to the attest client of the firm it is merging with.

**Ability to Supervise or Participate in Investment Decisions**

.79 A task force is considering whether the conclusions reached in the "Partnerships" and "Limited Liability Companies" sections of "Financial

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20 This tool is available at www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/QualityServicesDelivery/KeepingUp/DownloadableDocuments/InadvertentIndependenceViolationsPracticeTool.pdf.
relationships," interpretation concerning when a member has a direct financial interest are still appropriate, or if something broader might be more appropriate.

**Campaign Treasurer**

.80 This task force is determining whether the PEEC should undertake revising the guidance in "Campaign Treasurer."22

**Independence in State and Local Government Environment**

.81 This task force will determine if any clarifications are necessary in "The effect on independence of relationships with entities included in the governmental financial statements."23 If the PEEC deems revisions necessary, it will consider adding GASB citations to any terms that GASB defines that are included in the interpretation. It will also determine what the differences are between GASB's definition of basic financial statements and the AICPA's definition.

**Three-Year Project Agenda**

.82 The AICPA Professional Ethics Division maintains a three-year project agenda on its website that lists all current and future PEEC projects. The agenda is available at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/DownloadableDocuments/peec-three-year-agenda.pdf.

.83 PEEC meeting information, including meeting agendas, discussion materials, and minutes of prior meetings, is available at www.aicpa.org/InterestAreas/ProfessionalEthics/Community/MeetingMinutesandAgendas/Pages/MeetingInfo.aspx.

**Compliance Reminders Regarding Independence and Ethics Requirements of Other Authoritative Bodies**

.84 The independence and ethics rules under the AICPA code apply to all members of the AICPA. However, in addition to these rules, other rule-making and standard-setting bodies, such as the SEC, PCAOB, GAO, DOL, IFAC, IRS, the U.S. Department of the Treasury, banking and insurance agencies, state boards of accountancy, and state CPA societies also have independence or ethics rules, or both, with which members must comply, to the extent such rules are applicable. The rules of some of these other bodies are discussed briefly in this alert. You should refer to the original text of each organization's rules for full guidance.

**Continuing Professional Education Requirements**

.85 State boards of accountancy typically have programs that test compliance with their CPE requirements. Certain boards have found significant noncompliance by some CPAs and they have levied fines and other sanctions against such licensees. Members are reminded to comply with all applicable CPE requirements, which can vary from state to state. Members who fail to comply with the CPE requirements of states or other regulatory bodies will also be considered to be in violation of the AICPA code.

21 ET sec. 101 par. .17.
22 ET sec. 191 par. .164; as of December 15, 2014, ET sec. 1.275.025.
SEC and PCAOB Independence Requirements

.86 Rule 2-01, "Qualifications of Accountants," of Regulation S-X, sets forth the SEC's independence rules. The rule is designed to ensure that auditors are qualified and independent of their audit clients, both in fact and appearance. Accordingly, the rule establishes restrictions on financial, employment, business relationships and fee relationships between an accountant and an audit client. In addition, the rule contains extensive restrictions on the provision of certain nonaudit services to an audit client and its affiliates.

.87 Rule 2-01 begins with a general standard of auditor independence, which states the following:

The Commission will not recognize an accountant as independent, with respect to an audit client, if the accountant is not, or a reasonable investor with knowledge of all relevant facts and circumstances would conclude that the accountant is not, capable of exercising objective and impartial judgment on all issues encompassed within the accountant's engagement. In determining whether an accountant is independent, the Commission will consider all relevant circumstances, including all relationships between the accountant and the audit client, and not just those relating to reports filed with the Commission (Rule 2-01(b)).

.88 The following paragraph reflects the application of the general standard to particular circumstances. In addition, the second preliminary note to Rule 2-01 states the following:

The rule does not purport to, and the Commission could not, consider all circumstances that raise independence concerns, and these are subject to the general standard in Rule 2-01(b). In considering this standard, the Commission looks in the first instance to whether a relationship or the provision of a service: creates a mutual or conflicting interest between the accountant and the audit client; places the accountant in the position of auditing his or her own work; results in the accountant acting as management or an employee of the audit client; or places the accountant in a position of being an advocate for the audit client.

.89 The rule indicates that the preceding factors are general guidance only, and their application may depend on particular facts and circumstances. Thus, Rule 2-01 also provides that

in determining whether an accountant is independent, the Commission will consider all relevant facts and circumstances. For the same reason, registrants and accountants are encouraged to consult with the Commission's Office of the Chief Accountant before entering into relationships, including relationships involving the provision of services that are not explicitly described in the rule.

Audit Partner Rotation Requirements

.90 Members in public practice are reminded that lead audit partners, concurring or reviewing partners, and certain other partners on an audit engagement are required to rotate off their engagements after a specified period. Those periods are as follows:

- Lead and concurring or reviewing partners providing professional services on audit engagements may serve a maximum of five years
on the engagement, after which they must remain off the audit engagement for another five years.

- Other partners, who make decisions on significant accounting, audit, or other reporting matters or who also have contact with the client's management and audit committee, are subject to rotation requirements after seven years of providing such professional services to the client. Upon rotation, the partner must remain off the audit engagement for two years.

- Partners whose services are limited to consulting with the audit engagement team on technical accounting, auditing, or similar issues are not required to rotate.

.91 The SEC's document, "Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence Frequently Asked Questions," addresses the extent to which a partner who has rotated off an entity's audit engagement may provide services to that entity. FAQ No. 8 under "Audit Partner and Partner Rotation" reads as follows:

**Question:** After a lead or concurring partner rotates off an audit engagement, may that partner provide services to the issuer in a specialty partner capacity (that is, providing tax services or national office/technical services) and still have this period continue to be considered part of the partner's rotation off the audit engagement?

**Answer:** Any time audit partners spend time providing services which continue their direct relationship with the issuer, such time would not be considered as time off the audit engagement. However, limited discussions solely between the audit engagement team and a rotated-off partner generally would be considered as time off the audit engagement.

.92 A small firm exemption appears in SEC Rule 2-01(c)(6)(ii) of Regulation S-X and is as follows:

Any accounting firm with less than five audit clients that are issuers (as defined in section 10A(f) of the Securities Exchange Act of 1934 (15 U.S.C. 78j-1(f)) and less than ten partners shall be exempt from Rule 2-01(c)(6)(i) of Regulation S-X provided the PCAOB conducts a review at least once every three years of each of the audit client engagements that would result in a lack of auditor independence under this paragraph.

.93 Thus, a firm with four issuer audit clients and eight partners that is inspected by the PCAOB at least once every three years would qualify for the exemption. A critical distinction in the rule is that one should count all partners or other owners in the firm when determining whether the firm can use the exemption.

**Staff Secondments**

.94 The SEC independence rules, specifically Rule 2-01(c)(4)(vi) addressing nonaudit services, clearly prohibit a member of an accounting firm from acting as a member of management or as an employee. Acting as an employee includes a situation in which a firm seconds (that is, loans) staff to an audit

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24 This document can be found at www.sec.gov/info/accountants/ocafaqaudind080607.htm.
client, including when the client's management will direct the staff's activities. Thus, even if the activity involves performing an otherwise permissible service (such as tax services), independence would be considered impaired.

.95 The SEC staff released additional guidance on this issue in January 2014.25

**PCAOB Rules Regarding Independence and Ethics**

.96 The PCAOB has the authority to establish ethics and independence standards in accordance with Section 103(a), "Auditing, Quality Control, and Ethics Standards," and Section 103(b), "Independence Standards and Rules," of the Sarbanes-Oxley Act of 2002 (SOX). Firms that issue audit reports on public companies are required to register with the PCAOB. Failure to do so may result in disciplinary action. Additionally, any registered public accounting firm, or person associated with such a firm, that fails to adhere to applicable PCAOB standards may be the subject of a PCAOB disciplinary proceeding in accordance with Section 105, "Investigations and Disciplinary Proceedings," of SOX. Under Section 107, "Commission Oversight of the Board," of SOX, PCAOB rules become effective only after they are approved by the SEC. The PCAOB independence and ethics rules include the following:

- PCAOB Rules 3501–3526 (AICPA, *PCAOB Standards and Related Rules*, Select Rules of the Board) describe the independence and ethics standards promulgated by the board and approved by the SEC since the board's inception. 27

.97 PCAOB Rule 3100 generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards, which encompass auditing, attestation, quality control, ethics, and independence standards, in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices. This rule also requires registered public accounting firms and their associated persons to comply with all applicable standards. Accordingly, if the PCAOB's standards do not apply to an engagement or other activity of the firm, PCAOB Rule 3100, by its own terms, does not apply to that engagement or activity.

.98 PCAOB issued Auditing Standard No. 16, *Communications with Audit Committees* (AICPA, *PCAOB Standards and Related Rules*, Auditing Standards), on auditor communications with audit committees in August 2012. It is designed to enhance investor protection by providing timely and relevant communication between the auditor and an issuer's audit committee.

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26 Subsequently mentioned PCAOB rules can be found in "Select Rules of the Board" in AICPA *PCAOB Standards and Related Rules*.
27 The full text of these rules can be found at www.pcaobus.org/Standards/Pages/default.aspx.
Interim Ethics and Independence Standards

.99 PCAOB Rule 3500T sets forth ethics and independence standards for registered public accounting firms and their personnel. Pursuant to Rule 3500T, the PCAOB has provisionally designated the following rules of the AICPA Code of Professional Conduct as interim ethics and independence standards, to the extent not superseded or amended by the PCAOB:

- **Ethics**—Rule 102, *Integrity and Objectivity*, and its interpretations and rulings thereunder, as they existed on April 16, 2003
- **Independence**—Rule 101, *Independence*, and its interpretations and rulings thereunder, as they existed on April 16, 2003

.100 The PCAOB has provisionally designated the following rules and interpretation of the Independence Standards Board (ISB) as interim independence standards, to the extent not superseded or amended by the PCAOB:28


.101 In addition, the PCAOB requires compliance with the SEC's independence rules. The PCAOB's interim independence standards are not to be interpreted to supersede the SEC's independence requirements. Therefore, to the extent that a provision of the SEC's rule or policy is more restrictive—or less restrictive—than the PCAOB's Interim Independence Standards, a registered public accounting firm must comply with the more restrictive requirement.

.102 To the extent that the SEC's rules are more or less restrictive than the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

Federal Deposit Insurance Corporation

Applicability of Independence Standards to Audits of Insured Depository Institutions

.103 Depending upon the insured depository institution (bank or financial institution) audit client, an external auditor is subject to the independence standards issued by one or more of the following standard-setters: the AICPA, the SEC, and the PCAOB. For nonpublic financial institutions29 that are not

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28 You can find the full text of the rules and the interpretation at http://pcaobus.org/Standards/Pages/default.aspx. You can also find them in the "Interim Standards" section of AICPA's *PCAOB Standards and Related Rules*.

29 Nonpublic financial institutions are companies that are not, or whose parent companies are not, subject to the reporting requirements of the Securities Exchange Act of 1934 (the 1934 Act).
required to have annual independent audits pursuant to either Part 363\textsuperscript{30} of the Federal Deposit Insurance Corporation (FDIC's) regulations or Section 562.4\textsuperscript{31} of the Office of Thrift Supervision's (OTS's) regulations, the external auditor must comply with the AICPA's independence standards; the financial institution's external auditor is not required to comply with the independence standards of the SEC and the PCAOB.

\textbf{.104} In contrast, for financial institutions subject to the audit requirements, either in Part 363 of the FDIC's regulations or in Section 562.4 of the OTS's regulations, the external auditor should be in compliance with the independence standards of the AICPA, the SEC, and the PCAOB. To the extent that any of the rules within any one of these independence standards (AICPA, SEC, and PCAOB) is more or less restrictive than the corresponding rule in the other independence standards, the independent public accountant must comply with the more restrictive rule.

\textbf{.105} Generally, when an insured depository institution that is neither a public company nor the subsidiary of a public company becomes subject to Part 363 of the FDIC's regulations for the first time, the external auditor is required to be independent under the SEC and the PCAOB's independence rules for all periods included in the insured depository institution's initial Part 363 Annual Report. These independence requirements are similar to the SEC's independence requirements when an entity files with the SEC for initial public offering.

\textbf{.106} For financial institutions and bank holding companies that are public companies,\textsuperscript{32} regardless of size, the external auditor should be in compliance with the SEC's and the PCAOB's independence standards, as well as the AICPA's independence standards.


\textsuperscript{31} As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, supervision of certain Office of Thrift Supervision (OTS) thrifts was transferred to the Office of the Comptroller of the Currency and the FDIC, and the supervision of the Savings and Loan Holding Companies was transferred to the Board of Governors of the Federal Reserve System. These agencies are in the process of proposing rulemaking and incorporating the relevant OTS rules and regulations into their respective rules and regulations for the OTS institutions and thrift holding companies for which they assumed responsibility. Readers are encouraged to visit the agencies' websites for the most current information on the status of the agencies' rulemaking processes.

\textsuperscript{32} Public companies are companies, or subsidiaries of companies, that are subject to the reporting requirements of the 1934 Act.
The following table illustrates the applicability of the AICPA, SEC, and PCAOB independence standards:

<table>
<thead>
<tr>
<th>Applicability of Auditor Independence Standards</th>
<th>AICPA Independence Standards</th>
<th>SEC Independence Standards</th>
<th>PCAOB Independence Standards</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scenario 1</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Nonpublic institutions <strong>not</strong> subject to Part 363 of the FDIC's regulations or Section 562.4 of the Office of Thrift Supervision's (OTS's) regulations</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Scenario 2</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Public and nonpublic institutions subject to Part 363 of the FDIC's regulations or Section 562.4 of the OTS's regulations</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Scenario 3</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Institutions and holding companies that are public companies (regardless of size)</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**International Ethics Convergence and Monitoring**

As business has become increasingly global, the visibility and applicability of the IESBA code has grown. For example, a firm that audits a U.S. subsidiary of a foreign parent typically must confirm its compliance with the IESBA code to the parent company's auditor.

A few other examples follow:

- A local firm is part of a global accounting association that is deemed, under international standards, to be a network. All firms in the network must be independent of the other network firms' audit and review clients in accordance with those standards. In fact, the network typically requires its members to meet global ethics standards on all multinational assurance engagements.
- A regional firm in southern California serves as auditor of a small Los Angeles-based software developer that acquires a company in Bangalore, India. The Indian company's significant vendors, and its lenders, usually expect to rely on the California firm's audit report and, thus, they typically expect that firm to comply with IESBA requirements.
- A small firm's client expands its business by opening a branch office in Argentina. Lessors, vendors, and lenders in Argentina ask...
the firm to audit the client's financial information in accordance with international auditing standards, which will call for the firm to comply with IESBA ethics and independence standards.

The most recent version of the IESBA code has been effective since January 1, 2011. The IESBA publishes a "Handbook of the Code of Ethics for Professional Accountants" each year and the 2013 version contains a number of changes that were adopted by the IESBA during 2013 but have effective dates in 2014. The current IESBA Handbook (2013 version) can be found online at www.ifac.org/sites/default/files/publications/files/2013-IESBA-Handbook.pdf.

Resource Central

Continuing Professional Education

The AICPA offers a number of CPE courses that are valuable to CPAs working in public practice and industry, including the following specifically related to the independence and ethics:

- **Cost and Return: Professional Ethics in Business** (product no. 159891 [online])
- **Ethics: Non-Attest Services, Integrity and Objectivity** (159416 [online])
- **Business Ethics Accounting and Auditing: Real-World Business Ethics for CPAs in A&A** (product no. 733606 [text])
- **Independence** (product no. 159182 [online])
- **Professional Ethics: 2012/2013 Update and Refresher** (product no. 159434 [online])
- **Professional Ethics and Responsibilities in Tax Practice** (product no. 738704HS [CD-ROM], 158703 [online])
- **Professional Ethics: AICPA's Comprehensive Course** (product no. 732317 [text])
- **Professional Ethics: Complying With the GAO Rules** (product no. 739442HS [CD-ROM], 159442 [online])
- **Professional Ethics for CPAs in Business** (product no. 738903HS [CD-ROM], 158902 [online])
- **Real World Business Ethics** (product no. 733596001 [text])
- **Business Ethics—Real World Business Ethics: How Will You React?** (product no. 732040001 [text])
- **Business Ethics for Tax: Real World Business Ethics for Tax Practitioners** (product no. 733616 [text])
- **Selected Topics in Professional Ethics** (product no. 158387 [online])

Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

AICPA CPExpress, offered exclusively through CPA2Biz, is the AICPA's flagship online learning product. Divided into one-credit and two-credit courses that are available 24 hours a day, seven days a week, AICPA CPExpress offers hundreds of hours of learning in a wide variety of topics.

.113 Some courses covering topics of special interest to the independence and ethics include the following:

- **Compilations and Reviews: Independence Considerations**
- **Comp & Review Engagements: Current Engagement Environment and Recent SSARS Development**
- **A&A Issues Facing CPAs: Government Audit Standards and Independence**
- **Ethics: BAN&K Advisory Services LLC—You Are the Advisory Services Partner**
- **Ethics: Bank of Little Beach—You are the Valuation Specialist**
- **Ethics: Forensic Review Services LLC—You are the Forensic Investigator**
- **Ethics: Megatron Corp.—You Are the Corporate Controller**
- **Ethics: Pointer Electronics, Inc.—You Are the Engagement Quality Review (Concurring) Partner**
- **Ethics: Precious Mining, Inc.—You Are the Audit Committee Chair**
- **Ethics: Superlative Software Corp.—You Are the CFO**
- **Ethics: You are the Amended Return Preparer and You are the Outside Tax Advisor**
- **Ethics: You are the Outside Attorney for the Controller and You are the Tax Return Preparer**

To register for individual courses or to learn more, visit www.cpa2biz.com.

**Webcasts**

.114 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA webcasts are high-quality CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each webcast is archived and available for viewing. For additional details on available webcasts, please visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Browse/Store/Webcasts.jsp.

**Member Service Center**

.115 To order AICPA products, receive information about AICPA activities, and get help with your membership questions, call the AICPA Service Operations Center at 888.777.7077.

**Hotlines**

**Accounting and Auditing Technical Hotline**

.116 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. The hotline is available from 9 a.m. to 8 p.m. ET on weekdays. You can reach the Technical Hotline...
at 877.242.7212 or online at www.aicpa.org/Research/TechnicalHotline/Pages/TechnicalHotline.aspx. Members can also e-mail questions to aahotline@aicpa.org. Additionally, members can submit questions by completing a Technical Inquiry form found on the same website.

Ethics Hotline

In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at 888.777.7077 or by e-mail at ethics@aicpa.org.

AICPA Online Professional Library: Accounting and Auditing Literature

The AICPA has created your core accounting and auditing library online. The AICPA Online Professional Library is now customizable to suit your preferences or your firm’s needs. You can also sign up for access to the entire library. Get access—anytime, anywhere—to FASB ASC; the AICPA’s latest Professional Standards, Technical Practice Aids, Audit and Accounting Guides, Audit Risk Alerts, Best Practices in Presentation and Disclosure; and more. To subscribe to this essential online service for accounting professionals, visit www.cpa2biz.com.

Codified Clarity Standards

The best way to obtain the codified clarity standards is with a subscription to AICPA Professional Standards in the AICPA Online Professional Library. Although the individual Statements on Auditing Standards are available in paperback, this online codified resource is what you need to update your firm audit methodology and begin understanding how clarity standards change certain ways you perform your audits. For online access to AICPA Professional Standards visit www.cpa2biz.com/AST/AICPA_CPA2BIZ_Specials/MostPopularProductGroups/AICPAResourceOnline/PRD~PC-005102/PC-005102.jsp.

You can also get the clarified standards in paperback format. Codification of Statements on Auditing Standards is published each spring and includes the clarified auditing standards and the attestation standards. Professional Standards, which has the full complement of AICPA standards, is published each summer.

The codification of clarified standards includes various resources:

- A preface, "Principles Underlying the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards"
- A glossary of terms defined in the standards
- Appendixes describing the differences between generally accepted auditing standards and the International Standards on Auditing

Financial Reporting Center of AICPA.org

CPAs face unprecedented changes in financial reporting. As such, the AICPA has created the Financial Reporting Center to support you in the execution of high-quality financial reporting. This center provides exclusive
members-only resources for the entire financial reporting process, and can be accessed at www.aicpa.org/frc.

.123 The Financial Reporting Center provides timely and relevant news, guidance, and examples supporting the financial reporting process. You will find resources for accounting, preparing financial statements, and performing various types of engagements, including compilation and review, audit and attest, and assurance and advisory.

.124 For example, the Financial Reporting Center offers a dedicated section to the Clarity Project. For the latest resources available to help you implement the clarified standards, visit the "Improving the Clarity of Auditing Standards" page at www.aicpa.org/SASClarity.

Industry Websites

.125 The Internet covers a vast amount of information that may be valuable to auditors, including current industry trends and developments. Some of the more relevant sites for ethics and independence issues follow:

<table>
<thead>
<tr>
<th>Organization</th>
<th>Content</th>
<th>Website</th>
</tr>
</thead>
</table>
| AICPA        | Summaries of recent auditing and other professional standards, as well as other AICPA activities | www.aicpa.org  
www.cpa2biz.com  
www.ifrs.com |
<p>| AICPA Professional Ethics Executive Committee (PEEC) | AICPA Code of Professional Conduct; PEEC standards-setting projects and meeting information; information on the ethics enforcement process, including discipline actions, as well as an array of other resources | <a href="http://www.aicpa.org/Interest">www.aicpa.org/Interest</a> Areas/ProfessionalEthics/Pages/ProfessionalEthics.aspx |
| Department of Labor (DOL) | DOL Regulation 2509.75-9, Interpretive bulletin relating to guidelines on independence of accountant retained by Employee Benefit Plan, and contact information | <a href="http://www.dol.gov">www.dol.gov</a> |</p>
<table>
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<tr>
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<th>Content</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Government Accountability Office</td>
<td>Government Auditing Standards independence standard, frequently asked questions on independence, slide presentation on independence, and contact information</td>
<td><a href="http://www.gao.gov/yellowbook">www.gao.gov/yellowbook</a></td>
</tr>
<tr>
<td>International Federation of Accountants</td>
<td>Pronouncements, projects, and key contacts of the International Ethics Standards Board for Accountants (IESBA), including the IESBA's Code of Ethics for Professional Accountants</td>
<td><a href="http://www.ifac.org/Ethics">www.ifac.org/Ethics</a></td>
</tr>
<tr>
<td>PCAOB</td>
<td>Information on accounting and auditing activities of the PCAOB, including those on independence</td>
<td><a href="http://www.pcaob.org">www.pcaob.org</a></td>
</tr>
<tr>
<td>SEC</td>
<td>Information from the Office of the Chief Accountant for accountants and auditors, including independence; current SEC rule making; final rule releases 33-8183A and 33-8183, Strengthening the Commission’s Requirements Regarding Auditor Independence; and key contact information</td>
<td><a href="http://www.sec.gov">www.sec.gov</a></td>
</tr>
</tbody>
</table>
Appendix—Plain English Guide to Independence

A plain-English description of the AICPA independence rules follows. The purpose of this appendix is to help you understand independence requirements under the AICPA Code of Professional Conduct (AICPA Code) and, if applicable, other rule-making and standard-setting bodies. Independence generally implies one's ability to act with integrity and exercise objectivity and professional skepticism. The AICPA and other rule-making bodies have developed rules that establish and interpret independence requirements for the accounting profession. We use the term rules broadly to also mean standards, interpretations, rulings, laws, regulations, opinions, policies, or positions. This guide discusses in plain English the independence requirements of the principal rule-making bodies in the United States, so you can understand and apply them with greater confidence and ease.

This appendix is intentionally concise, so it does not cover all the rules (some of which are complex), nor does it cover every aspect of the rules herein. Nonetheless, this guide should help you identify independence issues that may require further consideration. Therefore, you should always refer directly to the rules, in addition to your firm’s policies on independence, for complete information.

Conventions and Key Terms Used

Some of the conventions used are described in the following list:

- The word Note in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.
- AICPA interpretations and rulings to the AICPA Code are linked.
- Internet addresses (URLs) and hyperlinks to other sources of information are provided.
- Information on additional resources appears at the end of this appendix to help you resolve your independence issues. (See the question "Where Can I Find Further Assistance With My Independence Questions?" in this appendix)

We describe the rules of the Securities and Exchange Commission (SEC) and the Public Company Accounting Oversight Board (PCAOB)—that is, those that apply to audits of SEC registrants and issuers—in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions when the SEC and the PCAOB either impose additional requirements, or their rules otherwise differ from the AICPA rules.

The following key terms are used:

Client (or attest client). An entity with respect to which independence is required.

Firm. A form of organization permitted by law or regulation (whose characteristics conform to resolutions of the AICPA Council) that is engaged in the practice of public accounting.

SEC registrant. An issuer filing an initial public offering, a registrant filing periodic reports under the securities laws, a sponsor
or manager of an investment fund, or a foreign private issuer that is (or is in the process of becoming) an SEC registrant. In this appendix, SEC audit client means an SEC registrant and its affiliates, as defined in the SEC rules.

**Issuer.** An entity whose securities are registered under the securities laws or that is required to file reports under Section 10(A) of the Securities Exchange Act of 1934 or that files, or has filed, a registration statement that has not yet become effective under the Securities Act of 1933.

**Note:** Certain SEC registrants (for example, broker-dealers and hedge funds) are not issuers (that is, they are nonissuers). Though these entities' auditors must be registered with the PCAOB, currently, they are not subject to the PCAOB independence rules and are exempt from certain SEC independence rules. However, due to the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the PCAOB has expanded its jurisdiction to include all registered broker-dealer auditors and is in the process of considering a permanent inspection program, as well as new or revised audit and independence standards for these auditors.

**Introduction**

**What Is Independence?**

Independence is defined in ET section 100-1, Conceptual Framework for AICPA Independence Standards (AICPA, Professional Standards), and is referred to herein as the conceptual framework, as follows:

- **Independence of mind.** The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.

- **Independence in appearance.** The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the attest engagement team had been compromised.

These definitions reflect the long-standing professional requirement that members who provide services to entities for which independence is required be independent both in fact (that is, of mind) and in appearance.

**What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?**

The "Other Considerations" section of Interpretation No. 101-1, "Interpretation of Rule 101," under Rule 101, Independence (AICPA, Professional Standards, ET sec. 101 par. .02), recognizes that it is impossible for the AICPA Code to identify all circumstances in which the appearance of independence might be questioned.

Specifically, Interpretation No. 101-1 requires that members use the conceptual framework when making independence decisions involving matters that are not specifically addressed in the independence interpretations and rulings in the AICPA Code. When threats to independence are not at an acceptable level, the member must apply safeguards to eliminate the threats or reduce them to an
acceptable level. If threats to independence are not at an acceptable level and require the application of safeguards, the member must document the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level.

The conceptual framework provides a valuable tool to help you comply with the requirement in the "Other Considerations" section of Interpretation No. 101-1 to evaluate whether a specific circumstance that is not addressed in the AICPA Code would pose an unacceptable threat to your independence.

When Is Independence Required, and Who Sets the Rules?

AICPA professional standards require your firm, including the firm's partners and professional employees, to be independent in accordance with Rule 101 whenever your firm performs an attest service for a client. Attest services include the following:

- Financial statement audits
- Financial statement reviews
- Other attest services, as defined in the Statements on Standards for Attestation Engagements

Performing a compilation of a client's financial statements does not require independence. However, if a nonindependent firm issues such a compilation report, the report should include an indication of the accountant's lack of independence pursuant to paragraph .21 of AR section 80, Compilation of Financial Statements (AICPA, Professional Standards).

You and your firm are not required to be independent to perform services that are not attest services (for example, tax preparation or advice or consulting services, such as personal financial planning), if they are the only services your firm provides to a client.

Note: You should familiarize yourself with your firm's independence policies, quality control systems, and list or database of attest clients.

In Addition to the AICPA, Who Else Sets Independence Rules?

Many clients are subject to oversight and regulation by governmental agencies. For example, the Government Accountability Office (GAO) sets independence rules that apply to entities audited under Government Auditing Standards (also referred to as the Yellow Book). For these clients (and others, such as those subject to regulation by the SEC or Department of Labor [DOL]), you and your firm also must comply with the independence rules established by those agencies.

The SEC regulates SEC registrants and issuers and establishes the qualifications of independent auditors. This section refers to these independence rules as SEC rules.

The PCAOB, a private standard-setting body whose activities are overseen by the SEC, is authorized to set, among other things, auditing, attestation, quality control, ethics, and independence standards for accounting firms that audit issuers. The PCAOB adopted interim ethics standards based on the following provisions of the AICPA Code: Rule 102, Integrity and Objectivity (AICPA, Professional Standards, ET sec. 102 par. .01); Rule 101; and interpretations and rulings under those rules. It also adopted Independence Standards Board (ISB) standards. To the extent that the SEC's rules are more or less restrictive than
the PCAOB's interim independence standards, registered public accounting firms must comply with the more restrictive requirements.

In addition to its detailed rules, the SEC looks to its general standard of independence and four basic principles to determine whether independence is impaired. The general standard is an appearance standard that considers whether a reasonable investor with knowledge of all relevant facts and circumstances would conclude that an accountant is independent.

Under the four basic principles, an auditor cannot (1) function in the role of management, (2) audit his or her own work, (3) serve in an advocacy role for the client, or (4) have a mutual or conflicting role with the client.

Other organizations that establish independence requirements that may be applicable to you and your firm include the following. You should contact these organizations directly for further information:

- State boards of accountancy
- State CPA societies
- Federal and state agencies

**Note:** Generally, the AICPA independence rules will apply to you in all situations involving an attest client. If an additional set of rules governing an engagement also applies, you should comply with the most restrictive rule or the most restrictive portions of each rule.

Once you determine that your firm provides attest services to a client and which rules apply, the next step is to determine how the rules apply to you.

**Applying the Rules—Client and Client Affiliates**

**Do I Need to Remain Independent From Just My Client or to Other Entities, As Well?**

Although, generally, we think of our clients as the entity for which we are performing an attest engagement, in some instances, you will need to remain independent from other entities. Specifically, if the engaging party is not the entity you are performing the attest engagement on, the AICPA Code requires that you also remain independent of the engaging party.

Come January 1, 2014, the AICPA Code will require you to remain independent of affiliates of any financial statement attest client. A financial statement attest client is considered to be any entity whose financial statements are audited, reviewed, or compiled when the member's compilation report does not disclose a lack of independence.

**What Entities Are Considered Affiliates of My Financial Statement Attest Client?**

Interpretation No. 101-18, "Application of the Independence Rules to Affiliates," under Rule 101 (AICPA, Professional Standards, ET sec. 101 par. .20), was added to the AICPA Code in November 2011. Although this interpretation may be implemented early, it is effective for engagements covering periods beginning on or after January 1, 2014, so you have a little time left to eliminate any prohibited relationships.
Following are the entities that will need to be considered affiliates of your client:

a. An entity (for example, subsidiary, partnership, or limited liability company [LLC]) that a financial statement attest client can control.

b. An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and is material to the financial statement attest client.

c. An entity (for example, parent, partnership, or LLC) that controls a financial statement attest client when the financial statement attest client is material to such entity.

d. An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

e. A sister entity of a financial statement attest client if the financial statement attest client and sister entity are each material to the entity that controls both.

f. A trustee that is deemed to control a trust financial statement attest client that is not an investment company.

g. The sponsor of a single employer employee benefit plan financial statement attest client.

h. Any union or participating employer that has significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

i. An employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client. A financial statement attest client that sponsors an employee benefit plan includes, but is not limited to, a union whose members participate in the plan and participating employers of a multiple or multiemployer plan.

j. An investment adviser, a general partner, or a trustee of an investment company financial statement attest client (fund) if the fund is material to the investment adviser general partner or trustee, and they are deemed to have either control or significant influence over the fund. When considering materiality, members should consider investments in, and fees received from, the fund.

**What Do I Do If a Financial Statement Attest Client’s Affiliates Can’t Be Identified?**

If after expending your best efforts to obtain the information to identify the affiliates of a financial statement attest client, you are unable to do so, all the following steps must be taken:

- Discuss the matter, including the potential impact on independence, with those charged with governance.
- Document the results of the discussion with those charged with governance.
- Document the efforts taken to obtain the information to identify the affiliates of the financial statement attest client.
Obtain written assurance from the financial statement attest client that it is unable to provide the member with the information necessary to identify the client’s affiliates.

**Are There Any Exceptions to the Affiliate Rules?**

Although the interpretation requires members to apply the independence provisions applicable to their financial statement attest clients to any affiliates, it was deemed appropriate and necessary to make four exceptions to this conclusion.

The first exception involves loans and applies to all affiliates. The AICPA Code currently prohibits a covered member from making a loan to, or having a loan from, an individual who is an officer, a director, or a 10 percent or more owner of an attest client. If this provision were applied to affiliates any time a member had a loan to or from an individual, especially one that is only an investor and not in a position of governance, he or she would need to take steps to ensure the individual was not in one of these positions at an affiliate. Accordingly, the exception concludes that only when the covered member has knowledge that the individual is in such a position with an affiliate of a financial statement attest client, the covered member should be required to consult the conceptual framework because without knowledge, the familiarity, undue influence, and financial self-interest threats would be at an acceptable level.

The second, third, and fourth exceptions may not be applied by those described as an affiliate under (a) or (b); rather, they may only be applied to those described as an affiliate under (c)–(j).

The second exception involves the provision of prohibited nonattest services. Specifically, when it is reasonable to conclude that the prohibited nonattest services do not create a self-review threat because the results of the nonattest services will not be subject to financial statement attest procedures, and any other threats that are created by the provision of the nonattest service (for example, management participation threats) that are not at an acceptable level are eliminated or reduced to an acceptable level by the application of safeguards, members should not be prohibited from providing these services to entities described as an affiliate under (c)–(j). This exception does not apply to those entities described as an affiliate under (a) or (b).

The third exception involves subsequent employment at an affiliate. The AICPA Code (that is, Interpretation No. 101-2, "Employment or Association With Attest Clients," under Rule 101 [AICPA, Professional Standards, ET sec. 101 par. .04]) currently requires the application of six specific safeguards when a former partner or employee becomes employed at an attest client in a key position. Under the proposed interpretation, if no exception were provided, these six safeguards would need to be applied when a former partner or employee becomes employed or associated with an affiliate in a key position. It was determined that it is not necessary to apply these safeguards to entities described as an affiliate under (c)–(j) if the individual’s position does not allow the individual to be in a key position with respect to the financial statement attest client. Again, this exception does not apply to those entities described as an affiliate under (a) or (b).

The fourth exception involves immediate family members and close relatives who are employed at those entities described as an affiliate under (c)–(j). Similar to the third exception previously described, covered members need only be concerned with employment positions their immediate family members and
close relatives have with such affiliates when these positions put them in a key position with respect to the financial statement attest client at those defined as an affiliate under (a) and (b).

Is There a Visual Aid to Help Me Understand the Affiliate Definitions?
Definitions (a)–(e) are subsequently shown and identified by the grey shaded boxes.
Is There an Executive Summary of the Interpretation?

<table>
<thead>
<tr>
<th>Type of Relationship</th>
<th>A</th>
<th>B</th>
<th>C</th>
<th>D</th>
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<th>F</th>
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<tr>
<td>Financial Interest In</td>
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<td>Nonattest Services Provided To</td>
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<td>Member’s Employment or Association With</td>
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<td>Former Employment or Association With</td>
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<td>Immediate Family Employment or Interest In</td>
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<td>Close Relative Employment or Interest In</td>
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**Tick Mark Key**

P: The independence provisions contained in the AICPA Code of Professional Conduct should be applied to this affiliate.
P: A member may have a loan to or from an individual who is an officer, a director, or a 10 percent owner of an affiliate; however, if the covered member has knowledge of the individual's relationship with the affiliate, he or she should consult ET section 100-1, *Conceptual Framework for AICPA Independence Standards* (AICPA, Professional Standards).

A: Firm will have to apply conditions (1)–(6) in Interpretation No. 101-2, "Employment or Association With Attest Clients," under Rule 101, *Independence* (AICPA, Professional Standards, ET sec. 101 par. .04), if the former employee is in a key position at the affiliate. Even if position is a nonkey position, when considering employment, the individual must report the consideration to the appropriate person in the firm and be removed from the engagement.

R: Immediate family members and close relatives of a covered member may be employed at an affiliate, as long as their position does not put them in a key position with respect to the financial statement attest client.

NSA: Services are permitted if not subject to audit; see the second exception for details.

N/A: The relationship is not applicable.

**Definitions of Affiliates**

Affiliate A: Entity that a financial statement attest client can control.

Affiliate B: An entity in which a financial statement attest client or an entity controlled by the financial statement attest client has a direct financial interest that gives the financial statement attest client significant influence over such entity and is material to the financial statement attest client.

Affiliate C: An entity that controls a financial statement attest client when the financial statement attest client is material to entity.

Affiliate D: An entity with a direct financial interest in the financial statement attest client when that entity has significant influence over the financial statement attest client, and the interest in the financial statement attest client is material to such entity.

Affiliate E: Sister entity of a financial statement attest client and sister are material to the entity that controls both.

Affiliate F: Trustee that is deemed to control a trust financial statement attest client that is not an investment company.

Affiliate G: Sponsor of a single employer employee benefit plan financial statement attest client.

Affiliate H: Union or participating employer having significant influence over a multiple or multiemployer employee benefit plan financial statement attest client.

Affiliate I: Employee benefit plan sponsored by a financial statement attest client or an entity controlled by the financial statement attest client.

Affiliate J: Investment adviser, general partner, and trustee of an investment company financial statement attest client (the fund) if the fund is material to the investment adviser, general partner, or trustee, and they are deemed to have either control or significant influence over the fund.
Applying the Rules—Covered Members and Other Firm Professionals

How Do the Independence Rules Apply to Me?

Whenever you are a covered member, you become subject to the full range of independence rules with regard to a specific client. You are a covered member if you are any of the following:

1. An individual on the client's attest engagement team
2. An individual in a position to influence the client's attest engagement
3. A partner or manager who provides more than 10 hours of nonattest services to the attest client
4. A partner in the office in which the lead attest engagement partner primarily practices in connection with the client's attest engagement
5. The firm, including the firm's employee benefit plans
6. An entity whose operating, financial, or accounting policies can be controlled\(^1\) by any of the individuals or entities described in items 1–5 or by 2 or more such individuals or entities if they act together

The SEC uses the term \textit{covered person}\(^2\) to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA's term \textit{covered member}. The only difference between the two definitions is that of classification. The AICPA considers consultants to be in a position to influence the engagement (the SEC uses the term \textit{chain of command}), whereas the SEC considers these persons to be on the attest engagement team. Overall, the definitions are the same.

\textbf{Note:} This alert uses the term \textit{covered member} (and \textit{covered person} with respect to SEC rules) extensively in explaining the "personal" independence rules (for example, rules that apply to you and your family's loans, investments, and employment). Therefore, it is important that you understand these terms before proceeding. Also, remember to check your firm's policies to determine whether they are more restrictive than the AICPA or SEC rules.

Do Any of the Rules Apply to Me If I Am Not a Covered Member?

Yes, these rules apply in certain circumstances, even if you are not a covered member. Due to their magnitude, two categories of relationships impair independence, even if you are not a covered member. These relationships are defined as follows:

- Director, officer, or employee (or in any capacity equivalent to a member of management) of the client, promoter, underwriter, voting trustee, or trustee of any of the client’s employee benefit plans

\footnotesize{\(^1\) For consolidation purposes, as defined by accounting principles generally accepted in the United States of America.}

\footnotesize{\(^2\) See Rule 2-01(f)(11). Also, see "Covered Persons in the Firm," in the Security and Exchange Commission's (SEC's) Final Rule Release [Section IV (H)(9)].}
Owner of more than 5 percent of an attest client's outstanding equity securities (or other ownership interests)

The independence rules prohibit these relationships if you are a partner or professional employee in a public accounting firm.

What If I Was Formerly Employed by a Client, or I Was a Member of the Client's Board of Directors?

You must be aware of a number of things, including the following:

- You may not participate in the client's attest engagement or be in a position to influence the engagement for any periods covering the time you were associated with the client. So, for example, if you worked for the client in 2012, you would be prohibited from serving on the client's audit engagement for the fiscal year 2012 financial statements. You also could not serve in a position that would allow you to influence the fiscal year 2012 engagement (for example, you could not directly or indirectly supervise the audit engagement partner).

- Before becoming a covered member, you must do the following:
  - Dispose of any direct or material indirect financial interests in the client.³
  - Collect and repay all loans to or from the client (except those specifically permitted or grandfathered).⁴
  - Cease active participation in the client's employee health and welfare plans unless the client is legally required to allow your participation in the plan (for example, through the Consolidated Omnibus Budget Reconciliation Act), and you timely pay 100 percent of your portion of the cost to participate.
  - Cease to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the client’s defined benefit plans, defined contribution plans, share-based compensation arrangements, deferred compensation plans, and other similar arrangements at the earliest date permitted under the plan. When the covered member does not participate on the attest engagement team or is not in a position to influence the attest engagement, he or she is not required to liquidate or transfer any vested benefits if such an action is not permitted under the terms of the plan or if a penalty⁵ significant to the benefits is imposed upon such liquidation or transfer.
  - Assess if you have any other relationships with the client to determine if such relationships create threats to

³ See the section, "When Do My (or My Family's) Financial Interests Impair Independence?" in this appendix.


⁵ A penalty includes an early withdrawal penalty levied under the tax law but excludes other income taxes that would be owed, or market losses that may be incurred, as a result of the liquidation or transfer.
independence that would require the application of safeguards to reduce the threats to an acceptable level.⁶

**What Rules Apply If I Am Considering Employment With an Attest Client?**

If an attest client offers you employment, or you seek employment with an attest client, you may need to take certain actions. If you are on that client's attest engagement team or can otherwise influence the engagement, you must promptly report any employment negotiations with the client to the appropriate person in your firm. You cannot participate in the engagement until your negotiations with the client end.

**What If I Accept Employment or a Board Position With an Attest Client?**

Being employed by a client or a member of the client's board of directors impairs independence. However, even if you leave your firm to take a position with a client, independence still may be affected. This would be the case if you accept a key position with the client, which means that you prepare financial statements or accounting records or are otherwise able to influence the client's statements or records. A few examples of key positions are controller, CFO, or treasurer. Remember that the substance, not only the position title, determines whether a position is considered "key."

If you meet the following conditions, having a key position with a client will not impair your firm's independence:

- The amounts the firm owes you (capital balance or retirement benefits) are based on a fixed formula and are not material to the firm.
- You cannot influence the firm's operations or financial policies.
- You do not participate or appear to participate in the firm's business or professional activities.

Your firm must consider whether it should apply additional procedures to ensure that your transition to the client has not compromised the firm's independence and that independence will be maintained going forward. Some things the firm should consider are as follows:

- Whether you served on the engagement team and for how long
- Positions you held with the firm and your status
- Your position and status with the client
- The amount of time that has passed since you left the firm

Based on these factors, the firm may decide to

- adjust the audit plan to reduce the risk that your knowledge of the plan could lessen the audit's effectiveness.
- reconsider the successor engagement team to ensure it has sufficient stature and experience to deal effectively with you in your new position.
- perform an internal technical review of the next attest engagement to determine whether engagement personnel exercised the

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⁶ See the section, "What Should I Do If No Specific Guidance Exists on My Particular Independence Issue?" in this appendix.
appropriate level of professional skepticism in evaluating your work and representations.\(^7\)

<table>
<thead>
<tr>
<th>Under SEC rules, if a former partner will be in an accounting role or financial reporting oversight role with an SEC audit client, he or she may not have the following:</th>
</tr>
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<tbody>
<tr>
<td>• A capital balance with the firm</td>
</tr>
<tr>
<td>• A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm</td>
</tr>
<tr>
<td>• Influence over the firm's operations or financial policies</td>
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The SEC uses the terms *accounting role* and *financial reporting oversight role*\(^8\) in its rules; taken together, these terms are consistent with the AICPA term *key position*. The SEC also requires a one-year cooling-off period for members of the audit engagement team of an issuer who assume a financial reporting oversight role with the client. In other words, if an engagement team member who participated on the audit of the current (or immediately preceding) fiscal year goes to work for a client, the firm's independence would be impaired.

Only members who provided fewer than 10 hours of audit, review, or other attest services to the client (and did not serve as either the lead or concurring partner for the client) would be excluded from the audit engagement team for purposes of this rule.

This rule applies to an issuer and its consolidated entities.

**What If I'm Employed as an Adjunct Faculty Member at an Educational Institution That Is an Attest Client?**

This is the one and only exception to the prohibition of being employed at an attest client. Although being employed by a client as an adjunct faculty member still raises threats to independence, when certain specified safeguards are in place, threats can be reduced to an acceptable level and independence maintained. The specific safeguards that a partner or professional employee must ensure are all in place is that they not

- be in a key position at the educational institution.
- participate on the attest engagement team.
- be an individual in a position to influence the attest engagement.
- participate in any employee benefit plans sponsored by the educational institution, unless participation is required.
- assume any management responsibilities or set policies for the educational institution.

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\(^{7}\) An objective professional with the appropriate stature and expertise should perform this review, and the firm should take any recommendation(s) that result from the review.

\(^{8}\) *Accounting role or financial reporting role* means a role in which a person is in a position to or does exercise more than minimal influence over the contents of the accounting records or anyone who prepares them or exercise influence over the contents of the financial statements or anyone who prepares them, such as when the person is a member of a board of directors or similar management or governing body, CEO, president, CFO, general counsel, chief accounting officer, controller, director of internal audit, director of financial reporting, treasurer, vice president of marketing, or any equivalent position.
Applying the Rules—Network Firms

What Is a Network Firm?

CPA firms frequently form associations with other firms and entities and cooperate with them to enhance their capabilities to provide professional services. On occasion, such cooperation creates the appearance that firms are closely aligned or connected. Such appearance exists when one or more of the following characteristics are present:

- The use of a common brand name (including common initials) as part of the firm name
- Common control (as defined by accounting principles generally accepted in the United States of America) among the firms through ownership, management, or other means
- Profits or costs, excluding costs of operating the association; costs of developing audit methodologies, manuals, and training courses; and other costs that are immaterial to the firm
- Common business strategy that involves ongoing collaboration among the firms whereby the firms are responsible for implementing the association’s strategy and are held accountable for performance pursuant to that strategy
- Significant part of professional resources
- Common quality control policies and procedures that firms are required to implement and that are monitored by the association

When a firm participates in such an association, and one or more of the preceding characteristics are present, the firm is considered a network firm. Any entity the firm controls by itself or through one or more of its owners is also considered a network firm. In addition, any entity that can control the firm or that the firm is under common control with would also be considered a network firm.

It is possible that not all firms in the association will meet one of the preceding characteristics. In such situations, only the subset of firms that meet one or more of the characteristics would be considered network firms.

How Do I Apply the Network Firm Rules?

Interpretation No. 101-17, "Networks and Network Firms," under Rule 101 (AICPA, Professional Standards, ET sec. 101 par. .19), explains that when your firm is considered a network firm, your firm is required to remain independent of other network firm's audit and review clients and vice versa. Thus, a network firm may provide audit or review services for a client only insofar as other network firms are independent of the client. For example, other network firms could not provide prohibited nonattest services (that is, services that would impair independence under Interpretation No. 101-3, "Nonattest Services," under Rule 101 (AICPA, Professional Standards, ET sec. 101 par. .05), for that client or have any prohibited relationships, such as investments by the firm in the client or loans to or from that client. For all other attest clients, members of network firms should consider any threats the firm knows or has reason to believe may be created by network firm interests and relationships. If those threats are not at an acceptable level, the members should apply safeguards to eliminate the threats or reduce them to an acceptable level.
When determining if a network exists, the SEC would look at all the facts and circumstances, especially how the firms treat one another when referring audit work (that is, do they place reliance on the work received by another firm, or do they treat the work the same as if an unaffiliated firm performed the work). At the SEC/PCAOB conference on December 10, 2007, it was noted that the SEC staff continue to follow the guidance issued in the SEC’s January 2001 independence rule-making regarding its definitions of firm and affiliate, meaning staff will consider specific facts and circumstances, including the following:

- Does the primary auditor refer to another network firm in his or her audit opinion?
- Do the firms have common ownership, profit-sharing, or cost-sharing agreements?
- Do the firms share management, have a common brand name, or use shared professional resources?
- Do the firms have common quality control policies and procedures?

**When Are the Rules Effective?**

This guidance is effective for engagements covering periods beginning on or after July 1, 2011.

**Applying the Rules—Family Members**

**When Is My Family Subject to the Rules?**

If you are a covered member with respect to a client, members of your immediate family (your spouse or equivalent and dependents) generally must follow the same rules that you follow. For example, your spouse’s investments must be investments that you could own under the rules. This rule applies even if your spouse keeps the investments in his or her own name or with a different broker.

This general rule has the following exceptions:

1. Your immediate family member’s employment with a client would not impair your firm’s independence, provided he or she is not in a key position.
2. Immediate family members in permitted employment positions may participate in certain employee benefit plans that are attest clients or sponsored by an attest client, provided the plan is offered to all employees in comparable positions, and the immediate family member does not serve in a position of governance for the plan or have the ability to supervise or participate in the plan’s investment decisions or selection of investment options.
3. Immediate family members of certain covered members may invest in a client through an employee benefit plan (for example, retirement or savings account), provided the immediate family member has no other investment options available for selection and, when

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9 This guidance was updated by the Professional Ethics Executive Committee and is effective on June 1, 2011. Early application is permitted.
such option becomes available, the immediate family member selects the option and disposes of any direct or material indirect financial interest in the attest client.

4. Immediate family members in permitted employment positions of certain covered members may participate in share-based compensation arrangements and nonqualified deferred compensation plans, provided certain safeguards are implemented.

5. The covered members whose families may invest or participate in the plans described in items (3) and (4) are

   a. partners and managers who provide only nonattest services to the client.

   b. partners who are covered members only because they practice in the same office where the client's lead attest partner practices in connection with the engagement.

At no time may any direct or material indirect financial interests in an attest client permitted by the preceding exceptions exceed five percent of the attest client's outstanding equity securities or other ownership interests.

The SEC rules concerning holding unexercised stock options require the immediate family member to exercise or forfeit vested stock options as soon as the closing market price of the underlying stock equals or exceeds the exercise price. The AICPA rule recognizes that a privately held entity may not have a ready market for its shares or that thinly traded securities may have volatile markets. Therefore, the triggering event requiring an immediate family member to exercise his or her vested stock options occurs when the market price of the underlying stock equals or exceeds the exercise price for 10 consecutive days.

Alternatively, the SEC's rules concerning employee stock ownership plans (ESOPs) are more restrictive than the AICPA rules in that the immediate family member must dispose of the publicly traded shares received as soon as possible. Because the AICPA rules deal exclusively with private sector securities, it is possible that when the immediate family member receives shares from an ESOP, he or she may not be able to dispose of the shares because there is not a ready market for the shares. Accordingly, the AICPA rules allow the immediate family member to require the employee to exercise his or her put option for the employer to repurchase the shares as soon as permitted by the ESOP terms. If the employer does not pay for the repurchase shares within 30 days, the repurchase obligation must be immaterial to the covered member during the payout period.

What About My Other Close Relatives?

The close relatives (siblings, parents, and nondependent children) of most covered members are subject to some employment and financial restrictions. Your close relative's employment by a client in a key position impairs independence, except for covered members who provide only nonattest services to a client.

Rules pertaining to your close relatives' financial interests differ depending on why you are considered a covered member:

- If you are a covered member because you participate on the client's attest engagement team, your independence would be considered
to be impaired if you are aware that your close relative has a financial interest in the client that either
- was material to your relative's net worth or
- enables the relative to exercise significant influence over the client.

- If you are a covered member because you are able to influence the client's attest engagement or are a partner in the office in which the lead attest engagement partner practices in connection with the engagement, your independence will be impaired if you are aware that your close relative has a financial interest in the client that
  - is material to your relative's net worth and
  - enables your relative to exercise significant influence over the client.

Under SEC rules, your close family members include your spouse (or equivalent) and dependents, your parents, nondependent children, and siblings. If you are a covered person, your independence is affected if your close family member
- has an accounting role or financial reporting oversight role with the SEC audit client (for example, the family member is a treasurer, CFO, accounting supervisor, or controller) or
- owns more than five percent of a client's equity securities or controls the client.

In addition, independence is considered to be impaired if any partner's close family member controls an SEC audit client.

Financial Relationships

When Do My (or My Family's) Financial Interests Impair Independence?

This section discusses various types of financial relationships and how they affect independence. Although this section focuses on how these rules apply to you and your family, keep in mind that your firm also is subject to the financial relationship rules (because firms are included in the AICPA definition of covered member).

As a covered member, you (and your spouse or equivalent and dependents) are not permitted to have
- a direct financial interest in that client, regardless of how immaterial it would be to your net worth.
- a material indirect financial interest in that client.

Note: The AICPA Code does not define, or otherwise provide, guidance on determining materiality. In determining materiality, you should apply professional judgment to all relevant facts and circumstances and refer to applicable guidance in the professional literature. Both qualitative and quantitative factors should be considered.

In addition, if you commit to acquire a direct or material indirect financial interest in a client, your independence would be impaired. For example, if you
sign a stock subscription agreement with the client, your independence would be considered impaired as soon as you sign the agreement.

Examples of financial interests include shares of stock; mutual fund shares; debt security issued by an entity; partnership units; stock rights; options or warrants to acquire an interest in a client; or rights of participation, such as puts, calls, or straddles.

The following types of financial interests are direct financial interests:

- Owned by you directly
- Under your control
- Beneficially owned\(^{10}\) by you through an investment vehicle, estate, trust, or other intermediary if you can either
  - control the intermediary or
  - have the authority to supervise or participate in the intermediary's investment decisions

For example, if you invest in a participant-directed 401(k) plan, whereby you are able to select the investments held in your account or are able to select from investment alternatives offered by the plan, you would be considered to have a direct financial interest in the investments held in your account.

You also have a direct financial interest in a client if you have a financial interest in a client through one of the following:

- A partnership, if you are a general partner
- A Section 529 savings plan, if you are the account owner
- An estate, if you serve as an executor and meet certain other criteria
- A trust, if you serve as the trustee and meet certain other criteria

For example, suppose you are a covered member with respect to ABC Co., and you are also a general partner of XYZ Partnership. XYZ Partnership owns shares in ABC Co. Under the independence rules, you would be deemed to have a direct financial interest in ABC Co. that would impair your independence, regardless of materiality.

An indirect financial interest arises if you have a financial interest that is beneficially owned through an investment vehicle, estate, trust, or other intermediary when you can neither control the intermediary nor have the authority to supervise or participate in the intermediary's investment decisions.

For example, if you invest in a defined contribution plan that is not participant-directed and you have no authority to supervise or participate in the plan's investment decisions, you would be considered to have an indirect financial interest in the underlying plan investments, in addition to a direct financial interest in the plan.

**Note:** Interpretation No. 101-15, "Financial Relationships," under Rule 101 (AICPA, *Professional Standards*, ET sec. 101 par. .17), provides extensive examples of various types of financial interests and

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\(^{10}\) A financial interest is beneficially owned if an individual or entity is not the record owner of the interest but has a right to some or all of the underlying benefits of ownership. These benefits include the authority to direct the voting or the disposition of the interest or to receive the economic benefits of the ownership of the interest.
whether they should be considered to be direct or indirect financial interests, including investments in mutual funds, retirement and savings plans, Section 529 plans, trusts, partnerships, and insurance products.

The SEC classifies your investment in an SEC audit client held through another entity (the intermediary) as direct if either of the following is true:

- You participate in the intermediary's investment decisions or have control over them.
- The investment in the client by the intermediary (which is not a diversified mutual fund) represents 20 percent or more of the value of its total investments.

If neither of the preceding applies, your investment in an SEC audit client through another entity would normally be considered to be an indirect financial interest in that client.

**What If My Immediate Family or I Receive a Financial Interest as a Result of an Inheritance or a Gift?**

If, due to an unexpected event, you or members of your immediate family receive a financial interest in an attest client that would impair your independence, you may qualify under an exemption in the rules if you meet the following criteria:

- The financial interest was unsolicited.
- You dispose of the interest as soon as practicable, but no later than 30 days after you become aware of it and have the right to dispose.
- If you do not have the right to dispose of the interest (for example, as in the case of stock options or restricted stock), you do not participate in the attest engagement for the client.

**What Are the Rules That Apply to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Those Mutual Funds?**

If you are a covered member with respect to a mutual fund attest client of your firm, and you or your immediate family own shares in the fund, you have a direct financial interest in the fund client.

The SEC rules also prohibit the firm and covered persons and their immediate family members from having any financial interest in an entity (even one that is not a client) that is part of an investment company complex that includes an SEC audit client.

**Which Rules Pertain to My Mutual Fund Investments (and Those of My Family) If My Firm Audits Companies Held in Those Mutual Funds?**

Financial interests that you and your immediate family have in clients through a mutual fund are considered to be indirect financial interests in those clients unless the fund is a diversified mutual fund.

If a mutual fund is diversified, and you or your immediate family, or both, own five percent or less of its outstanding shares, the fund's holdings in clients
for which you are a covered person will not be considered material indirect financial interests in those clients. Thus, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in audit clients for which you are a covered person.

If the fund is not diversified or you or your family, or both, own more than five percent of the fund's equity, you should treat the fund's holdings as indirect financial interests.

For example, suppose ABC Mutual Fund, a diversified mutual fund, owns shares in a client, XYZ, and

- ABC Mutual Fund's net assets are $10 million;
- your shares in ABC Mutual Fund are worth $50,000;
- ABC Mutual Fund has 10 percent of its assets invested in XYZ; and
- your indirect financial interest in XYZ is $5,000 ($50,000 \times 0.10).

If $5,000 is material to your net worth, independence would be considered to be impaired.

**May I Have a Joint Closely Held Investment With a Client?**

As a covered member, if you or the client, individually or collectively, controls an investment, that investment is considered to be a joint closely held investment. If this joint closely held investment is material to your net worth, independence would be considered to be impaired. In this rule, the term *client* includes certain persons associated with the client, such as officers, directors, or owners who are able to exercise significant influence over the client.

The SEC rules prohibit you and your immediate family from having a joint business venture with an SEC audit client or persons associated with the client in a decision-making capacity (meaning officers, directors, or substantial shareholders), regardless of whether the venture is material to your net worth. The SEC believes that these joint ventures, regardless of whether they are material, cause the client and audit firm to have mutuality of interests, which impairs independence.

**May My Family or I Borrow Money From, or Lend Money to, a Client?**

If you are a covered member with respect to an attest client, you and your immediate family may not have a loan to or from

- the client.
- an officer or director of the client.
- an individual holding 10 percent or more of the client's outstanding equity securities (or other ownership interests).

Certain exceptions affect this rule. First, specific loans exist that covered members are permitted to have from financial institution attest clients, including

- car loans and leases collateralized by the vehicle.
- credit card and overdraft reserve account balances that are kept current and do not exceed $10,000 (by payment due date, including any grace period).
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- passbook loans fully collateralized by cash deposits at the same financial institution.
- loans fully collateralized by an insurance policy.

In addition, if you have a loan from a client financial institution (for example, a bank) that meets certain criteria, your loan may be grandfathered (that is, you may be allowed to keep it). For your loan to be grandfathered, you must have obtained it under normal lending procedures, terms, and requirements. The following loans may be grandfathered:

- Home mortgages
- Other secured loans
- Unsecured loans that are immaterial to your net worth

Generally speaking, a loan may be grandfathered if you obtained it before

- you became a covered member with respect to the client.
- the financial institution became a client.
- the client acquired the loan.

To maintain your loan’s grandfathered status, you must keep the loan current (that is, make timely payments according to the loan agreement). Also, you cannot renew or renegotiate the terms of the loan (for example, the interest rate or formula) unless the change was part of the original agreement (for example, an adjustable rate mortgage).

The SEC rules differ from the AICPA rules in that secured loans (other than a mortgage on your primary residence) and immaterial unsecured loans may not be grandfathered.

May I Have a Brokerage Account With a Client?

The AICPA rules indicate that for independence to be maintained, a covered member whose assets are held by a broker-dealer client must not receive any preferential treatment or terms, and any assets that are subject to risk of loss must be immaterial to the covered member’s net worth. In addition, margin accounts may be subject to the preceding loan rules.¹¹

Under the SEC rules, you may have a brokerage account with an SEC audit client if your account (1) only holds cash or securities and (2) is fully insured by the Securities Investor Protection Corporation.

May I Have a Bank Account With a Client?

As a covered member, you may have a bank account with a client financial institution (for example, checking, savings, money market accounts, and certificates of deposit) if your deposits are fully insured by state or federal deposit insurance agencies or if uninsured amounts are not material to your net worth.¹²

¹¹ See the question, “May My Family or I Borrow Money From, or Lend Money to, a Client?” in this section.

¹² Both AICPA and SEC rules permit a practical exception for firms that maintain deposits exceeding insured limits when the likelihood of the financial institution experiencing financial difficulties is considered remote.
The SEC prohibits covered persons and their immediate families from having bank account balances with an SEC audit client in excess of Federal Deposit Insurance Corporation (FDIC) insurance limits. That is, deposits in excess of FDIC limits are considered to impair independence even if the amounts are immaterial to you and your family.\(^{13}\)

**May I Have an Insurance Policy With a Client?**

The AICPA rules\(^{14}\) indicate that to maintain independence, a covered member must not receive any preferential treatment or terms when purchasing an insurance policy from a client. If the policy has an investment option, the financial interest rules must be applied.

The SEC prohibits covered persons and their immediate family members from owning an individual insurance policy issued by an SEC audit client unless both of the following criteria are met:

- He or she obtained the policy before the professional became a covered person.
- The likelihood of the insurer becoming insolvent is remote.

**May I Give Gifts or Entertainment to, or Accept Gifts or Entertainment From, a Client?**

Ethics Ruling No. 114, "Acceptance or Offering of Gifts and Entertainment to or From an Attest Client," of ET section 191, *Ethics Rulings on Independence, Integrity, and Objectivity* (AICPA, *Professional Standards*, ET sec. 191 par. .228–.229), addresses the exchange of gifts and entertainment among covered members, the attest client, and certain persons associated with the client (for example, persons in key positions and persons owning 10 percent or more of the client's outstanding equity securities or other ownership interests).

Independence is impaired if the firm, a member of the attest engagement team, or a person able to influence the engagement accepts a gift that is not clearly insignificant.

A covered member may give a gift to persons associated with the client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it was reasonable in the circumstances.

Ethics Ruling No. 113, "Acceptance or Offering of Gifts or Entertainment," of ET section 191 (AICPA, *Professional Standards*, ET sec. 191 par. .226–.227), addresses the broader issue of integrity and objectivity when partners, professionals, or their firms exchange gifts or entertainment with clients or persons associated with clients. Generally, gifts are differentiated from entertainment by whether the client participates in the activity with the firm member (for example, giving tickets to a sporting event for the client to use would be considered

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\(^{13}\) The SEC treats money market funds (as opposed to money market accounts) as mutual funds for the purposes of its rules. Also see Rule 2-01(c)(1)(B).

a gift versus attending the event with the client, which would be considered
entertainment).  

Relevant factors in determining reasonableness include the event or occasion (if any) giving rise to the gift or entertainment, cost or value, frequency, whether business was conducted, and who participated.

**Business Relationships**

**Which Business Relationships With a Client Impair Independence?**

As a partner or professional employee of your firm, independence would be considered to be impaired if you entered into certain business relationships with an attest client of the firm. Accordingly, you may not serve a client as any of the following:

- Employee, director, officer, or in any management capacity
- Promoter, underwriter, or voting trustee
- Stock transfer or escrow agent
- General counsel (or equivalent)
- Trustee for a client's pension or profit-sharing trust

In essence, any time you are able to make management decisions on behalf of a client or exercise authority over a client's operations or business affairs, independence is impaired.

Your independence is considered impaired even if you were a volunteer board member because you would be part of the client's governing body and, therefore, would be able to participate in the client's management decisions.

Two possible exceptions apply to this rule:

- If you are an honorary director or trustee for a client that is a nonprofit charitable, civic, or religious organization, you may hold such position with a client if
  - your position is purely honorary,
  - you do not vote or participate in managing the organization, or
  - your position is clearly identified as honorary in any internal or external correspondence.

- In addition, you may serve on a client's advisory board if all the following criteria are met:
  - The board's function is purely advisory.
  - The board does not appear to make decisions for the client.
  - The advisory board and any decision-making boards are separate and distinct bodies.
  - Common membership between the advisory board and any decision-making groups is minimal.

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16 When evaluating your independence under this rule, you should examine the applicable board or committee charter to determine whether it is consistent with this ethics ruling.
The SEC prohibits direct or material indirect business relationships with an SEC audit client (or persons associated with a client), except when the firm is acting as a consumer in the ordinary course of business (for example, purchasing goods or services from a client at normal commercial terms, and these goods or services will be consumed by the firm). Examples of prohibited business relationships include joint business ventures, limited partnership agreements, and certain leasing interests.

Nonattest Services

Which Rules Describe the Nonattest Services That My Firm and I May or May Not Provide to Attest Clients?

The term nonattest services includes accounting, tax, and consulting services that are not part of an attest engagement. Nonattest services specifically addressed in the rules are the following:

- Bookkeeping services
- Nontax disbursement services
- Internal audit assistance services
- Benefit plan administration services
- Investment advisory or management services
- Tax compliance services
- Corporate finance consulting or advisory services
- Appraisal, valuation, or actuarial services
- Executive or employee search services
- Business risk consulting services
- Information systems design, installation, or integration services
- Forensic accounting services

In addition to considering the general standard and four guiding principles, the SEC rules generally prohibit a CPA from providing the following services to an SEC audit client during the audit and professional engagement period:

- Bookkeeping and other services related to the client's accounting records or financial statements
- Financial information systems design and implementation
- Appraisal or valuation services
- Actuarial services
- Internal audit outsourcing
- Management functions
- Human resources

17 Defined in the AICPA Code of Professional Conduct, an attest engagement is one that requires independence under AICPA professional standards; for example, audits and reviews of financial statements or agreed-upon procedures performed under the attestation standards are considered attest engagements.
Broker-dealer, investment adviser, or investment banking
Legal services
Expert services unrelated to the audit

Under PCAOB rules, the following types of services also are subject to significant restrictions if the auditor provides them to an issuer during the audit and professional engagement period:

- Aggressive or confidential tax transactions
- Personal tax services provided to persons in financial reporting oversight roles

If your firm performs nonattest services for an attest client, the independence rules impose limits on the nature and scope of the services that your firm may provide. In other words, the extent to which your firm may perform certain tasks will be limited by the rules. Further, certain services will be prohibited in total (for example, serving as a client’s general counsel). These rules apply during the period of the professional engagement and the period covered by the financial statements (to which the attest services relate). However, if the member provided the entity with prohibited nonattest services prior to the entity becoming an attest client, independence would not be impaired if the prohibited nonattest services related to periods prior to the periods covered by the financial statements the member is engaged to audit, and those prior period financial statements were audited by another firm (or, in the case of a review engagement, reviewed or audited by another firm).

In August 2007, the SEC updated its frequently asked questions (FAQ) document, Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence—Frequently Asked Questions. FAQ No. 7 under the "Prohibited and Non-audit Services" section addresses the question of whether a successor auditor who performed one of the preceding services during the audit period (period covered by the financial statements) would be independent of an SEC audit client. The FAQ states that if the services (a) relate solely to the prior period audited by the predecessor auditor, and (b) were performed before the successor auditor was engaged to audit the current audit period, independence would not be impaired.

This section does not discuss each of these services but, rather, focuses on a few for purposes of illustration. To see the full context of the rules, see Interpretation No. 101-3 and SEC Rule 2-01(c)(4), "Non-audit services." You also are encouraged to review the Frequently Asked Questions: Performance of the Nonattest Services developed by the Professional Ethics Division and the "Prohibited and Non-audit Services" section of Office of the Chief Accountant: Application of the Commission’s Rules on Auditor Independence—Frequently Asked Questions developed by the SEC’s Office of the Chief Accountant.

The AICPA rules require a member to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy and the SEC, GAO, and DOL.
SEC and PCAOB rules require independence of an issuer that is an audit client and various affiliated entities of the client.\textsuperscript{18}

\textbf{Note:} SEC rules also require a client's audit committee (or equivalent) to preapprove all audit and nonaudit services provided by the firm to an issuer and the issuer's consolidated entities. Proposals to provide tax or internal control-related services are subject to more extensive audit committee preapproval requirements under PCAOB Rule 3524, \textit{Audit Committee Pre-approval of Certain Tax Services}, and Rule 3525, \textit{Audit Committee Pre-Approval of Non-audit Services Related to Internal Control Over Financial Reporting} (AICPA, \textit{PCAOB Standards and Related Rules}, Select Rules of the Board).

PCAOB Rule 3526, \textit{Communication with Audit Committees Concerning Independence} (AICPA, \textit{PCAOB Standards and Related Rules}, Select Rules of the Board), superseded the PCAOB's interim standard, ISB Standard No. 1, \textit{Independence Discussions with Audit Committees} (AICPA, \textit{PCAOB Standards and Related Rules}, Interim Standards), and its interpretations. Before accepting a new audit engagement and annually thereafter, the auditor must describe in writing to the issuer's audit committee all relationships between the auditor and the client (including affiliates of both) that could reasonably be thought to bear on independence, discuss these matters with the audit committee, and document the substance of that discussion (effective September 30, 2008).

\textbf{AICPA General Requirements}

\textbf{General Requirement 1}

One of the key principles underlying the AICPA rules on nonattest services is that you may not assume management responsibilities or even appear to assume management responsibilities. Management responsibilities involve leading and directing an entity, including significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. Examples of management responsibilities include such activities as

- setting policies or strategic direction for the client.
- directing or accepting responsibility for the actions of the client's employees, except to the extent permitted when using internal auditors to provide assistance for services performed under auditing or attestation standards.
- authorizing, executing, or consummating transactions or otherwise exercising authority on behalf of a client or having the authority to do so.
- preparing source documents in electronic or other form evidencing the occurrence of a transaction. \textit{Source documents} are the documents upon which evidence of an accounting transaction are initially recorded and are often followed by the creation of many additional records and reports that do not, however, qualify as initial recording. Examples of source documents are purchase orders, payroll time cards, and customer orders.
- having custody of client assets.

\textsuperscript{18} See Rule 2-01(f)(4) and (6).
deciding which recommendations of the member or other third parties to implement or prioritize.

- reporting to those charged with governance on behalf of management.

- serving as the client’s stock transfer or escrow agent, registrar, general counsel, or its equivalent.

- accepting responsibility for management of a client’s project.

- accepting responsibility for preparation and fair presentation of the client’s financial statements in accordance with the applicable financial reporting framework.

- accepting responsibility for designing, implementing, or maintaining internal control.

- performing ongoing evaluations of the client’s internal control as part of its monitoring activities.

**General Requirement 2**

To help ensure compliance with the first general requirement, the second requirement states that the client must agree to assume certain responsibilities related to the nonattest services engagement. So, prior to agreeing to perform any nonattest services for the client, the member must obtain the client’s agreement that the client will

- assume all management responsibilities.

- oversee the service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, and experience. The member should assess and be satisfied that such individual understands the services to be performed sufficiently to oversee them but is not required to possess the expertise to perform or reperform the services.

- evaluate the adequacy and results of the services performed.

- accept responsibility for the results of the services.

With regard to the preceding list, the member should be satisfied that the client designee will be able to meet this criteria, make informed judgment on the results of the nonattest services, and be responsible for making all significant judgments and decisions that are the proper responsibility of management. The client also must be willing to commit the time and resources needed for the designee to fulfill these duties.

**General Requirement 3**

Before performing nonattest services, the firm should establish and document its understanding with the client regarding the following:

- Objectives of the engagement
- Services to be performed
- Client’s acceptance of its responsibilities
- Member's responsibilities
- Any limitations of the engagement

The firm should document the understanding in the engagement letter, audit planning memo, or other internal firm file.
Alert

**Note:** Routine activities (for example, assisting clients with technical accounting questions, advising on internal controls, or providing periodic training on new pronouncements) that are part of the normal member-client relationship are exempt from the second and third general requirements.

### What Are the Rules Concerning Performing Bookkeeping Services for a Client?

The AICPA independence rules prohibit members from assuming management responsibilities in all circumstances. Accordingly, a member may provide bookkeeping services if the client oversees the services and, among other things, performs all management responsibilities in connection with the services. For example, if a member is engaged to provide bookkeeping services that will result in a set of financial statements, the client must

- approve all account classifications.
- provide source documents to the member so that the member can prepare journal entries.
- take responsibility for the results of the member's services (for example, financial statements).

**Note:** Proposing adjusting entries to a client's financial statements as a part of the member's audit, review, or compilation services is considered a normal part of those engagements and would not be considered the performance of a nonattest service subject to the general provisions of Interpretation No. 101-3, provided the client reviews these entries, understands the impact on its financial statements, and records any adjustments identified by the member that the client believes appropriate.

Because of self-audit concerns, performing any type of bookkeeping service for an SEC audit client is considered to impair independence under SEC rules unless it is reasonable to expect that the results of the auditor's services will not be subject to the firm's audit procedures. The SEC considers there to be a rebuttable presumption that the results of these services would be subject to audit procedures; therefore, the firm must overcome the presumption to perform the service.

This presumption of self-audit also applies to (1) financial information design and implementation; (2) appraisals, valuations, fairness opinions, or contribution-in-kind reports; (3) actuarial-related advisory services; and (4) internal audit outsourcing.

### May My Firm Provide Internal Audit Assistance to a Client?

To perform internal audit assistance for a client and maintain independence, your firm may not, in effect, manage the internal audit activities of the client. For example, you and your firm may not

- make decisions on the client's behalf.
- report to the client's governing body.
To maintain independence, the client must

- designate an individual or individuals who possess suitable skill, knowledge, and experience (preferably within senior management) to oversee the internal audit function.
- determine the scope, risk, and frequency of internal audit activities.
- evaluate the findings and results of internal audit activities.
- evaluate the adequacy of the audit procedures performed and related findings.

Internal audit services provided to an SEC audit client impair independence unless it is reasonable to expect that the results of the auditor's services would not be subject to the firm's audit procedures.


**May My Firm Manage a Project For a Client?**

Responsibility for client projects, including whether to proceed with a project, is management's responsibility. Accordingly, if a member accepts responsibility for management of a client's project, then the member's independence would be impaired even if the project did not affect the client's financial statements. However, if the member's services were limited to providing assistance, advice, suggestions, or recommendations regarding matters that are within his or her areas of knowledge or experience, independence would not be impaired.

**May My Firm Provide Valuation, Appraisal, or Actuarial Services to a Client?**

Your firm may not provide valuation, appraisal, or actuarial services to a client if

- the results of the service would be material to the client's financial statements, and
- the service involves a significant amount of subjectivity.

For instance, your firm may not perform a valuation in connection with a business combination that would have a material effect on a client's financial statements because that service involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

Two limited exceptions apply to this rule. First, valuation, appraisal, or actuarial services performed for nonfinancial statement purposes may be provided if they otherwise meet the rule's general requirements. (For example, the client assigns an individual who is in a position to make an informed judgment on, and accept responsibility for, the results of the service to oversee the service.) Also, your firm may provide an actuarial valuation of a client's pension or postretirement liabilities because the results of the valuation would be reasonably consistent, regardless of who performs the valuation.
The SEC prohibits your firm from providing valuation, appraisal, or any service involving a fairness opinion or contribution-in-kind report\textsuperscript{19} to an SEC audit client unless it is reasonable to expect that your firm would not audit the results of those services.

In August 2008, the staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether, under Interpretation No. 101-3, members could assist an attest client in applying Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 805, Business Combinations, or 350, Intangibles—Goodwill and Other, while maintaining independence. Specifically, the FAQ addresses whether the following services would be considered to impair independence:

- Providing the client advice on valuation methodologies and assumptions needed to perform the valuation
- Providing advice on valuation templates, software, or other tools that allow the client to determine an appropriate value for acquired assets, goodwill, contingent consideration, and so on

**May My Firm Provide Investment Advisory Services to a Client?**

Here are examples of what you and your firm may do under the AICPA rules, provided the general requirements are met:

- Make recommendations to a client about the allocation of funds to various asset classes
- Analyze investment performance

However, the AICPA rules also indicate that you and your firm may not do the following:

- Make investment decisions for the client
- Execute investment transactions
- Take custody of a client's assets

**May My Firm Design or Implement an Information System for a Client?**

Your firm may not design or develop a client's financial information system or make more than insignificant modifications to the source code underlying such a system. In addition, operating a client's local area network is prohibited.

Your firm may install an accounting software package for a client, including helping the client set up a chart of accounts and financial statement format. Your firm may perform network maintenance, such as updating virus protection, applying routine updates and patches, or configuring user settings, as specified by management. Your firm also may provide training to the client's employees on how to use an information system. Your firm may not, however, supervise the client's employees in their day-to-day use of the system because that activity is a management function.

\textsuperscript{19} Per the SEC, fairness opinions and contribution-in-kind reports are opinions and reports in which your firm provides its opinion on the adequacy of consideration in a transaction.
Your firm is not precluded from designing, implementing, integrating, or installing an information system that is unrelated to the client's financial reporting process.\(^{20}\)

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<th>SEC rules prohibit your firm from providing any service related to an SEC audit client's financial information system design or implementation unless the results of your firm's services would not be subject to audit procedures during an audit of the client's financial statements. Your firm may do either of the following:</th>
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<td>• Evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider</td>
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<tr>
<td>• Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider</td>
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*Note:* If your audit client is an issuer, your firm must obtain preapproval for these and other internal control-related services, in accordance with PCAOB Rule 3525.

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**May My Firm Provide a Client With Training Services?**

The staff of the Professional Ethics Division issued nonauthoritative guidance (in the form of an FAQ) on the question of whether a member's independence would be impaired if he or she provided training to a client that is implementing changes to its financial reporting system or process. The FAQ concludes that a member's independence would not be impaired if the client personnel are provided with a general understanding of the financial reporting system or process. It goes on to explain that if client personnel already have a general understanding, the member may provide more specific training to client personnel on how the system or process applies to the client's specific circumstances. It cautions members that they should ensure that the training does not involve supervising client personnel in either the implementation or daily operation of the financial system or process or result in the member performing other management responsibilities, such as making operational decisions or implementing the internal controls necessary for the system or process to run effectively.

**Fee Issues**

**What Types of Fee Arrangements Between My Firm and a Client Are Prohibited?**

Two types of fee arrangements—contingent fees and commissions—are prohibited if the arrangement involves certain attest clients, even though the fee is not related to an attest service.

A contingent fee is an arrangement whereby no fee is charged unless a specified result is attained, or the amount of the fee depends on the results of your firm's services. Some examples of contingent fees are as follows:

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\(^{20}\) Frequently asked questions are available to assist members in understanding and implementing the new information technology services provisions and may be obtained at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.
Your firm receives a "finder's fee" for helping a client locate a buyer for one of your client's assets.

Your firm performs a consulting engagement to decrease a client's operating costs. The fee is based on a percentage of the cost reduction the client achieves as a result of your service.

The following are exceptions:

- Fees fixed by a court or other public authority
- In tax matters, fees based on the results of judicial proceedings or the findings of governmental agencies

A commission is any compensation paid to you or your firm for recommending or referring a third party's product or service to a client or recommending or referring a client's product or service to a third party.

The following are examples of commissions:

- If you or your firm refers a client to a financial planning firm that pays you a commission for the referral
- If you or your firm sells accounting software to a client and receives a percentage of the sales price (a commission) from a software company
- If you or your firm refers a nonclient to an insurance company client that pays you a percentage of any premiums subsequently received (a commission) from the nonclient

Commissions or contingent fee arrangements with a client are not allowed if your firm also provides one of the following services to a client:

- An audit of financial statements
- A review of financial statements
- A compilation of financial statements if a third party (for example, a bank or an investor) will rely on the financial statements, and the report does not disclose a lack of independence
- An examination of prospective financial statements

You may have commission and contingent fee arrangements with persons associated with a client, such as officers, directors, and principal shareholders, or with a benefit plan that is sponsored by a client (that is, the plan itself is not an attest client). For example, you may receive a commission from a nonclient insurer if you refer an officer of an attest client to the insurer, and the officer purchases a policy. Even though this situation is permitted, you are still required to tell the officer that you received a commission for making the referral.

**Note:** State boards of accountancy and state societies also may have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.
adapted from the SEC's definition, the PCAOB rule eliminated the exception for fees in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies. In addition, the PCAOB rule specifically indicates that the contingent fees cannot be received directly or indirectly from an issuer that is an audit client.

When Are Referral Fees Permitted?

Rule 503, Commissions and Referral Fees (AICPA, Professional Standards, ET sec. 503 par. .01), provides an exception for referral fees for recommending or referring a CPA's services to another person or entity. That is, you may receive a fee for referring a CPA's services to any person or entity, or if you are a CPA, you may pay a fee to obtain a client. You must inform the client if you receive or pay a referral fee.

Is Independence Affected When a Client Owes the Firm Fees for Professional Services That the Firm Has Already Provided?

If a client owes your firm fees for services rendered more than one year ago, your firm's independence is considered impaired. It does not matter if the fees are related to attest services; what matters is that the client has an outstanding debt with the firm. This is the case even if the client has given you a note receivable for these fees.

The SEC generally expects payment of past due fees before an engagement has begun, although a short-term payment plan may be accepted if the SEC audit client has committed to pay the balance in full before the current year report is issued.21

Does Being Compensated for Selling Certain Services to Clients Affect My Independence?

The AICPA rules do not specifically address this issue.

The SEC prohibits audit partners from being directly compensated for selling nonattest services to issuers that are audit clients. The SEC believes that such financial incentives could threaten an audit partner's objectivity and that the appearance of independence could be affected by such compensation arrangements.22

The rule does not prevent an audit partner from sharing in profits of the audit practice or overall firm. It also does not preclude the firm from evaluating a partner based on factors related to the sale of nonaudit services to issuers (for example, the complexity of engagements or overall management of audit or nonaudit engagements).

21 The exception generally has been applied only to engagements to audit a client's financial statements included in its annual report, not in a registration statement.

22 Accounting firms with 10 or fewer partners and 5 or fewer audit clients that are issuers, as defined by the SEC, are exempt from this rule.
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Does It Matter If a Significant Proportion of My Firm’s Fees Comes From a Particular Client?

The conceptual framework states that a financial self-interest threat may exist due to "excessive reliance on revenue from a single attest client." In addition, Rule 102 and ET section 55, Article IV—Objectivity and Independence (AICPA, Professional Standards), discuss in broad terms that members should be alert for relationships that could diminish their objectivity and independence in performing attest services. The significance of a client to a member (or his or her firm), measured in terms of fees, status, or other factors, may diminish a member's ability to be objective and maintain independence when performing attest services.

To address this issue, firms should consider implementing the following policies and procedures to identify and monitor significant clients to help mitigate possible threats to a member's objectivity and independence:

- Policies and procedures for identifying and monitoring significant client relationships, including the following:
  - Considering client significance in the planning stage of the engagement.
  - Basing the consideration of client significance on firm-specific criteria or factors that are applied on a facts and circumstances basis (see the "Factors to Consider in Identifying Significant Clients" section that follows).
  - Periodically monitoring the relationship. What constitutes periodic is a matter of judgment, but assessments of client significance that are performed at least annually can be effective in monitoring the relationship. During the course of such a review, a client previously deemed to be significant may cease to be significant. Likewise, clients not identified as significant could become significant whenever factors the firm considers relevant for identifying significant clients arise. (For example, additional services are contemplated.)

- Policies and procedures for helping mitigate possible threats to independence and objectivity, including the following:
  - Assigning a second (or concurring) review partner who is not otherwise associated with the engagement and who practices in an office other than those who perform the attest engagement
  - Subjecting the assignment of engagement personnel to approval by another partner or manager
  - Periodically rotating engagement partners
  - Subjecting significant client attest engagements to internal firm monitoring procedures
  - Subjecting significant client attest engagements to preissuance or postissuance reviews or the firm's external peer review process

The most effective safeguards a firm can employ will vary significantly, depending on the size of the firm; the way the firm is structured (for example,
whether highly centralized or departmentalized); and other factors. For example, smaller firms (particularly those with one office) tend to be simpler and less departmentalized than larger firms. Generally, their processes will be less formal and involve fewer people than those of larger firms. Further, the firms' managing partners may engage in frequent and direct communications with the firms' partners and professional staff on client matters and be personally involved in staff assignments. Larger firms draw from a sizeable and diverse talent pool. In those firms, partners who are not affiliated with the engagement (or client service office or business unit) can choose second (or concurring) review partners from outside the office performing the attest engagement. Midsized or regional firms may have aspects of both their smaller and larger counterparts, such as combining the ability to choose second review partners from an office other than the client service office while maintaining a relatively close connection to specific client relationships.

Factors to Consider in Identifying Significant Clients

The following are both qualitative and quantitative factors that can reveal a significant client:

- The size of the client in terms of the percentage of fees or the dollar amount of fees versus total revenue of the engagement partner, office, or practice unit of the firm.\(^{23}\)
- The significance of the client to the engagement partner, office, or practice unit of the firm in light of the following:
  - The amount of time the partner, office, or practice unit devotes to the engagement
  - The effect on the partner's stature within the firm due to his or her relationships with the client
  - The manner in which the partner, office, or practice unit is compensated
  - The effect that losing the client would have on the partner, office, or practice unit
- The importance of the client to the firm's growth strategies (for example, the firm is trying to gain entry into a particular industry)
- The stature of the client, which may enhance the firm's stature (for example, the firm is trying to gain entry into a particular industry)
- Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the client)
- Whether the engagement is recurring

Judgment is necessary to determine whether a client is significant to the firm, office, practice unit, or partner of the firm. Firms will vary considerably in terms of the degree to which they consider some factors to be more pertinent than others. Gauges that relate to each relevant level within a firm (for example,  

\(^{23}\) Assessing client significance at the business or practice unit level may be a more meaningful measure for firms that structure their practices along industry lines (such as healthcare or financial services).
firm, geographic region, office, or practice unit) may be useful but likely will be different for various levels within the firm.

In general, if a firm derives more than 15 percent of its total revenues from one SEC audit client or group of related clients, independence may be impaired because this may cause the firm to be overly dependent on the client or group of related clients.

Further Assistance

Where Can I Find Further Assistance With My Independence Questions?

This appendix does not address many subjects included in the AICPA rules. Readers are encouraged to view the online version of the code at www.aicpa.org/Research/Standards/CodeofConduct/Pages/default.aspx.

In addition, readers should refer to ET section 100-1, which can be found online at www.aicpa.org/Research/Standards/CodeofConduct/Pages/et_100.aspx, in evaluating whether a specific circumstance that is not addressed in the AICPA Code would pose an unacceptable threat to independence.

As specific services and situations arise in practice, refer to the independence literature and consult with those responsible for independence in your firm. If you need further assistance researching your question, contact one of the following organizations for guidance.

The AICPA has a variety of resources for practitioners:

- For information about the AICPA’s ethics standard-setting projects, exposure drafts, and meetings, go to www.aicpa.org/INTERESTAREAS/PROFESSIONALETHICS/COMMUNITY/Pages/community.aspx.
- For questions related to understanding the nonattest services rules, consult the Background and Basis for Conclusions document for nonattest services at www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/BasisforConclusionsNonAttestServices.doc.
- For questions related to applying the nonattest services rules, go to www.aicpa.org/InterestAreas/ProfessionalEthics/Resources/Tools/DownloadableDocuments/NonattestServicesFAQs.doc.
- For independence inquiries by phone, call 888.777.7077. Send e-mail inquiries to ethics@aicpa.org.
- The AICPA interactive CD-ROM course on independence, Independence, teaches the AICPA and SEC independence rules and qualifies for four hours of continuing professional education credits. Go to www.cpa2biz.com/AST/Main/CPA2BIZ_Primary/Ethics/PRDOVR~PC-739155HS/PC-739155HS.jsp.
- The PCPS Independence Toolkit, which includes the "Inadvertent Independence Violations Practice Tool" to assess the impact and determine appropriate next steps when an independence violation is identified. Go to www.aicpa.org/InterestAreas/PrivateCompaniesPracticeSection/Resources/KeepingUp/Pages/PCPSIndependenceToolkit.aspx.
The 2011 Yellow Book Independence—Nonaudit Services Documentation Practice Aid will assist auditors performing audits in accordance with the 2011 revision to Government Auditing Standards (the 2011 Yellow Book) issued by the GAO in identifying and evaluating threats to independence for nonaudit services when considering whether to provide a nonaudit service. It will also assist auditors in applying the conceptual framework for independence contained in the 2011 Yellow Book (Yellow Book Conceptual Framework) and in complying with the Yellow Book's independence documentation requirements. Go to www.aicpa.org/InterestAreas/GovernmentalAuditQuality/Resources/AuditPracticeToolsAids/Pages/YellowBookAuditToolsandAids.aspx.

SEC resources are as follows:

- Information for accountants, including independence, may be found online at the Office of the Chief Accountant at www.sec.gov/about/offices/oca/ocaprof.htm.
- U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549; 202.551.5300 (Phone); 202.772.9252 (Fax).

The PCAOB has a website at www.pcaobus.org. Rules can be found at www.pcaobus.org/Rules/Pages/default.aspx, and standards can be found at http://pcaobus.org/Standards/Pages/default.aspx.

GAO resources are as follows:

- Obtain the GAO Yellow Book requirements at www.gao.gov/yellowbook.
- Direct inquiries should be sent to Michael Hrapsky, Senior Project Manager, Government Auditing Standards, at 202.512.9535 or e-mail yellowbook@gao.gov.

DOL resources are as follows:

- DOL Regulation 2509.75-9, Interpretive Bulletin Relating to Guidelines on Independence of Accountant Retained by Employee Benefit Plan. This regulation can be found at http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&sid=e46da7169dc9db98a57461c30d1115bf&rgn=dv5&view=text&node=29:9.1.3.1.1&idno=29#29:9.1.3.1.1.0.10.9.
- Direct inquiries to the DOL at 1.866.4.USA.DOL.
Banking regulators' resources are as follows:


- The following organizations comprise the Federal Financial Institutions Examination Council (FFIEC): the Board of Governors of the Federal Reserve System; the FDIC; the National Credit Union Administration; and the Office of the Comptroller of the Currency. The FFIEC issues financial institution letters (FILs) that are addressed to the CEOs of the financial institutions on the FIL's distribution list, generally FDIC-supervised institutions. FILs may announce new regulations and policies, new FDIC publications, and a variety of other matters of principal interest to those responsible for operating a bank or savings association. FILs have addressed auditor conduct (for example, internal audit outsourcing and use of indemnification clauses in engagement letters) in recent years and may apply to both public and nonpublic institutions. Additional information is available. Go to http://search.fdic.gov/search?access=p&output=xml_no_dtd&sort=date:D:L:d1&site=fils&ie=UTF-8&btnG=Search&client=fils&oe=UTF-8&proxystylesheet=fils&q=auditor+independence&ip=69.113.123.203&filter=p for additional information.

International Federation of Accountants (IFAC) resources are as follows:

- Information about the International Ethics Standards Board for Accountants (IESBA) can be found on the IFAC's website at www.ifac.org/Ethics/.