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AUDIT CONDUCT NEWS

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When Business Relationships Impair Your Firm's Independence

You purchase your client's product, are quoted in response to a question about your client in a local paper, or refer business to a client. Perhaps you issued a joint white paper with a client or bought a sponsorship to a conference the client hosted. If you perform an audit or other attest service for this client, do you have an independence issue on your hands because it appears you are "in business" with them? What are the relevant independence rules and how do you and your firm stay on the right side of them?

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, and professional organizations. She also helps CPA firms enhance their quality controls over ethics and independence compliance.

AICPA and SEC Rules

Both SEC and AICPA restrict auditors from having certain types of business relationships with their attest clients because they impair a firm's independence – in fact and/or appearance -- but many firms may be unaware of the breadth of relationships that can cause issues under the rules, particularly under the SEC's rules. This article reviews the relevant rules and the types of activities and relationships that create real or perceived business relationships that threaten your firm's compliance with independence rules and suggests ways you and your firm can stay in compliance.

First, here's a brief summary of the rules and where to find them:

Rule	Where the rule is found:	What the rule says:
AICPA	AICPA Code of Professional Conduct, 1.265 http://pub.aicpa.org/codeofconduct/Ethics.aspx#	**Cooperative Arrangement:** A material "cooperative arrangement" with an attest client (or its affiliate) may cause self-interest, familiarity, or undue influence threats to independence. Examples of cooperative arrangements are: a. Prime and subcontractor arrangements to provide services or products to a third party b. Joint ventures with the client to develop or market products or services to third parties c. Arrangements to combine one or more of the firm's services or products with one or more of the client's services or products and market the package with references to both parties d. Arrangements in which the firm distributes or markets the client's products or services or the client distributes or markets the firm's products or services A firm does not have a cooperative arrangement if it meets all of the following safeguards: (1) The firm and attest client's participation are governed by separate agreements, arrangements, or understandings that do not create rights or obligations between the firm and client, (2) the firm and the attest client do not assume responsibility for the other's activities or results, and (3) neither party has the authority to act as the other's representative or agent. **Joint Closely-Held Investment:** If a covered member (including the firm) has a material joint closely held investment with an attest client or one of the client's officers, directors, or owner who can exercise significant influence over the attest client during the period of the professional engagement, independence would be impaired. For example: A joint closely held investment includes a vacation home that a covered member and attest client's CEO own together, if the covered member and the CEO control the investment and the investment is material to the covered member.
SEC	§ 210.2-01 Qualifications of accountants [Rule 2-01(c) (3)] * Also addressed in the SEC Codification of Financial Reporting Policies (several examples in 602.02.e) and SEC Staff's Frequently Asked Questions (Q+A no 2 under "Other")	An accountant is not independent if, at any point during the audit and professional engagement period, the accounting firm or any covered person in the firm has any direct or material indirect business relationship with an audit client, or with persons associated with the client in a decision-making capacity, such as a client's officers, directors, or substantial stockholders. The relationships described in this paragraph do not include a relationship in which the firm (or covered person in the firm) provides professional services to an audit client or is a consumer in the ordinary course of doing business with the client.

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In short, the AICPA rule precludes cooperative arrangements with attest clients and their affiliates that are material to either party. Similarly, joint closely-held investments between a covered member and the attest client, including certain persons associated with the client, are problematic if material to the covered member. Situations causing threats that are not addressed in the rule require members to apply the AICPA's Conceptual Framework for Independence (ET sec. 1.210) to assess whether threats to independence, if significant, may be offset by safeguards. For example, self-interest, familiarity, or undue influence threats to independence could arise.

Applying the SEC rule can be challenging due to its lack of a materiality threshold for direct relationships, lack of guidance on how to interpret the terms "direct business relationship" and "indirect business relationship," and broader scope. The SEC rule applies not only to the audit client and its affiliates (e.g., parents, subsidiaries, material equity investees/ investors) but also to the client's officers, directors, and significant shareholders (which includes both individuals and entities). This means that if a firm wishes to provide joint services with Company A, a private nonclient, the firm must identify all of Company A's affiliates in addition to A's officers, directors, and significant shareholders. This sounds relatively simple but can be complicated due to the fluid nature of business (for example, mergers, acquisitions, board / officer appointments and resignations, and changes in ownership), and lack of publicly available information for private entities, including private equity firms that may have numerous companies in their portfolios.

SEC Rule Exclusions

The SEC rule does not consider two types of activities to be business relationships. The first is when a CPA firm renders professional services to its audit client (or the audit client's affiliate). Professional services are attestation, tax, and advisory services that CPA firms traditionally provide. Firms should be careful that they do not sell items other than professional services to clients whose audits are subject to SEC independence rules, since these would be considered prohibited, independence-impairing business relationships.

Second, a firm may purchase its audit client's goods or services without creating a business relationship if:

- The client sells the goods or services to the CPA firm in the ordinary course of conducting its business, e.g., the client is an office supply company and sells copy paper to the firm, ***and***
- The firm consumes the client's product or service, e.g., the firm's personnel use the paper in their day-to-day activities, ***and***
- The transaction(s) is not material to the firm or the client (consider both quantitative and qualitative factors).

Determining whether a firm consumes a client's goods or services can be tricky at times. Internal use, as in the example given above, provides a clear answer as do the firm's purchase of laptop computers, phones, phone services, and electricity from audit clients.

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The CPA firm consumes these goods and services in its day-to-day operations, which helps the firm provide services to clients. But what if the firm uses software they purchase from an audit client to create a deliverable the firm sells to its clients? On one end of the spectrum is a joint deliverable where the audit client and the firm collaborate and are both credited with an end product that is sold to clients. Clearly, that is a prohibited business relationship. The "gray area" arises when the firm purchases software that it uses to provide services to clients – but there is no reference to the audit client, no co-marketing, or profit-sharing, the firm pays a flat fee for the software, etc. In these cases, firms should carefully consider whether they are consuming the client's product in creating the deliverable or engaging in a mutually beneficial business relationship with the client. The appearance of the relationship should be scrutinized.

Lastly, consider materiality. Many firms use a quantitative measure but a qualitative assessment is just as important. A firm's annual purchases from its audit client may be under a certain percentage of revenue for both sides (say only 1 percent), but if the goods or services are critical or significant to the firm (e.g., no other vendor can supply the firm this good or service to the firm) or the client (e.g., the client is using its business with the firm as a way to launch a new product line), the purchase likely is qualitatively material and would not qualify for the SEC's exemption.

All-Important Appearance

Perhaps the most challenging aspect of complying with independence rules in this area is ensuring that the activities a firm and its people engage in do not create the appearance of a business relationship where none is intended (e.g., there is no oral or written agreement between the parties and no profit sharing, etc.). Firms and their personnel should be alert to situations that could lead a reasonable and informed third party to question whether a business relationship between the firm and its audit client appears to exist. Joint activities with the client in the public domain, such as corporate sponsorships, co-authoring, co-speaking, co-branding and the like can raise questions about the nature of the relationship and whether the firm appears to be independent. Usually, the more companies that are involved in these events, including the firm's competitors, the less likely the firm and the client will appear to have some special or exclusive relationship.