

## New Guidance on Nonattest Services

In February 2010, the staff of the AICPA Professional Ethics Division issued three new Frequently Asked Questions (FAQs) on Interpretation No. 101-3, "Performance of Nonattest Services." The FAQs, which are not authoritative, bring the total number of FAQs on the topic to 48 and address such issues as documentation of the engagement, performance of management functions, and among others, controllership, tax, and valuation services. There are two important caveats to keep in mind when considering this guidance:

1. Compliance with all applicable provisions of Interpretation No. 101-3, e.g., the "General Requirements" is presumed.
2. The FAQs address only the application of AICPA independence rules to the circumstances. If other regulatory requirements apply, those other rules must be applied in addition to the AICPA rules.

### About the Author & Publisher

Cathy Allen, founder of **Audit Conduct, LLC**, develops courses and customized training on professional ethics and auditor independence for CPA firms, professional organizations, and other stakeholders of the accounting profession. She also helps CPA firms enhance their quality controls over ethics and independence compliance.

The new FAQs address two types of services that attest clients may request from their audit firms in connection with their consideration, planning, and/or implementation of changes to their financial reporting systems or processes. Two examples discussed in the FAQs are transitioning the client's financial reporting system from US GAAP to International Financial Reporting Standards (IFRS) and implementing eXtensible Business Reporting Language (XBRL) into the financial reporting system. Highlights of the new FAQs are provided below:

#### Training attest client personnel in connection with a change in reporting systems or processes:

- The firm may provide client personnel general training on the subject matter. Once the member is satisfied that the client has a general understanding of the subject matter, the member may also provide specific training on how the new system or process applies to the client's specific circumstances.
- Members of the firm should not perform management activities, for example, they should not:
  - Supervise the client's personnel as they implement or operate the new system or perform new processes.
  - Make operational decisions for the client.
  - Implement the internal controls necessary for the new system or process to run effectively.

#### Providing project management services to an attest client:

- Taking responsibility for managing a client's project impairs independence because it is a management function. Note: This would be true even if the project did not impact the financial statements.
- Independence would not be impaired if the member's involvement was limited to providing assistance, advice, suggestions and/or recommendations regarding matters that are within the member's area(s) of expertise. For example, the member may provide feedback on management's plans (including how management will prioritize its activities) and help the client understand the general considerations for the project.
- Management must make all decisions related to the project.

#### Assist client management with its determination of whether or not to proceed with a project:

- A member may assist the attest client by providing guidance on the relevant issues. For example, the member may help the client gather information that management will use to conduct its analysis or provide advice and make recommendations on the assumptions management will use in its analysis.
- The member should not make the decision of whether or not to proceed with the project.

## Revised AICPA Independence Rules

In February 2010, the AICPA Professional Ethics Executive Committee (PEEC) agreed to adopt revised and clarified independence rules impacting:

1. Ethics Interpretation 101-1, *Interpretation of Rule 101*, as it applies to covered members formerly associated with an attest client and participation of a covered member's immediate family in an employer's benefit plan. (Effective: June 1, 2011 with earlier application allowed)
2. Ethics Ruling No. 107, *Participation in Health and Welfare Plan Sponsored by Client* (Effective: May 31, 2010)
3. Interpretation 101-15, *Financial Relationships* (ET§101.17) (Effective: May 31, 2010)

Changes 2 and 3 were of an editorial nature and aligned those standards to Interpretation 101-1. Highlights of the revised 101-1 provisions are summarized in the following table:

### HIGHLIGHTS OF REVISIONS: INTERPRETATION 101-1

#### Revisions to Application of the Independence Rules to Covered Members (see "Covered Members" on page 3) Formerly Employed by a Client or Otherwise Associated with a Client:

- Allows government employees to continue participation in a government sponsored benefit plan of a former employer under certain conditions
- Clarifies that in addition to other applicable provisions in 101-1, a covered member should also consider other relationships with the client that may cause threats to independence and whether such threats require application of safeguards in accordance with *Conceptual Framework for AICPA Independence Rules* (ET§101.01)

#### Revisions to Application of the Independence Rules to a Covered Member's Immediate Family (IMF):

- As a result of permitted employment, an IMF (spouse, spousal equivalent, or dependent) of a covered member may participate in the attest client's plan other than certain share-based arrangements or nonqualified deferred compensation plans if:
  - The plan is offered to others in comparable employment positions
  - IMF is not involved in governance for the plan
  - IMF is unable to supervise or participate in plan's investment decisions/options
- An IMF of a covered member may hold a direct or material, indirect financial interest in the attest client via participation in the plan if:
  - Financial interest is due to unavoidable consequence of participation in the plan (if another investment option is available, i.e., not the attest client, the IMF must select that option)
  - Covered member is in category 3 or 4 only (i.e. persons on the attest team or able to influence the attest engagement may not apply this provision)—see "Covered Members" on page 3

#### Share-based Compensation Arrangements: Beneficial Interest in Attest Client

- As a result of permitted employment, an IMF of a covered member may participate in a share-based compensation arrangement that results in rights to acquire shares in the attest client (e.g., an employee stock option plan or restricted stock plan) if:
  - Covered member is in category 3 or 4 only
  - The IMF exercises or forfeits the rights once vesting occurs and the closing market price of the underlying stock equals or exceeds the exercise price during the "market period" (10 consecutive days)
  - Exercise or forfeiture occurs as soon as practicable (within 30 days after market period ends)
- If IMF exercises right to acquire shares he/she disposes of shares as soon as practicable (within 30 days of exercise)
- If employer repurchases shares and the payable due the IMF remains unpaid after 30 days, the payable is not material to the covered member during the payout period

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### Share-Based Compensation Arrangements: Stock Appreciation

- As a result of permitted employment, an IMF of a covered member may participate in a share-based compensation arrangement (depends on the appreciation of the attest client's underlying shares, e.g., a stock appreciation or phantom stock plan) if:
  - Covered member is in category 3 or 4 only
  - Arrangement does not provide for issuance of rights to acquire financial interests in the attest client (e.g. stock awards)
  - IMF exercises or forfeits vested compensation rights if underlying stock price equals or exceeds exercise price during the market period
  - Exercise or forfeiture occurs as soon as practicable (within 30 days after market period ends)
  - Compensation payable for more than 30 days is not material to covered member during the payout period

### Nonqualified Deferred Compensation Plan

- As a result of permitted employment, an IMF of a covered member may participate in a nonqualified deferred compensation plan if:
  - Covered member is in category 3 or 4 only
  - Deferred compensation payable to IMF is not funded by financial interests in the attest client; any unfunded benefits are not material to the covered member

### Effective Date: June 1, 2011

#### Covered Members (§92.06):

1. Individual on the attest engagement team
2. Individual in a position to influence the attest engagement team
3. Partner or manager who provides 10 or more hours of permitted nonattest services
4. Partner in the same office as the lead attest engagement partner

## Conceptual Framework Approach

Dan Crews, CPA flips through Rule 101, *Independence*, of the AICPA *Code of Professional Conduct*, but to no avail. The answer to his question is not addressed by the independence interpretations or rulings. So what should Dan do? The answer may be found in the first interpretation of independence (ET§101.02) in a section aptly titled, *Other Considerations*:

*It is impossible to enumerate all circumstances in which the appearance of independence might be questioned. In the absence of an independence interpretation or ruling under rule 101 [ET section 101.01] that addresses a particular circumstance, a member should evaluate whether that circumstance would lead a reasonable person aware of all the relevant facts to conclude that there is an unacceptable threat to the member's and the firm's independence. When making that evaluation, members should refer to the risk-based approach described in the Conceptual Framework for AICPA Independence Standards [see ET section 100.01]. If the threats to independence are not at an acceptable level, safeguards should be applied to eliminate the threats or reduce them to an acceptable level.*

Dan calls his firm's assurance leader and is referred to ET 100.01 of the Code. He reads the *Conceptual Framework for AICPA Independence Standards* (the Framework), which describes a systematic, risk-based

approach for identifying and evaluating "threats" to independence and determining whether "safeguards" would eliminate threats or reduce them to an acceptable level. The Framework also defines the key terms used and provides examples of threats and safeguards. For example, "safeguards" are, "controls created by the profession, legislation or regulation, or implemented by the firm or the client." One sample safeguard included in the Framework is, "the use of different partners and engagement teams that have separate reporting lines in the delivery of permitted nonattest services to an attest client, particularly when the separation between reporting lines is significant."

### Here are Dan's facts:

- Dan is a senior manager in his firm's assurance practice in Washington, DC. He works primarily on DC office clients but occasionally works on clients in the firm's Baltimore office.
- His wife's mother (Mary) has an investment in Cartwright Publishing, Inc., the firm's largest privately held audit client. The Cartwright audit is performed by personnel in the Baltimore office. (In addition to DC and Baltimore, the firm operates two other offices in Virginia.)

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- Mary's investment in Cartwright amounts to four percent of the client's outstanding equity, which is material to her net worth.
- Dan does no work for this client nor does he expect to in the future. He has no influence over the engagement.
- Mary is wheelchair-bound and lives with Dan and his wife; Mary is financially independent.
- Dan and his wife are the executors of Mary's will and the sole beneficiaries of her estate.

While Dan does not know if he will inherit the Cartwright stock while he is employed by the firm, the possibility that he and his wife would profit from any appreciation in the value of Cartwright stock certainly exists. Dan believes the situation causes a financial self-interest threat to his independence. Although Mary is not

an immediate or close family member as defined in the Code, she does live in his home and has a material investment in one of the firm's largest audit clients, which comprises 4 % of the client's equity. If the interest was more than five percent and held by Dan or his immediate family, the rules would indicate an impairment of independence even though Dan is not a covered member. Taken all together, Dan believes threats to the appearance of his independence do exist.

#### **Dan then considers the following safeguards:**

1. Dan does no work for this client and is not able to influence the engagement team. He generally does not work in the Baltimore office, which performs the audit.
2. His firm has policies and procedures that are designed to implement and monitor quality

control in attest engagements. The firm's most recent peer review resulted in only one minor comment.

3. Dan plans to discuss his situation with the Cartwright engagement partner and suggest that his situation be discussed with the client's audit committee.

Assuming the audit committee agrees, Dan concludes that the safeguards already in place and notification of the issue to the audit committee sufficiently reduce the threats to his independence to an acceptable level.

Dan notes that the requirement in Interpretation 101-1, *Other Considerations*, also requires the following:

*In cases where threats to independence are not at an acceptable level, thereby requiring the application of safeguards, the threats identified and the safeguards applied to eliminate the threats or reduce them to an acceptable level should be documented.* [NOTE: FOOTNOTE REMOVED]

Dan prepares documentation of the facts involved in his matter, and also notes the people with whom he consulted, the nature of the discussion with the audit committee and its resolution, and the applicable dates. He then shares this information with the engagement partner for his input, review and approval, and for inclusion in the audit workpapers. ■

