Plain English Guide to Independence

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Preface

How this guide can help you

Independence generally refers to acting with integrity and exercising objectivity and professional skepticism. Sounds straightforward, but the ins and outs of independence can get complicated in a technical profession like ours that so profoundly affects the public interest.

Auditing and accounting scandals over recent decades have highlighted the need for more accessible independence guidance. Not only do you need to understand the details in the AICPA Code of Professional Conduct (the code), but you also need to understand the applicable guidance from other authoritative sources like the SEC and Government Accountability Office.

The AICPA *Plain English Guide to Independence* presents your independence responsibilities in easy-to-understand language, offering real-world examples to help you apply independence guidance with greater confidence. We use the term *standards* broadly to mean rules, standards, interpretations, laws, regulations, opinions, policies, or positions.

This guide is intentionally limited to a subset of standards that most widely affects practice. It does not cover all independence standards (some of which are complex), nor does it cover every aspect of the requirements.

Nonetheless, this guide should help you identify independence issues that may require further consideration. For complete information, you should always refer directly to the AICPA code, SEC rules, or other authoritative guidance, in addition to your firm's policies on independence.

Conventions and key terms

This guide uses the following conventions to enhance your reading:

- The word "***Note***" in boldface italics emphasizes important points, highlights applicable government regulations, or indicates that a rule change may soon occur.
- The AICPA rules and interpretations of the rules are linked the first time they appear in a chapter.
- The first time a term that's defined in the AICPA code appears in a section, it will be in italics and linked to the definition.
- Internet addresses (URLs) and hyperlinks to other sources of information are provided.

- Information on additional resources appears at the end of this guide to help you resolve your independence issues. (See the section "Where can I find further assistance with my independence questions?" in chapter 11 of this guide.)

We describe the rules of the SEC and the PCAOB (that is, those that apply to audits of SEC registrants, issuers, and broker-dealers) in boxed text (like this one) and provide citations to specific rules. Generally, we provide these descriptions when the SEC and the PCAOB impose either additional requirements or their rules otherwise differ from the AICPA rules.

For purposes of this guide, the following definitions apply:

- An SEC registrant is 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 guide, *SEC audit client* means an *SEC registrant* and its *affiliates*, as defined in the SEC rules.
- An issuer is an entity 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 guide, *SEC audit client* means an *SEC registrant* and its *affiliates*, as defined in the SEC rules.
- A broker-dealer is an entity that is defined in Sections 3(a)(4) and 3(a)(5) of the Exchange Act and is required to file a balance sheet, income statement, or financial statement under Section 17(e)(1)(A) of the Exchange Act and where these statements are required to be certified by a registered public accounting firm.

Certain SEC independence rules apply to “issuers” rather than “audit clients.” According to a CAQ alert, the following SEC independence rules apply only to issuer audits:

- Employment cooling-off for former members of the audit engagement team (Rule 2-01(c)(2)(iii)(B)–(C))
- Partner rotation (Rule 2-01(c)(6))
- Audit committee administration of the engagement (i.e., audit committee pre-approval) (Rule 2-01(c)(7))
- Audit partner compensation (Rule 2-01(c)(8))

> ***Note***
> The auditors of all registered broker-dealers and certain other entities must be registered with the PCAOB, and these auditors need to apply the SEC and PCAOB independence rules.

Chapter 1

Introduction

What is independence?

Our definition reflects a long-standing professional requirement: Any member of the AICPA must be independent both in fact (that is, of mind) and in appearance when providing services to entities for which *independence* is required. How does that work, exactly?

Independence has two aspects: your personal mindset and the way an action appears to others.

Independence of mind is the state of mind that permits you to perform an attest service without being affected by influences that compromise professional judgment. This allows you to act with integrity and exercise objectivity and professional skepticism.

Independence in appearance means avoiding circumstances that would cause a third party to reasonably conclude that your or your *firm's* integrity, objectivity, or professional skepticism is compromised. This doesn't mean any third party who might be an observer. It means a reasonable and informed third party who has knowledge of all relevant information, including *safeguards* you've applied. Keeping in mind our dual aspect definition of independence, you also should consider how the *threat* itself might be perceived by a reasonable and informed third party. Is someone observing from the outside likely to see a particular threat as acceptable?

That's independence defined, but don't interpret that explanation as absolute. Take the phrase "without being affected by influences that compromise professional judgment" as an example. This is not intended to convey that you must be free of all influences that might compromise objective judgment.

Instead, you should think about whether influences may be present that create a threat to your acting with integrity and exercising objectivity and professional skepticism while performing a particular engagement. If such a threat exists, you need to consider whether it is at an *acceptable level* or can be reduced to an acceptable level.

How can I ensure my independence of mind?

Professional judgment is key to making informed decisions about what you can do in a situation and to determine whether these decisions are appropriate under the circumstances. Professional judgment simply means approaching the facts and circumstances with your full training, skill, and experience. Sometimes, it's a matter of working things out on your own. Other times, you'll need to consult with others.

Be open to further investigation or action, including consultation, and stay aware of conscious or unconscious bias that could affect your professional judgment.

Here are some examples of bias that can affect you when identifying, evaluating, and addressing *threats*:

- *Anchoring bias* — Using an initial piece of information as an anchor against which subsequent information is inadequately assessed
- *Automation bias* — Favoring output generated from automated systems, even when human reasoning or contradictory information raises questions about whether such output is reliable or fit for purpose
- *Availability bias* — Placing more weight on events or experiences that immediately come to mind or are readily available than on those that are not
- *Confirmation bias* — Placing more weight on information that corroborates an existing belief than on information that contradicts or casts doubt on that belief
- *Groupthink* — The tendency for a group of people to discourage individual creativity and responsibility and, as a result, to reach a decision without critical reasoning or consideration of alternatives
- *Overconfidence bias* — The tendency to overestimate one's own ability to make accurate assessments of risk or other judgments or decisions
- *Representation bias* — The tendency to base an understanding on a pattern of experiences, events, or beliefs that is assumed to be representative
- *Selective perception* — The tendency for a person's expectations to influence how the person views a particular matter or person

Seeking advice from experts, consulting with others to obtain additional input, and training on how to identify bias may help mitigate the effects of bias.

What should I do if no specific guidance exists for my independence issue?

It is impossible for the AICPA Code of Professional Conduct (code) to address every circumstance that might lead to questions about your *independence*. In the course of your career, you will encounter situations that the code doesn't directly speak to. When this happens, use the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010).[1]

When *threats* to independence are not at an *acceptable level*, you must apply *safeguards* to eliminate the threats or reduce them to an acceptable level. You also need to document the threats you identify as well as the safeguards you use to eliminate the threats or reduce them to an acceptable level.

[1]You can find all ET sections in the AICPA Code of Professional Conduct.

If you can demonstrate that you applied safeguards that eliminated or reduced threats, you won't be in violation of the "Independence Rule" (ET sec. 1.200.001). However, the code requires documentation of the *threats* you encounter and the *safeguards* you apply. If you don't maintain this documentation, you'll be in violation of the "Compliance With Standards Rule" (ET sec. 1.310.001).

In addition to the conceptual framework itself, we have a toolkit that can both help you use the framework and also satisfy the documentation requirements.

What should I think about when evaluating threats and safeguards?

It's important to evaluate *threats* and *safeguards* with an inquiring mind. This means considering the source, relevance, and adequacy of the information you're using along with the nature, scope, and results of the professional service being provided. This is your professional skepticism at work.

Use professional judgment when evaluating a situation for potential threats and in determining if a safeguard is appropriate. Also, be alert to whether

- the information you're using might be influenced by bias or self-interest.
- the information could lead to conclusions other than your own.
- facts and circumstances have changed, especially for continuing engagements.

Even if you've appropriately reduced or eliminated a threat previously, new information or changes in facts and circumstances can raise that threat again. So, especially during continuing engagements, you'll need to reevaluate and readdress threats accordingly.

When does AICPA guidance require me to be independent?

AICPA professional standards require your *firm*, including the *firm's partners* and professional employees, to be independent when performing an *attest engagement* for an *attest client*.

A compilation is an attest engagement. Although performing a compilation of an attest client's *financial statements* does not require independence, if a nonindependent firm issues a compilation report, you must indicate your lack of independence in a final paragraph of your compilation report.[2]

If you are engaged to perform only nonattest services for a *client*, AICPA professional standards do not require you and your firm to be independent. Examples of such services are financial statement preparation, tax preparation or advice, or consulting services such as personal financial planning.

[2] Per paragraph .22 of AR-C section 80, *Compilation Engagements*. You can find all AR-C sections in AICPA *Professional Standards*.

> ***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 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), you and your *firm* also must comply with the independence rules established by those agencies.

The SEC

The SEC regulates SEC registrants and issuers and establishes the qualifications of independent auditors. In this guide, we refer to these independence rules as SEC rules.

The PCAOB

The Public Company Accounting Oversight Board, or PCAOB, is a private standard-setting body whose activities are overseen by the SEC. Among other things, the board is authorized to set auditing, attestation, quality control, ethics, and independence standards for accounting *firms* that audit issuers and broker-dealers.

In 2003, the PCAOB adopted interim ethics standards based on the following provisions of the AICPA code that were current at the time. Since then, of course, the board has updated its guidance, but this is where they started:

- Rule 102, *Integrity and Objectivity*
- Rule 101, *Independence*
- Ethics rulings under Rules 102 and 101

In 2003, the PCAOB also adopted the following guidance from the Independence Standards Board (ISB):

- Independence Standard No. 2, *Certain Independence Implications of Audits of Mutual Funds and Related Entities*
- Independence Standard No. 3, *Employment with Audit Clients*

- ISB Interpretation 99-1, *Impact on Auditor Independence of Assisting Clients in the Implementation of FAS 133 (Derivatives)*

Some SEC rules are more restrictive than the PCAOB's interim independence standards and some are less restrictive. You may think it makes sense to always follow guidance from one body or another but, in fact, registered public accounting firms must comply with the more restrictive requirements.

In May 2006, Rule 3520 became effective, which states, "A registered public accounting firm and its associated persons must be independent of the firm's audit client throughout the audit and professional engagement period." The firm and its associated persons are still required to comply with both PCAOB and SEC rules.

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

Under the four guiding principles, an auditor cannot function in the role of management, audit the auditor's own work, serve in an advocacy role for the client, or have a mutual or conflicting role with the client.

Note

Generally, the AICPA authoritative independence standards will apply to you in all situations involving an *attest client*. If additional standards governing an engagement also apply, you should comply with the most restrictive standards or the most restrictive portions of the standard.

Once you determine that your firm provides attest services for a *client* and which standard applies, the next step is to determine how that standard applies to you.

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

- State boards of accountancy
- State CPA societies
- Federal and state agencies (for example, banking and insurance regulators)
- The International Ethics Standards Board for Accountants (IESBA)

Chapter 2

Attest client and affiliates

Do I need to remain independent from just my attest client or from other entities as well?

Although we think of our *attest clients* as the entities for which we perform *attest engagements*, in some instances, you will need to remain independent from other entities as well. The AICPA Code of Professional Conduct (the code) requires you to remain independent of *affiliates* of any *financial statement attest client*.

How do I determine whether there's a requirement of independence for a client affiliate?

A *financial statement attest client* is any entity whose *financial statements* are audited, reviewed, or compiled when your compilation report does not disclose a lack of *independence*.

If the engaging entity is not your *attest client*, you need to determine whether the engaging entity is an *affiliate* that requires independence. If the engaging entity does not meet the definition of an affiliate, you need to determine whether that entity presents *threats* to your compliance with the "Integrity and Objectivity Rule" (ET sec. 1.100.001) and the "Conflicts of Interest for Members in Public Practice" interpretation (ET sec. 1.110.010). If threats exist, you need to address those threats.

When a *client* is a financial statement attest client, the "Client Affiliates" interpretation (ET sec. 1.224.010) of the "Independence Rule" (ET sec. 1.200.001) requires you to apply to that client's affiliates the same guidance applicable to the financial statement attest client (that is, the "Independence Rule" and related interpretations).

> ***Note***
> The "Client Affiliates" interpretation does not apply to affiliates of state and local government clients or compliance audits. (See "State and Local Government Affiliates.")

Which entities are considered affiliates of my financial statement attest client?

The following entities are *affiliates* of your *financial statement attest client*. This is the same list from the "Client Affiliates" interpretation.

a. An entity (for example, subsidiary, partnership or 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 entity (such as a union, participating employer or a group association of employers) that has significant influence over a multiemployer employee benefit plan financial statement attest client and the plan is material to such entity.

i. The participating employer that is the plan administrator of a multiple-employer employee benefit plan financial statement attest client.

j. A single or multiple-employer employee benefit plan sponsored by either a financial statement attest client or an entity controlled by the financial statement attest client — All participating employers of a multiple-employer employee benefit plan are considered sponsors of the plan.

k. A multiemployer employee benefit plan when a financial statement attest client or entity controlled by the financial statement attest client has significant influence over the plan and the plan is material to the financial statement attest client.

l. 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 that 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.

The SEC definition of "affiliate of an audit client" is under SEC Rule 2-01(f)(4) and further expanded on for investment company complexes under Rule 2-01(f)(14).

Under SEC rules, entities meeting the definition of an affiliate of an audit client are part of the audit client.

The SEC considers the following entities to be affiliates of an audit client (for purposes of this list, the term "client" means the "entity under audit"):

- Entities that control the client (for example, parent)
- Entities that the client controls (for example, subsidiary)
- Entities under common control with the client (sister entity) if the client and sister entity are each material to the controlling entity
- Entities that have significant influence over the client and where the client is material to that entity (for example, investor, if the client is material)
- Entities over which the client has significant influence and where the entity is material to the client (for example, material investees)
- Entities in an "investment company complex" (ICC) when the client is an investment company or investment adviser or sponsor

In SEC Rule 2-01(f)(14), the term "investment company complex" applies when identifying affiliates of an audit client that is an investment company, investment adviser, or sponsor. The definition of "investment company" also includes unregistered funds.

Should I apply the "**Client Affiliates**" interpretation and the definition of ***affiliates*** to individuals associated with a financial statement attest client?

The *interpretation* and definition do not apply to individuals. However, if you know or have reason to believe that an individual has a relationship with the *financial statement attest client* meeting any of the following criteria, this could create *threats* to your *independence*:

- The individual controls a financial statement attest client when the financial statement attest client is material to the individual.

- The individual holds a *direct financial interest* in the financial statement attest client when that individual has *significant influence* over the financial statement attest client, and the interest in the financial statement attest client is material to the individual.
- The individual *controls* a financial statement attest client and sister entity of the financial statement attest client when the financial statement attest client and sister entity are each material to the individual.

In such circumstances, evaluate those threats using the "Conceptual Framework for Independence."

If your *firm* has a relationship with an individual that meets any of these criteria and you conclude that threats are not at an *acceptable level*, you should apply *safeguards* to eliminate the threats or reduce them to an acceptable level.

For example, a firm provides personal cash management services to an individual who has a material controlling ownership interest in a financial statement attest client (audit client). The services involve firm personnel paying the individual's personal bills and providing monthly recordkeeping to the individual. Because firm personnel have access to the individual's personal bank account when providing these services, the audit partner believes the firm's independence is *impaired* with respect to the individual. The audit partner should apply the "Conceptual Framework for Independence"to evaluate whether the services would create threats to the audit client.

As part of the evaluation, the audit partner confirms that the checking account is funded by the individual only after the monthly recordkeeping has been approved and that only personal bills, not business expenses, run through this account. Accordingly, the partner concludes that the services have no effect on the audit client's cash or expense accounts, will not be subject to auditing procedures and, therefore, no significant threats to independence exist.

What do I do if I can't identify affiliates of a financial statement attest client?

If you aren't able to identify the *affiliates* of a *financial statement attest client*, even after your best efforts, you need to do all the following:

1. Discuss the matter, including the potential effect on *independence*, with *those charged with governance*.
2. Document the results of the discussion with those charged with governance.
3. Document the efforts you made to obtain the information to identify the affiliates of the financial statement attest client.
4. Obtain written assurance from the financial statement attest client that it is unable to provide the information necessary to identify its affiliates.

What if my financial statement attest client is acquired after I begin the engagement?

When a *financial statement attest client* is acquired while you are performing an *attest engagement*, your *independence* won't be *impaired* as long as the attest engagement covers only periods prior to the acquisition, and you will not continue to perform financial statement attest services for the acquirer. If both conditions are not met, you would need to resign from the engagement.

What if an acquisition or merger results in a new affiliate of my financial statement attest client?

When a new *affiliate* is created for a *financial statement attest client* and the *firm* expects to continue providing financial statement attest services after the effective date of the transaction, you should identify and evaluate previous and current *financial interest* and relationships with the new affiliate and then take steps to end any financial interest or relationship that would *impair independence*.

If you are not able to end the financial interest or relationship in an orderly manner prior to the effective date of the transaction, you should evaluate the *threat* to independence and discuss with *those charged with governance* the evaluation of the significance of the threats and the reasons that the relationship cannot be ended.

After the discussion, if those charged with governance ask you to continue to provide financial statement attest services, you should continue only under the following circumstances:

- The financial interest or relationship with the new affiliate that would impair independence will end as soon as reasonably possible but no later than six months after the effective date of the transaction.
- The individual who has the financial interest or relationship will not be a *member* of the *attest engagement team* responsible for the engagement quality control review.
- *Safeguards* will be applied and discussed with those charged with governance.

If you don't expect to continue to provide financial statement attest services to the new affiliate, you may issue the current report covering a period after the effective date of the transaction if all of the following conditions are met:

- You have completed a significant amount of work on the financial statement attest engagement prior to the effective date of the transaction.
- You expect to complete the financial statement attest engagement and issue the attest report within a reasonable amount of time.

- Those charged with governance request that you complete the financial statement attest engagement despite your continuing financial interest or relationship that impairs independence.
- You have evaluated the significance of the threat to independence and have discussed the results with those charged with governance.
- The individual who has the financial interest or relationship will not be a member of the attest engagement team responsible for the engagement quality control review.
- Safeguards will be applied and discussed with those charged with governance.
- You cease to be auditor no later than the date that the attest report is issued.

The SEC rule includes transition provisions for mergers and acquisitions involving audit clients, provided that the following apply:

a. The auditor is in compliance with any independence standards that are applicable to the entities involved in the transaction from the origination of the relationships or services in question and throughout the period in which the applicable independence standards apply.

b. The potential independence-impairing service or relationship is addressed before the effective date of the merger or acquisition. In discussing this requirement in the related release, the commission noted that when it is not possible to transition an independence-impairing service or relationship in an orderly manner without causing significant disruption to the audit client before the effective date of the merger or acquisition, it is expected to be addressed promptly after the effective date of the merger or acquisition. The release goes on to say that although the commission continues to believe a six-month period is an appropriate limit, it was not included in the final rule so that it would not become standard practice when a shorter time period was appropriate.

c. The firm's quality control system has procedures and controls that require the firm be timely notified about the audit client's merger and acquisition activity and, upon notification, allows the firm to identify, before the effective date, services or relationships that could result in independence violations.

Are there any other exceptions to the affiliate rules?

The AICPA Professional Ethics Executive Committee (PEEC) also deemed appropriate that *members* don't need to apply the *independence* provisions applicable to their *financial statement attest clients* to any *affiliates* in six other situations. The exception described in number 1 in the following list applies to all affiliates, and the exceptions described in numbers 2–6 are applicable only to entities that are affiliates under items (*c*)–(*l*) of the code's definition of *affiliate* (ET sec. 0.400):

Exception applicable to all affiliates

1. Loans. This exception applies to all affiliates as described in list items (*a*)–(*l*) of the definition of affiliates. The code prohibits a loan to or from an individual who is an officer or director of an *attest client* or has a *beneficial ownership interest* and who has *significant influence* over that *client*. Specifically, this is anyone with decision-making authority at the client.

   If we apply this provision to affiliates, any time a *member* has a loan to or from an individual at an affiliate, you'd need to take steps to ensure that the individual does not have significant influence over the attest client; otherwise, your *independence* may be *impaired*.

   Accordingly, this exception provides that you need to consult the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010) only when you already know that the individual is in a position with significant influence over the client. Without this knowledge, the familiarity, undue influence, and financial self-interest threats are at an *acceptable level*.

Exceptions applicable only to affiliates in items (*c*)–(*l*) of the definition

> ***Note***
> As stated in the opening paragraph of this section, exceptions 2–4 are not applicable to affiliates described in items (*a*) and (*b*) of the definition of *affiliate*.

2. Nonattest exception. This exception relates to providing nonattest services that would otherwise impair your independence. Specifically, you can provide these services to entities described as an affiliate under (*c*)–(*l*) when the services do not create a self-review threat.

   There is no self-review threat when

   a. the results of the nonattest services will not be subject to *financial statement* attest procedures and

b. you eliminate or reduce to an acceptable level any other *threats* that arise and are not at an *acceptable level* when you provide the nonattest service (for example, management participation threats).

3. Subsequent employment exception. This exception comes into play if you go to work at an affiliate of an attest client of your former firm. The code — specifically the “Subsequent Employment or Association With an Attest Client” interpretation (ET sec. 1.279.020) — requires you to apply specific *safeguards* if you were an employee at a firm and then take a *key position* at an attest client of your former firm.

With this exception, it’s not necessary to apply these safeguards to entities described as an affiliate under (*c*)–(*l*).

4. Immediate family exception. If you have *immediate family* members and *close relatives* who are employed at any entity described as an affiliate under (*c*)–(*l*), as long as they are not in a key position with respect to the financial statement attest client.

5. Lease exception. The “Leases” interpretation (ET sec. 1.260.040) of the “Independence Rule” lays out circumstances that will impair your independence with no remedy if you have a lease with an attest client. With this exception, if you have a lease with an entity described as an affiliate in items (*c*)–(*l*) of the definition of *affiliate*, you can use the “Conceptual Framework for Independence” to evaluate threats to your independence and apply safeguards to mitigate any threats that are not at an acceptable level.

6. Staff augmentation arrangement exception. The “Staff Augmentation Arrangements” interpretation (ET sec. 1.275.007) lays out strict requirements for loaning staff to an attest client. Under the interpretation, six specific safeguards must be met, or your independence will be impaired with no remedy.

The staff augmentation exception allows you to use the “Conceptual Framework for Independence” to evaluate threats when loaning staff to an entity described as an affiliate under items (*c*)–(*l*). With this exception, you can evaluate whether threats created by the agreement are at an acceptable level and if you discover they aren’t, you can apply safeguards. If, even using the conceptual framework, there aren’t effective safeguards, you shouldn’t enter into the staff augmentation arrangement.[3]

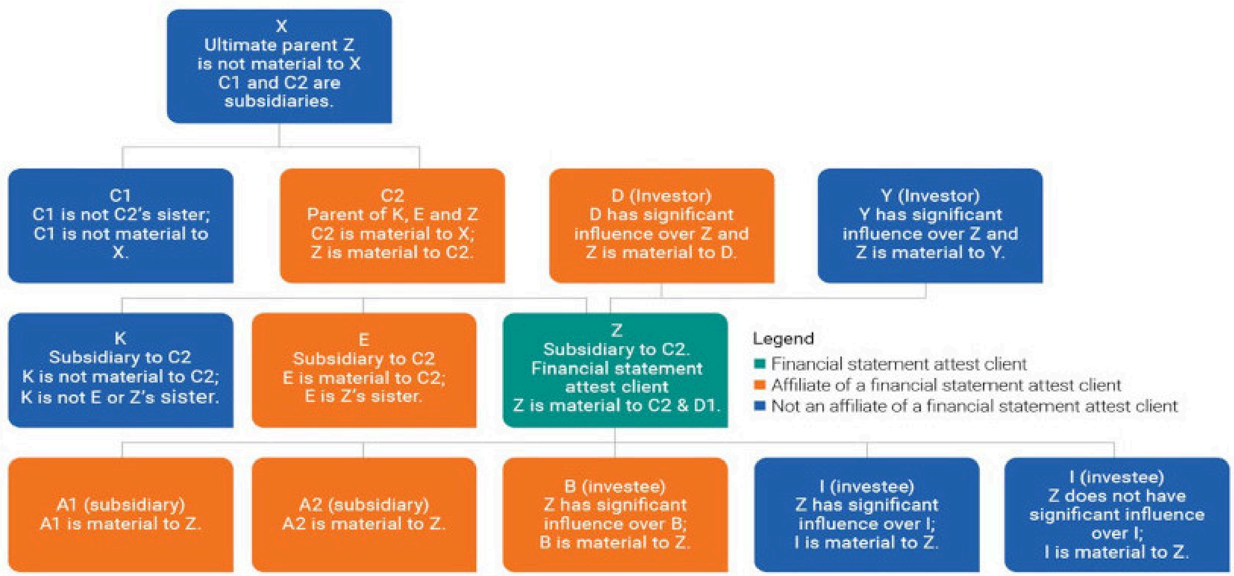
Is there any additional guidance to help me understand how to apply the affiliate definition and related interpretation?

Q&A section 120, *Affiliates*, provides Q&As 1–18 that can help you better understand how the definitions and guidance provided in the “Client Affiliates” interpretation apply to *affiliates* of employee benefit plans subject to the Employee Retirement Income Security Act.

[3]See “How does a staff augmentation arrangement affect my independence?” in chapter 3, “Applying the rules: Covered members and other firm professionals,” of this guide.

Is there a visual aid to help me understand the affiliate definition?

The following chart helps explain how the entities described in items (*a*)–(*e*) of the *affiliate* definition could be related to the *financial statement attest client*. The letters used in the visual aid correspond with the letters of the list items in the affiliate definition.



Is there an executive summary of the interpretation?

	Affiliate											
Type of relationship	A	B	C	D	E	F	G	H	I	J	K	L
Financial interest in	P	P	P	P	P	P	P	P	N/A	P	P	P
Loan to from	PS	PS	PS	PS	PS	PS	PS	PS	PS	PS	PS	PS
Nonattest services provided to	P	P	NSA	NSA	NSA	NSA	NSA	NSA	NSA	NSA	NSA	NSA
Member's employment or association with	P	P	A	A	A	A	A	A	A	A	A	A
Former employment or association with	P	P	P	P	P	P	P	P	P	P	P	P
Immediate family employment or interest in	P	P	R	R	R	R	R	R	R	R	R	R
Close relative employment or interest in	P	P	R	R	R	R	R	R	R	R	R	R

Tickmark key

P: The independence provisions contained in the AICPA Code of Professional Conduct (code) should be applied to this affiliate.

PS: A member may have a loan to or from

- an individual who is an officer or a director of an affiliate of a financial statement attest client unless the officer or director has the ability to affect decision-making at the financial statement attest client, or
- an individual with a beneficial ownership or an affiliate of a financial statement attest client unless the ownership interest gives the individual significant influence over the financial statement attest client.

However, if the covered member has knowledge of the individual's relationship with the affiliate, the covered member should consult the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010).

A: The firm will have to apply safeguards outlined in paragraph .02 of the "Subsequent Employment or Association With an Attest Client" interpretation (ET sec. 1.279.020) if the former employee is in a key position at the affiliate. Even if the position is not a key 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 the 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.

Affiliate definitions

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 the 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 if the 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-employer or multiemployer employee benefit plan financial statement attest client

Affiliate I: Employee benefit plan sponsored by either 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

Affiliate K: The participating employer that is the plan administrator of a multiple-employer employee benefit plan financial statement attest client

Affiliate L: A multiemployer employee benefit plan when a financial statement attest client or entity controlled by the financial statement attest client has significant influence over the plan and the plan is material to the financial statement attest client

Is independence different for state and local government affiliates?

Yes and no. You will need to remain independent of affiliates of your state and local government *financial statement attest clients*, with one exception related to nonattest services. (This will be discussed later.) *Financial interests* in and other relationships with affiliates may create *threats* to *independence*. We have three questions to consider.

What is a state and local government entity?

State and local governments are entities that should be following generally accepted accounting principles (GAAP) as set by GASB. State and local governments include general purpose governments like states, cities and Indian tribes, and special purpose governments such as school districts, utility districts, and certain hospitals and universities. You can find a more extensive list of general and special purpose governments in paragraph .03*d* of the "State and Local Government Client Affiliates" interpretation (ET sec. 1.224.020), which became effective for years beginning after December 15, 2021.

State and local governments may not have individuals who serve as officers, directors or owners. When an independence interpretation references those individuals, you should consider applying that guidance to officials of the state and local government financial statement attest client who have governance responsibilities or control over financial reporting.

Use your professional judgment to determine whether other independence interpretations have similar terms you should consider substitutions for in the state and local government environment.

What are the criteria for determining whether an entity is an affiliate in this environment?

An entity could be a fund, a component unit, a department, an agency or other organizational unit as described in paragraph .03*b* of the interpretation. If the entity is not required by the applicable financial reporting framework (GAAP, for example) to be included in the *financial statements* of your *attest client*, it would not meet the definition of an affiliate.

So, who are affiliates? If they are material to your financial statement attest client, funds and blended component units are more likely than not affiliates. You would need convincing evidence to support why these entities would not be affiliates. Additionally, entities included in the financial statements of your attest client, when you don't reference another auditor, are affiliates.

For all other entities, there are two thresholds in determining an affiliate. If the entity does not meet both of these, it isn't an affiliate:

1. The entity cannot be material to the financial statement attest client as a whole. Materiality is intended to be applied at the level of the financial statement attest client's financial statements, rather than individual opinion units in circumstances in which there may be more than one opinion unit.

2. The financial statement attest client cannot have more than minimal influence over the entity's accounting or financial reporting process. Paragraphs .09–.10 of the interpretation provide examples of and clarification on factors to consider when reaching your conclusion related to "more than minimal influence."

Investments could also be affiliates. Paragraph .03*c* of the interpretation lists things that are and are not considered investments. If your financial statement attest client has an investment the client can control, it is an affiliate unless the investment is trivial and clearly inconsequential. Additionally, if the investment is material, and the financial statement attest client can't control the investment but has *significant influence* over it, the investment is an affiliate.

You would also apply this evaluation to any investments held by an affiliate that is included in the financial statements of your financial statement attest client where you don't reference another auditor.

The focus so far has been on affiliate relationships, but there are other circumstances and relationships that could create threats to independence. These situations may arise with entities that are affiliates or those that don't meet that threshold (nonaffiliates). If you determine that a threat exists, either in appearance or fact, you will need to apply the "Conceptual Framework for Independence" interpretation to evaluate whether that threat is or can be reduced to an *acceptable level*. Paragraph .06 of the interpretation provides a few examples of such circumstances and relationships.

What is the exception for nonattest services in this environment?

You can provide otherwise prohibited nonattest services to affiliates if those nonattest services don't create self-review threats related to the financial statement attest client. This is because the results of those services will not be subject to financial statement attest procedures.

For all other threats that might arise when you perform nonattest services, you can apply safeguards where available to deal with the threats.

This exception does not apply to nonattest services on investments or for entities that are included in the financial statements of your financial statement attest client and other auditors are not referenced in the opinion.

The revised interpretation became effective for years beginning after December 15, 2021. To assist with implementing the interpretation, the Professional Ethics Division developed an implementation guide as well as other resources.

Is the affiliate guidance different for compliance audits?

Yes. In November of 2022, PEEC approved revisions to the code to address compliance audits and specifically affiliates as related to this type of audit. With these revisions, the *affiliate* requirements do not apply in a *compliance audit*.

Two new definitions were added to the code: compliance audit and *compliance audit client*. Revisions were made to the definition of *financial statement attest client* and the "Client Affiliates" and "State and Local Government Client Affiliates" interpretations.

What hasn't changed is that you should apply the "Independence Rule" (ET sec. 1.200.001) and its applicable *interpretations* to the compliance audit client.

What has changed is that the “Client Affiliates” interpretation (ET sec. 1.224.010) and the “State and Local Government Client Affiliates” interpretation (ET sec. 1.224.020) are not applicable to compliance audits.

Keep in mind that you should apply *independence* requirements to each type of *attest engagement* you perform for a *client* and comply with the more restrictive requirements.

Q&A section 10.01–.06 can assist you in implementing these revisions, which will be effective for compliance audits commencing after June 15, 2023. Early implementation is allowed.

Chapter 3

Covered members and other firm professionals

How do the independence standards apply to me?

Whenever you are a *covered member*, you become subject to the full range of *independence* guidance for your *attest clients*. You are a covered member if you are any of the following:

a. An individual on the *attest engagement team* for the client

b. An *individual in a position to influence the attest engagement*

c. A *partner*, *partner equivalent* or *manager* who provides more than 10 hours of nonattest services to the attest client

d. A partner or partner equivalent in the *office* in which the lead *attest engagement* partner primarily practices in connection with the client's attest engagement

e. The *firm*, including the firm's employee benefit plans.

f. An entity whose operating, financial, or accounting policies can be *controlled* by any of the individuals or entities described in items (*a*)–(*e*) or by two or more such individuals or entities if they act together

> The SEC uses the term "covered person"[4] to describe the individuals in a firm who are subject to SEC independence rules. This term is largely consistent with the AICPA's term *covered member*.

[4]See Rule 2-01(f)(11). Also, see the definition of *covered persons in the firm* in Section IV(H)(9) of the SEC's Final Rule Release *Revision of the Commission's Auditor Independence Requirements*.

Note
This guide uses the term *covered member* (and *covered person* when referencing SEC rules) extensively in explaining the "personal" independence guidance (for example, guidance that applies to you and your family's loans, investments, and employment). Be sure you understand these terms before reading further. Also, remember to check your firm's policies to determine whether they are more restrictive than the AICPA or SEC standards.

Do threats exist if I am on the attest engagement team for an extended period?

If you are senior personnel and are on an *attest engagement team* for an extended period, there is a familiarity threat. Our Q&As on senior personnel's long association on an attest engagement can help your understanding of this area (Q&A sections 100.03–.04).

Do any of the standards apply to me if I am not a covered member?

Yes, *independence* standards apply in certain circumstances even if you are not a *covered member*. Due to their significance, two categories of relationships *impair* independence even if you are not a covered member. Independence guidance prohibits these relationships if you are a *partner* or professional employee in a public accounting *firm*:

- 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.
- Owner of more than 5 percent of an *attest client's* outstanding equity securities (or other ownership interests) — The 5 percent prohibition also extends to *immediate family* members. For more on this, see paragraph .03 of the "Overview of Financial Interests" interpretation (ET sec. 1.240.010).

What if I was formerly employed by an attest client or was a member of the attest client's board of directors?

You must be aware of several things, including the following:

a. You can't participate in the *client's attest engagement* or be in a position to influence the engagement for any periods covering the time you were employed by or on the board of directors of the *attest client*. For example, if you worked for the attest client during its 2021 fiscal year, you can't be part of the attest client's audit engagement for the fiscal year 2021 *financial statements*. You also can't serve in a position that would allow you to influence the fiscal year 2021 engagement (for example, you can't directly or indirectly supervise the audit engagement *partner*). Additionally, if comparative financial statements are being issued that include the 2021 fiscal year, you can't participate in the engagement.

b. Before becoming a *covered member*, you must do the following:

   i. Dispose of any *direct financial interests* or material *indirect financial interests* in the attest client.[5]

   ii. Collect and repay all *loans* to or from the attest client (except those specifically permitted or that have transition provisions.)[6]

   iii. Cease active participation in the attest client's employee health and welfare plans (except for benefits under the Consolidated Omnibus Budget Reconciliation Act of 1985).

   iv. Cease to participate in all other employee benefit plans by liquidating or transferring all vested benefits in the attest 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 you do not participate on the *attest engagement team* or you're not an *individual in a position to influence the attest engagement*, you are 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 penalty[7] significant to the benefits is imposed upon such liquidation or transfer.

   v. Assess whether you have any other relationships with the attest client to determine whether such relationships create *threats* to *independence* that would require the application of *safeguards* to reduce the threats to an *acceptable level*.[8]

See the "Former Employment or Association With an Attest Client" interpretation (ET sec. 1.277.010) for further details.

What rules apply if I am considering employment with an attest client?

If an *attest client* offers you a job or you apply for a job 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

[5] See the section "When do my (or my family's) financial interests impair independence?" in chapter 6, "Applying the standards: Financial relationships," of this guide.
[6] Also, see the "Loans and Leases With Lending Institutions" interpretation (ET sec. 1.260.020).
[7] 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.
[8] See the section "What should I do if no specific guidance exists for my independence issue?" in chapter 1, "Introduction," of this guide.

the attest client to the appropriate person in your *firm*. You cannot participate in the engagement until your negotiations with the attest client end and employment with the client is no longer a possibility.

See the "Considering Employment or Association With an Attest Client" interpretation (ET sec. 1.279.010) for further details.

What if I accept employment or a board position with an attest client?

Being employed by an *attest client* or member of the attest client's board of directors *impairs independence*. Even if you leave your *firm* to take a position with an attest client, the firm's independence may be affected. This would be the case if you accept a *key position* with the attest client, which means you prepare *financial statements* or accounting records or are otherwise able to influence the attest client's statements or records.

A few examples of key positions are controller, CFO, or treasurer. The substance of your work, not only the position title, determines whether a position is considered "key."

If you meet the following conditions, having a key position with an attest 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 attest client has not compromised the firm's independence and that independence will be maintained going forward. The firm should consider:

- 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 attest client; and
- 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 make the audit less effective;

- reconsider the composition of the successor engagement team to ensure that those staffing it have sufficient stature and experience to deal effectively with you in your new position; or
- perform an internal technical review of the next *attest engagement* to determine whether engagement personnel exercised the appropriate level of professional skepticism in evaluating your work and representations.[9]

See the "Subsequent Employment or Association With an Attest Client" interpretation (ET sec. 1.279.020) for further details.

Under SEC Rule 2-01(c)(2)(iii), if a former partner, principal, shareholder, or professional employee will be in an accounting role or financial reporting oversight role with an SEC audit client, the former partner may not have the following:

- A capital balance with the firm
- A financial arrangement with the firm (for example, retirement benefits) that is not fully funded by the firm
- Influence over the firm's operations or financial policies

The SEC uses the term *accounting role* for a person who prepares the accounting records or can or does exercise more than minimal influence over the contents of the accounting records. The term *financial reporting oversight role* refers to any individual who has direct responsibility for oversight over those who prepare the registrant's financial statements and related information that are included in the filings with the commission. The AICPA term *key position* covers both of these.

The SEC also requires a one-year cooling-off period for members of the audit engagement team of an issuer who assumes 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 will be impaired.

Only members who provided fewer than 10 hours of services 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 audit client and all affiliates.

[9] An objective professional with the appropriate stature and expertise should perform this review, and the firm should take any recommendations that result from the review.

What if I am an adjunct faculty member at an educational institution that is an attest client of my firm?

This is the only exception to the prohibition on employment at an *attest client*. Although employment as an adjunct at an attest client still raises *threats* to *independence*, you can put *safeguards* in place to maintain your independence. If you are a *partner* or professional employee, you must 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; or
- assume any management responsibilities or set polices for the educational institution.

How does a staff augmentation or loaned staff arrangement affect my independence?

The code refers to this as staff augmentation arrangements, which involve lending *firm* personnel to an *attest client* so that the attest client is responsible for the direction and supervision of activities. This arrangement is different from a nonattest services engagement because the attest client — not the firm — is supervising the loaned staff.

This can create familiarity, management participation, advocacy, or self-review *threats* to the firm's *independence*. If you ensure all the following *safeguards* are in place, threats to your independence will be at an *acceptable level*:

- The arrangement is due to an unexpected situation that would create a significant hardship for the attest client if your firm didn't step in and offer help. Unexpected loss of a key employee is a good example.
- The arrangement is not expected to reoccur.
- The arrangement is 30 days or fewer.
- The staff doesn't participate in an *attest engagement* covering any period that includes the staff augmentation arrangement, nor is the staff able to influence such an engagement.
- The staff performs only activities that are allowable under the "Nonattest Services" subtopic (ET sec. 1.295).
- The firm is satisfied that management has designated someone with suitable skill, knowledge, and experience to oversee the activities of the staff.

For further details, see the "Staff Augmentation Arrangements" interpretation (ET sec. 1.275.007) and Q&A section 150, *Current Employment or Association With an Attest Client*.

Chapter 4

Network firms, alternative practice structures, and firm mergers and acquisitions

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*. At times, this cooperation gives the impression that firms are closely aligned or connected. Here are some factors that contribute to this impression:

- The use of a common brand name (including common initials) as part of the firm name
- Common *control* among the firms through ownership, management, or other means
- Profits or costs sharing, 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
- The sharing of a significant part of professional resources, for example personnel, supplies, or information systems
- Common quality control policies and procedures that firms are required to implement and that are monitored by the association

When a firm is associated with other firms and the relationship includes any of the characteristics in that list, 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's possible that a firm will be part of the association but will not have any of the characteristics in the preceding list. In that case, even though the firm is part of the association, it's not considered a network firm.

How do I apply the network firm guidance?

The "Networks and Network Firms" interpretation (ET sec. 1.220.010) of the "Independence Rule" (ET sec. 1.200.001) explains that when your *firm* is considered a *network firm*, your firm is required to remain *independent* of other network firms' audit and review *clients* and vice versa.

Therefore, a network firm may provide audit or review services for a client only if other network firms within the same association of firms are independent of the client. For example, other network firms could not provide prohibited nonattest services 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*, you should consider any *threats* you know or have reason to believe may be created by network firm interests and relationships. If those threats are not at an *acceptable level*, apply *safeguards* to eliminate the threats or reduce them to an acceptable level.

When a network firm that is part of the *network* and is located outside of the United States departs from the "Independence Rule," the domestic network firm's independence is not *impaired* as long as the foreign network firm has, at a minimum, complied with the independence requirements of the International Ethics Standards Board for Accountants' Code of Ethics for Professional Accountants.

The SEC does not define associated entities. In its 2000 release, the staff noted that its intention was to address any questions "in light of all relevant facts and circumstances, looking to the factors identified in [the staff's] previous guidance on this subject" (Section H. *Definitions*, 2. "Accounting firm"). In addition to whether there is full compliance with applicable local independence standards, other considerations may include the Commission's general standard for auditor independence in Section 210.2-01(b) and whether the relevant facts and circumstances of the relationship between two or more entities indicates that they should be treated as associated entities. Additional nonexclusive factors considered may include:

- Does the primary auditor refer to another firm in the audit opinion? If the answer is yes, this potentially indicates the two firms are not associated entities because it clarifies the division of responsibility between the firms.
- Does the primary auditor treat the work done by a firm outside its network as though the work was done by the attest client's management? If the answer is yes, this potentially indicates the two firms are not associated entities, because it suggests that the primary auditor does not assume responsibility for the other firm's work, similar to how they would not assume responsibility for the work of the client's management.

Do alternative practice structures affect independence?

As the "Alternative Practice Structures" interpretation (ET sec. 1.220.020) explains, an alternative practice structure (APS) can affect *independence*. An APS is a relationship in which a *firm* that provides attest services is closely aligned with another public or private organization that performs other *professional services*.

When applying the "Independence Rule" and its interpretations in this environment, it is important to understand the following:

- Which entities in the relationship are the "attest firms," the "professional services subsidiaries," and "other public company entities" as defined in the interpretation
- The direct reporting relationships of the partners and managers in the attest firms so you can determine which of the following individuals and entities are also required to comply with the "Independence Rule" and its interpretations:
  - — Direct superiors
  - — Entities within the APS over which direct superiors can exercise significant influence
- The chain of command over direct superiors to identify the indirect superiors because independence would be *impaired* if indirect superiors (which start with the person to whom the direct superior reports and goes up the line from there) have material financial relationships with an *attest client* of the attest firms
- Which entities are "other public company entities" because, although they are permitted to provide nonattest services to *attest clients* of the attest firms that would impair independence, independence will be impaired if, during the *period of the professional engagement*, any other public company entity
  - — has a material financial relationship with an attest client of the attest firm;
  - — has *significant influence* over an attest client of the attest firm; or
  - — is (or any of its employees) connected with an attest client of the attest firm as a promoter, underwriter, voting trustee, director, or officer.

The attest firm cannot provide attest services to its parent company or any of the parent company subsidiaries without impairing independence. Additionally, if an attest client of the attest firm holds a material investment in the parent company or allows the attest client to exercise significant influence over the parent company during the period of the professional engagement, independence will be impaired.

Given the emerging nature, rapid evolution, and differing facts and circumstances surrounding each of these transactions, the SEC staff have shared limited high-level considerations for audit firms to include in their analysis when evaluating these transactions and their implications on auditor independence. If companies or their auditors have questions about the application of the Commission's auditor independence rules when considering alternative practice structures, they are encouraged to consult with the staff in the SEC's Office of the Chief Accountant: sec.gov/about/divisions-offices/office-chief-accountant.

The SEC staff statement provided by the then SEC Chief Accountant, Paul Munter, "Auditor Independence and Ethical Responsibilities: Critical Points to Consider When Contemplating an Audit Firm Restructuring," discusses considerations when determining the effects on independence to a firm when moving away from the traditional firm structure to an alternative practice structure.

How do I apply independence guidance in a merger or acquisition?

The "Firm Mergers and Acquisitions" interpretation (ET sec. 1.220.040) under the "Independence Rule" provides guidance in situations in which *independence* may become *impaired* as a result of a *firm* merger or acquisition. The guidance applies when either (1) a *member's* firm merges with or acquires another firm or entity or all or part of the business thereof or (2) a member's firm, or all or part of the business thereof, is merged with or acquired by another firm.

The interpretation focuses on two types of relationships that could impair independence: employment or association with an *attest client* and the provision of nonattest services that will impair independence (prohibited nonattest services).

Employment or association with an attest client

The interpretation requires certain *safeguards* to be in place in order for independence to be maintained when a *partner* or professional employee of one firm is employed by or associated with an attest client of the other firm.

Such safeguards require that the partner or professional employee terminate the relationship prior to the closing date of the merger or acquisition and be prohibited from participating on the *attest engagement team* or being an *individual in a position to influence the attest engagement* if the engagement covers any period in which the *partner* or employee was employed or associated with the attest client. The partner or employee must also comply with any applicable safeguards under the provisions of the "Former Employment or Association With an Attest Client" interpretation regarding disassociation from an attest client, such as the safeguard that requires any *covered member* to cease participation in the attest client's employee benefit plans.

The interpretation also requires that a responsible individual within the firm (for example, an individual with responsibility for the policies and procedures relating to independence) assess the prior relationship that the partner or professional employee had with the attest client as well as the position that the individual will hold at the firm to determine whether *threats* are at an *acceptable level*. If threats are determined not to be at an acceptable level, the responsible individual will need to be satisfied that safeguards are applied that will eliminate or reduce threats to an acceptable level.

The interpretation further requires that, in situations in which the partner or professional employee will interact with the attest engagement team or in which the attest engagement team will evaluate work performed by the partner or professional employee while they were employed or associated with the attest client, an individual within the firm with the appropriate stature, expertise, and objectivity must review the subsequent *attest engagement* prior to issuing the attest report to determine whether the attest engagement team maintained integrity, objectivity, and professional skepticism as appropriate.

Finally, the interpretation requires that the nature of the relationship and any safeguards that were applied be discussed with *those charged with governance* and that such discussion take place as soon as practicable under the circumstances but before issuing the attest report and encourages the substance of the discussions be documented.

Nonattest services

The interpretation provides independence guidance in situations in which one firm provided prohibited nonattest services to an attest client of the other firm. The interpretation acknowledges that the significance of the threats differs depending on whether the prohibited nonattest services were provided by the “acquiring firm” with respect to an attest client of the acquired firm or by the "acquired firm" with respect to an attest client of the acquiring firm.

In situations in which the acquiring firm provided prohibited nonattest services to an attest client of the acquired firm during the *period of the professional engagement* or the period covered by the *financial statements*, threats would be so significant that they could not be reduced to an *acceptable level*. For example, in the situation in which the acquired firm's attest client would become an attest client of the acquiring firm (that is, the surviving firm) upon the merger or acquisition, any prohibited nonattest services performed by the acquiring firm for such an attest client would impair independence if the attest engagement were to continue.

Alternatively, if the acquired firm provided the prohibited nonattest services to an attest client of the acquiring firm during the period of the professional engagement or the period covered by the financial statements, the acquiring firm's independence will not be impaired provided certain conditions are met. The first condition is for the acquired firm to either terminate the prohibited nonattest services or modify the nonattest services such that the services will no longer be considered to impair independence. This condition should be met prior to the closing date of the acquisition. The second condition is that any individual who participated in the prohibited nonattest services engagement not be on the attest engagement or in a position to influence the attest engagement. The last condition is for the firm to perform an evaluation to determine whether threats are either at an acceptable level or can be reduced to an acceptable level by the application of safeguards. The extent of the evaluation performed would be based on whether the prohibited nonattest services will be attributable to the acquiring firm. The nonattest services will be considered attributable to the acquiring firm if the acquiring firm will assume responsibility (that is, be held liable or accountable or both) for the results of the prohibited nonattest services performed by the acquired firm.

In evaluating the significance of any threats, the interpretation provides various factors that should be considered; and, where threats are determined not to be at an acceptable level, the interpretation provides examples of possible safeguards to be applied. In cases in which no safeguards exist that can eliminate or reduce threats to an acceptable level, independence would be impaired.

The interpretation also requires that a responsible individual within the firm discuss with those charged with governance the nature of any prohibited services performed that are subject to the evaluation, along with any safeguards applied, and encourages documentation of such discussion. This discussion should occur as soon as practicable under the circumstances but before issuing the attest report.

Chapter 5

Family members

When is my family subject to independence standards?

If you're a *covered member*, your *immediate family* (your spouse or equivalent and dependents) generally needs to follow the same guidance you're required to follow as a covered member. For example, your spouse's investments must be investments you could own. This applies even if the investments are in your spouse's own name or with a different broker than the one you use. In addition, when materiality is a factor, your *financial interests* are combined with your immediate family members'.

If you are not a covered member, see the section "Do any of the standards apply to me if I am not a covered member?" in chapter 3, "Covered members and other firm professionals."

There are a few exceptions to your family members' requirements, as described in the following list.

> ***Note***
> For items (*c*) and (*d*), your family may invest or participate in the plans if you are a *partner* or *manager* who provides only nonattest services to the *attest client* or if you are a partner or *partner equivalent* who is a covered member only because you practice in the same *office* where the attest client's lead attest partner practices.

At no time may any *direct* or material *indirect financial interests* in an attest client permitted by the preceding exceptions exceed 5 percent of the attest client's outstanding equity securities or other ownership interests.

a. Your immediate family member's employment with an attest client would not *impair* your *firm'sindependence* as long as the family member is not in a *key position*.

b. Immediate family members may participate in employee benefit plans (other than certain share-based arrangements or nonqualified deferred compensation plans) that are your or your firm's attest clients or sponsored by such. There are some qualifications here, though:

    i. The plan must be offered to all employees in comparable positions.

   ii. Your immediate family member cannot be in a position of governance for the plan and cannot supervise or participate in the plan's investment decisions or selection of investment options.

c. Immediate family members may invest in an attest client through employee benefit plans that aren't considered *share-based compensation arrangements* or nonqualified deferred compensation arrangements (for example, retirement or savings accounts). This also has some qualifications you need to be aware of:

   i. The family member must have no other investment options available for selection

   ii. When such an option becomes available, the family member must select the option and dispose of any financial interest in the attest client.

d. Immediate family members in permitted employment positions may participate in share-based compensation arrangements and nonqualified deferred compensation plans, as long as you've identified possible *threats* to your independence and implemented *safeguards* to mitigate those threats.

Under SEC rules, if you are a covered person, your independence is affected if your immediate family member has any direct investment, has any material indirect investment, has the authority to make investment decisions for a trust that contains the securities of another client, or owns more than 5 percent of a client's equity securities or controls the client.

The SEC rules concerning holding unexercised stock options require that the immediate family member dispose of the financial interest as soon as practicable. 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 the 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's rules in that the immediate family member must dispose of the publicly traded shares received as soon as possible but not later than 30 days after the person has the ability to dispose of them. Because the AICPA's rules deal exclusively with private sector securities, it is possible that, when the immediate family member receives shares from an ESOP, the family member may not be able to dispose of the shares because there is not a ready market for the shares. Accordingly, the AICPA's rules allow the immediate family member to require the employee to exercise the employee's 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 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 an *attest client* in a *key positionimpairsindependence*, except for covered members who are considered covered members only because they provided more than 10 hours of nonattest services to the attest client.

Guidance pertaining to your close relatives' *financial interests* differs 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 is impaired if you are aware that your close relative has a financial interest in the attest client that either

- — is material to your relative's net worth or
- — enables the relative to exercise *significant influence* over the attest client.

- If you are a covered member because you are able to influence the *attest engagement* or are a *partner* or *partner equivalent* 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 attest client that
  - — is material to your relative's net worth and
  - — enables your relative to exercise significant influence over the attest client.

> Under SEC rules, 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 if any partner's close family member owns more than 5 percent of a client's equity securities or controls an SEC audit client.

Chapter 6

Financial relationships

When do my (or my family's) financial interests impair independence?

This chapter discusses various types of financial relationships and how they affect *independence*. Although this chapter focuses on how these rules apply to you and your family, keep in mind that your *firm* is also subject to the financial relationship rules because the AICPA Code of Professional Conduct (the code) includes firms in its definition of *covered member*.

As a *covered member*, you (and your spouse or spousal equivalent and dependents) are not permitted to have a

- *direct financial interest* in an *attest client*, regardless of how immaterial it would be to your net worth, or
- material *indirect financial interest* in the attest client.

You would also have an *indirect financial interest* in the underlying investments of a Section 529 savings plan and a *direct financial interest* in the savings plan itself.

> ***Note***
> The 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 an attest client, your independence would be *impaired*. For example, if you sign a stock subscription agreement with the attest client, your independence will be 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 an attest 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 by you through an investment vehicle, an estate, a trust, or another intermediary if you either
  - — can control the intermediary or
  - — have the authority to supervise or participate in the intermediary's investment decision

For example, if you invest in a participant-directed 401(k) plan and you're 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 an attest client if you have a financial interest in an attest client through one of the following:

- A partnership if you are a general partner
- 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 guidance, you would be deemed to have a direct financial interest in ABC Co. This impairs your independence, regardless of materiality.

An indirect financial interest is if you have a financial interest that is beneficially owned through an investment vehicle, an estate, a trust, or another intermediary, and 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 have an indirect financial interest in the underlying plan investments in addition to a direct financial interest in the plan.

Note

The "Financial Interests" subtopic (ET sec. 1.240), the "Trusts and Estates" subtopic (ET sec. 1.245), and the "Insurance Products" subtopic (ET sec. 1.257) of the "Independence Rule" (ET sec. 1.200.001) provide extensive examples of various types of financial interests and whether they are 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 guidance 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 the interest is material, but 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*.

Which guidance applies 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 guidance pertains 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 *attest clients* through a mutual fund are considered to be *indirect financial interests* in those attest clients unless the fund is a diversified mutual fund.

If a mutual fund is diversified, and you or your immediate family (or both) own 5 percent or less of its outstanding shares, the fund's holdings in attest clients for which you are a *covered member* will not be considered material indirect financial interests in those attest clients. Therefore, you would be relieved of the burden of having to monitor whether, and to what degree, the fund invests in attest clients for which you are a covered member.

If the fund is not diversified or if you or your family (or both) own more than 5 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 attest 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 × 0.10).

If $5,000 is material to your net worth, *independence* is *impaired*.

May my family or I borrow money from or lend money to an attest 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 attest client;
- an officer or a director of the attest client with the ability to affect decision-making; or
- an individual with a beneficial ownership interest that gives the individual significant influence over the attest client.

There are some exceptions to this guidance. First, covered members are permitted to have some types of loans from *lending institution* attest clients, including

- 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);
- passbook loans fully collateralized by cash deposits at the same financial institution; and
- loans fully collateralized by an insurance policy.

In addition, your loan from a lending institution that is an attest client may be eligible for a transition provision (that is, you may be allowed to keep it). For the following loans to be eligible for a transition provision, they must have been obtained under normal lending procedures, terms, and requirements:

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

Generally speaking, a loan may be eligible for a transition provision if you obtained it before

- you became a covered member with respect to the attest client;
- the lending institution became an attest client; or
- the attest client acquired the loan.

To maintain your loan's eligibility for a transition provision status, you must keep the loan current (that is, make timely payments according to the *loan* agreement). In addition, 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).

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

Under the SEC rules, there are no transition provisions. The SEC rules provide exceptions only for the following loans obtained from a lending institution under its normal lending procedures, terms, and requirements:

- Automobile loans and leases collateralized by the automobile
- Loans fully collateralized by the cash surrender value of an insurance policy
- Loans fully collateralized by cash deposits at the same financial institution
- Mortgage loans collateralized by the borrower's primary residence provided the loan was not obtained while the covered person in the firm was a covered person
- Student loans provided the plans were not obtained while the covered person in the firm was a covered person

An accountant would not be independent when the accounting firm, any covered person in the firm, or any of his or her immediate family members has any loan (including any margin loan) to or from an audit client, or an audit client's officers, directors, or beneficial owners (known through reasonable inquiry) of the audit client's equity securities where such beneficial owner has significant influence over the audit client. "Significant influence" refers to the principles in FASB *Accounting Standards Codification* (ASC) 323, *Investments — Equity Method and Joint Ventures*. "Reasonable inquiry" is an inquiry by the auditor to the audit client in conjunction with the consideration of the audit client's governance structure, governing documents, commission filings, or other information prepared by the audit client that may relate to the identification of a beneficial owner.

The prior test for loans to or from owners of record or beneficial owners of an audit client's equity securities (1) has been replaced with a test for beneficial owners known through reasonable inquiry of an audit client's equity securities and (2) no longer references a more than 10 percent ownership test, but rather is based on significant influence over the audit client.

May I have a brokerage account with an attest client?

AICPA guidance indicates that for *independence* to be maintained, a *covered member* whose assets are held by a broker-dealer *attest 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.[10]

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

May I have a bank account with an attest client?

As a *covered member*, you may have a bank account with a client bank or similar depository 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.[11]

> The SEC prohibits covered persons and their immediate families from having bank account balances with an SEC audit client in excess of 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.[12]

May I have an insurance policy with an attest client?

AICPA guidance[13] indicates that to maintain *independence*, a *covered member* must not receive any preferential treatment or terms when purchasing an insurance policy from an *attest client*. If the policy has an investment option, the *financial interest* rules must be applied.

[10] See the "May my family or I borrow money from, or lend money to, an attest client?" section of this guide.
[11] 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.
[12] The SEC treats money market funds (as opposed to money market accounts) as mutual funds for purposes of its rules. See Rule 2-01(c)(1)(ii)(B).
[13] The guidance is found in the "Insurance Products" subtopic (ET sec. 1.257) of the "Independence Rule" (ET sec. 1.200.001).

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:

- The individual 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 an attest client?

The "Offering or Accepting Gifts or Entertainment" interpretation (ET sec. 1.285.010) under the "Independence Rule" addresses the exchange of gifts and entertainment among *covered members* and the *attest client*, including any individual in a *key position* with the attest client or an individual with a beneficial ownership interest (known through reasonable inquiry) that gives the individual *significant influence* over the attest client.

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 attest client and not impair independence if the gift is reasonable in the circumstances. In addition, covered members may give or receive entertainment, provided it too is reasonable in the circumstances.

The "Offering or Accepting Gifts or Entertainment" interpretation (ET sec. 1.120.010) under the "Integrity and Objectivity Rule" (ET sec. 1.100.001) covers a broader issue when *partners*, professionals, or their *firms* exchange gifts or entertainment with *clients* (not just *attest 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 a gift, but if the member and client attend the event together, that's entertainment.)[14]

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.

[14]See the "Differentiating Between Gifts and Entertainment" section of the basis-for-conclusions document published during the development of this interpretation.

Chapter 7

Business relationships

Which business relationships with an attest client impair independence?

As a *partner* or professional employee of your *firm*, *independence* will be *impaired* if you enter into certain business relationships with an *attest client* of the firm. Accordingly, you may not serve an attest 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 an attest client's pension or profit-sharing trust

In essence, any time you are able to assume management responsibilities for an attest client or exercise authority over an attest client's operations or business affairs, independence is impaired. Your independence is impaired even if you are a volunteer board member because that makes you part of the attest client's governing body and, therefore, you can participate in managing the entity.

Three possible exceptions apply to this guidance:

1. You may serve as an adjunct faculty member of an educational institution that is an *attest client* provided certain safeguards are in place (see chapter 3).
2. If you are an honorary director or trustee for an attest client that is a not-for-profit charitable, civic, or religious organization, you may hold such position with a client if
    a. your position is purely honorary;
    b. you do not vote or participate in managing the organization; or
    c. your position is clearly identified as honorary in any internal or external correspondence.
3. In addition, you may serve on a client's advisory board if all the following criteria are met:
    a. The board's function is purely advisory.[15]
    b. The board does not appear to make decisions for the attest client.

c. The advisory board and any decision-making boards are separate and distinct bodies.

d. Common membership of the advisory board and any decision-making groups is minimal.

The SEC prohibits direct or material indirect business relationships or an indirect material relationship with an SEC audit client (or beneficial owners with significant influence over the audit 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.

May I have a joint closely held investment with an attest client?

As a *covered member*, if you or the *attest client* (individually or collectively) control 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* is *impaired*. In this guidance, the term "attest client" includes certain persons associated with the attest client, such as officers, directors, or owners who are able to exercise *significant influence* over the attest client.

[15]When evaluating your independence, you should examine the applicable board or committee charter to determine whether it is consistent with the "Independence Rule" (ET sec. 1.200.001).

The SEC rules prohibit you and your immediate family from having

a. any direct or material indirect investment in an entity for which the audit client has an investment in that entity that is material to the audit client and has the ability to exercise significant influence over that entity or the entity has an investment in an audit client that is material to that entity and has the ability to exercise significant influence over that audit client;

b. any material investment in an entity over which an audit client has the ability to exercise significant influence; or

c. the ability to exercise significant influence over an entity that has the ability to exercise significant influence over an audit client.

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 I have a cooperative arrangement with an attest client?

A cooperative arrangement exists when a *member* or the *firm* and an *attest client* participate jointly in a business activity. Here are some examples of cooperative arrangements:

- Joint ventures to develop or market products or services
- Combining services or products of the firm and attest client and marketing the package with reference to both parties
- The firm acting as a distributor or marketer of the attest client's products or services or the attest client acting as a distributor or marketer of the firm's products or services

These types of arrangements create *threats* to the member and the firm's *independence*, and no *safeguards* can reduce the threat to an *acceptable level* if the arrangement is material to the firm or the attest client during the *period of the professional engagement*.

If all of the following safeguards are applied, there is no cooperative engagement:

- The participation of the firm and attest client are governed by separate agreements that do not create rights or obligations between the firm and the attest client.
- Neither the firm nor the attest client assumes responsibility for the other's activities or results.
- Neither party has the authority to act as the other's representative or agent.

Chapter 8

Nonattest services

What are some nonattest services that my firm and I may or may not provide to attest clients?

Nonattest services include accounting, tax, and consulting services that are not part of an *attest engagement*. Activities such as *financial statement* preparation, cash-to-accrual conversions, and reconciliations outside the scope of the attest engagement constitute a nonattest service. The following nonattest services are specifically addressed in the guidance:

- Advisory services
- Appraisal, valuation, or actuarial services
- Benefit plan administration services
- Bookkeeping, payroll, and other disbursement services
- Business risk consulting services
- Corporate finance consulting services
- Executive or employee recruiting services
- Forensic accounting services
- Hosting services
- Information systems design, implementation, or integration services
- Internal audit services
- Investment advisory or management services
- Tax services

In addition to considering the general standard and the four guiding principles (mutual or conflicting interest with the audit client, position to audit their own work, acting as management or an employee of the audit client, and position of being an advocate for the audit client), 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, service opinions, or contribution-in-kind reports
- Actuarial services
- Internal audit outsourcing services
- Management functions
- Human resources
- Broker-dealer, investment adviser, or investment banking services
- Legal services
- Expert services unrelated to the audit

Under PCAOB rules, the following types of services are also 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

Independence guidance imposes limits on the nature and scope of nonattest services your *firm* may provide to an *attest client*. In other words, the guidance limits the extent to which your firm may perform certain tasks. Further, some services will be prohibited entirely (for example, serving as an attest client's general counsel). These rules apply during the *period of the professional engagement* and the period covered by the *financial statements*. However, if the firm provided the entity with prohibited nonattest services prior to the entity becoming an attest client, independence is not be impaired as long as the prohibited nonattest services relate to periods prior to the period covered by the financial statements the firm 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).

The SEC staff FAQ document *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence — Frequently Asked Questions*, updated in June 2019, includes 11 questions related to nonaudit services provisions of the rules.

FAQ No. 4 under section E addresses the question of whether a successor auditor who performed one of the prohibited services (bookkeeping, internal audit outsourcing, valuation services, actuarial services, or financial information system design and implementation) during the prior audit period would be independent of the SEC audit client during the current audit period. 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. However, independence would be impaired if the successor auditor was engaged to help design a client's financial system in the prior audit period, and the system is not implemented until the current period.

FAQ No. 11 under section E addresses the question of whether an auditor, prior to being dismissed, is precluded from proposing on prohibited nonaudit services to be provided after the audit has been completed and the professional engagement period has ended. The FAQ states that proposing on prohibited nonaudit services while the firm is still the auditor heightens the threat, both in fact and appearance, of audit team members acquiescing to management in order to increase the firm's chance of winning the prohibited nonaudit services engagement. As such, independence could be impaired.

This chapter doesn't discuss each of these prohibited nonattest services. Rather, it focuses on a few for purposes of illustration. To see the full context of the guidance, see the "Nonattest Services" subtopic (ET sec. 1.295) under the "Independence Rule" (ET sec. 1.200.001) and SEC Rule 2-01(c)(4).

Other helpful resources are Q&A section 200, *Nonattest Services*, developed by the AICPA Professional Ethics Division, and the "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.

AICPA guidance requires a *member* to comply with more restrictive independence provisions, if applicable, of certain regulators, such as state boards of accountancy and the SEC, the Government Accountability Office, and the Department of Labor.

SEC and PCAOB rules require independence of an issuer that is an audit client and various affiliated entities of the client.[16]

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, *Audit Committee Pre-approval of Certain Tax Services*, and Rule 3525, *Audit Committee Pre-Approval of Non-audit Services Related to Internal Control Over Financial Reporting*.[17] PCAOB Rule 3526, *Communication with Audit Committees Concerning Independence*, superseded the PCAOB's interim standard Independence Standards Board Standard No. 1, *Independence Discussions with Audit Committees*, 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 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).

AICPA general requirements

General requirement 1

The "General Requirements for Performing Nonattest Services" interpretation (ET sec. 1.295.040) explains the main *safeguards* you need to apply when you provide nonattest services to your *attest clients*.

The first general requirement explains that the attest client must agree to assume some responsibilities related to the nonattest services engagement in order for your independence to be intact. Prior to agreeing to do any nonattest services for the attest client, you need to get the client to agree to do the following:

a. Assume all management responsibilities described in the "Management Responsibilities" interpretation (ET sec. 1.295.030) under the "Independence Rule."

b. Oversee the service by designating an individual, preferably within senior management, who has suitable skill, knowledge, and experience. You should assess and be satisfied that this person understands the services to be performed sufficiently to oversee them. This doesn't mean the person is required to have the expertise to perform or re-perform the services.

[16]See Rule 2-01(f)(4) and (6).
[17]PCAOB rules can be found in PCAOB *Standards and Related Rules*.

c. Evaluate the adequacy and results of the services performed.

d. Accept responsibility for the results of the services.

You should be satisfied that the attest client designee can meet these criteria, make an 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 attest client also must be willing to commit the time and resources needed for the designee to fulfill these duties.

General requirement 2

One of the key principles underlying the AICPA guidance 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 making significant decisions regarding the acquisition, deployment, and control of human, financial, physical, and intangible resources. You can find examples of management responsibilities in the “Management Responsibilities” interpretation under the “Independence Rule.”

General requirement 3

Before performing nonattest services, your *firm* should establish and document with the attest client its understanding of the following:

- Objectives of the engagement
- Services to be performed
- Attest client’s acceptance of its responsibilities
- Your firm's responsibilities
- Any limitations of the engagement

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

> ***Note***
> Routine activities such as providing advice and responding to questions as part of the normal client-member relationship are exempt.

Are financial statement preparations, cash-to-accrual conversions, and reconciliations considered nonattest services?

Under AICPA *independence* guidance, the preparation of *financial statements*, cash-to-accrual conversions, and reconciliations are outside the scope of the *attest engagement*, so they are nonattest services. These activities don't impair independence if the requirements of the *interpretations* of the "Nonattest Services" subtopic are met.

For additional information, listen to episode 25 of the *Ethically Speaking* podcast.

Is there guidance for performing bookkeeping services for an attest client?

The AICPA *independence* guidance prohibits *members* from assuming management responsibilities in all circumstances. Accordingly, a member may provide bookkeeping services if the *attest 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 attest client must

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

Note
Proposing adjusting entries to an attest client's financial statements as part of the member's audit, review, or compilation services is considered a normal part of those engagements and, according to the provisions of the "Nonattest Services" subtopic, it's not considered performance of a nonattest service as long as the attest client reviews these entries and understands the effect on its financial statements and records of any adjustments identified by the member that the attest 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 conclude 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 financial information systems design and implementation; appraisals, valuations, fairness opinions or contribution- in-kind reports; actuarial services; and internal audit outsourcing.

May my firm assist an attest client with executive or employee recruiting?

Assisting *attest clients* with executive or employee recruiting may create familiarity and undue influence threats to your *independence*. You may know of individuals or attest clients that are seeking a new position or employee, and simply passing on the name or resume of an individual would not impair independence. However, be cautious when engaged to perform recruiting services.

Three prohibitions apply to recruiting for all positions because the management participation threat is too significant to overcome. They are:

- Hires or terminates attest client employees
- Negotiating with a candidate on behalf of the attest client and
- Committing the attest client to compensation and benefit arrangements.

Additional prohibitions apply to recruiting for key positions as these positions are often considered part of the attest client management. You should take special care not to take on management responsibilities. The specific prohibitions include:

- Advising on the specific terms of employment for a specific candidate
- Searching for or seeking out candidates
- Performing reference checks of candidates
- Recommending only one candidate
- Ranking candidates whether or not using the client criteria

The code does permit you to advise the attest client during the hiring process related to the description of the position or benefits for a position as long as the attest client makes the final decision. You may also assist in screening candidates against the client-provided criteria and performing background checks. As with any service, you should use your professional judgement to determine if threats to your independence are at an *acceptable level*.

May my firm provide internal audit services to an attest client?

To perform internal audit assistance for an *attest client* and maintain *independence*, your *firm* may not, in effect, manage the internal audit activities of the attest client. For example, you and your firm may not do any of the following:

- Perform ongoing evaluations or control activities that affect the execution of transactions (for example, reviewing *loan* originations as part of the attest client's approval process or reviewing customer credit information as part of the customer's sales authorization process) or ensure that transactions are properly executed or accounted for, or both, or perform routine activities in connection with the attest client's operating or production processes that are equivalent to those of an ongoing compliance or quality control function.
- Perform separate evaluations on the effectiveness of a significant control such that the *member* is, in effect, performing routine operations that are built into the attest client's business process.
- Have the attest client management rely on the member's work as the primary basis for the attest client's assertions on the design or operating effectiveness of internal controls.
- Determine which, if any, recommendations for improving the internal control system should be implemented.
- Report to the board of directors or audit committee on behalf of management or the individual responsible for the internal audit function.
- Approve or be responsible for the overall internal audit work plan, including the determination of the internal audit risk and scope, project priorities, and frequency of performance of audit procedures.
- Be connected with the attest client as an employee or in any capacity equivalent to a member of management (for example, being listed as an employee in the attest client's directories or other attest client publications; permitting themselves to be referred to by title or description as supervising or being in charge of the attest client's internal audit function; or using the attest client's letterhead or internal correspondence forms in communications).

For you to maintain your independence, the attest client must do the following:

- 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, including those you will perform in providing the services.
- Evaluate the findings and results of internal audit activities, including those you will perform in providing the services.
- Evaluate the adequacy of the audit procedures performed and findings resulting from the performance of those procedures.

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

Note
For entities regulated by the FDIC or other banking agencies, see the FDIC Interagency policy statement on the internal audit function and its outsourcing.

May my firm provide valuation, appraisal, or actuarial services to an attest client?

Your *firm* may not provide valuation, appraisal or actuarial services to an *attest client* if

- the results of the service would be material to the attest 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 an attest client's financial statements because that service involves significant subjectivity (for example, setting the assumptions and selecting and applying the valuation methodology).

The following two limited exceptions apply to this rule:

1. Valuation, appraisal, or actuarial services performed for nonfinancial statement purposes may be provided if *safeguards* from the "General Requirements for Performing Nonattest Services" interpretation are met. (For example, the attest 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.)

2. Your firm may provide an actuarial valuation of an attest 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 to an SEC audit client unless it is reasonable to conclude that your firm would not audit the results of those services.

The staff of the Professional Ethics Division issued nonauthoritative guidance (Q&A section 220) on whether members could assist an attest client in applying FASB Accounting Standards Codification (ASC) 805, *Business Combinations*, or FASB ASC 350, *Intangibles — Goodwill and Other*, while maintaining independence. Specifically, the Q&A addresses whether the following services will impair independence:

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

May my firm provide investment advisory services to an attest client?

Here are examples of what you and your *firm* may do under the AICPA guidance, provided the *safeguards* from the "General Requirements for Performing Nonattest Services" interpretation are met:

- Make recommendations to an *attest client* about the allocation of funds to various asset classes.
- Analyze investment performance.

AICPA guidance indicates that you and your firm may not do the following:

- Make investment decisions for the attest client.
- Execute investment transactions.
- Take custody of an attest client's assets.

May my firm design or implement an information system or provide network maintenance services for an attest client?

Effective January 1, 2023, your *firm* may not design or develop an *attest client's* financial information system. In addition, performing ongoing functions, processes or activities that involve management functions is prohibited. Some examples of this are operating an attest client's network, supervising client personnel, and operating or managing the attest client's information technology help desk.

As long as you meet all the requirements of the "Nonattest Services" subtopic, your firm may install and configure a commercial off-the-shelf financial information system package for an attest client, including helping the client set up a chart of accounts and *financial statement* format. However, your firm may not customize that software (that is, modify or enhance the features and functions in ways that go beyond the options provided by the third-party vendor).

Your firm may perform network maintenance, such as updating virus protection and applying certain updates and patches not developed by your firm, as long as the firm doesn't have the responsibility to perform ongoing maintenance. Your firm also may provide advice, training, or instruction to the attest client's employees on how to use an information system. However, your firm may not supervise the attest client's employees in their day-to-day use of the system because that activity is a management responsibility.

Your firm may design, develop, install, or implement an information system that is unrelated to the attest client's financial information system as long as you meet the requirements of the "Nonattest Services" subtopic.

Your firm may not perform interface services and data translation services for off-the-shelf financial information systems unless you use a third-party application for the services and you are not developing code for the application to work.

Q&A section 250 includes questions related to information systems services and how these services may affect your independence. AICPA Professional Ethics Division staff have also developed a practice aid to assist practitioners in determining how a proposed service may affect independence.

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:

- Evaluate internal controls of a financial information system as it is being designed, implemented, or operated for the client by another service provider.
- Make recommendations on internal control matters to management in connection with a system design and implementation project being performed by another service provider.

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.

May my firm provide hosting services to an attest client?

Providing hosting services to an *attest client* after June 30, 2019, will impair your *independence* because you will be maintaining internal control over the attest client's data or records. Hosting services involve

1. acting as the sole host of an attest client's financial or nonfinancial information system;
2. taking custody of or storing an attest client's data or records so that the attest client would need to come to you to make their data or records complete; or
3. providing the attest client with electronic security or backup services for its data or records. Examples of hosting services include housing a client's website, keeping your client's general ledger on your servers or servers leased by your *firm*, or being your client's disaster recovery provider.

Keeping copies of a client's data or records to support a service you provided is not the same as providing hosting services. It's also not hosting if you use general ledger software to facilitate the delivery of bookkeeping services if you and the client maintain separate instances of the software on your respective servers and you just pass updated financial information to the client.

Another circumstance that is not hosting is when the attest client retains a third-party service provider to maintain its general ledger in a cloud-based platform and grants you access to this software to provide bookkeeping services. If you use a portal to electronically exchange data or records, terminate access to the data or records in the portal within a reasonable time frame after the engagement ends. This will ensure you don't inadvertently provide hosting services.

A different way to think about hosting services is to ask this question: If the client were to end the professional relationship with your firm and engage another firm to provide the same services, would the former client need to come back to you for its books and records to be complete? If the answer is no, then your firm is not providing hosting services.

If the answer is yes, then you may be providing hosting services. You can find additional examples in the "Hosting Services" interpretation (ET sec. 1.295.143). Also, the staff of the Professional Ethics Division issued nonauthoritative guidance (Q&A section 240) that includes specific nonattest services questions and answers (including regarding hosting).

Listen to episode 3, episode 4, and episode 12 of the *Ethically Speaking* podcast for discussion of topics related to hosting.

May my firm provide an attest client with training services?

Paragraph .04 of Q&A section 200 addresses the question of whether a *member's independence* would be impaired if the member provided training to an attest client that is implementing changes to its financial reporting system or process. The Q&A concludes that a member's independence would not be impaired if the attest client personnel are provided with a general understanding of the financial reporting system or process. It goes on to explain that if attest client personnel already have a general understanding, the member may provide more specific training to attest client personnel on how the system or process applies to the attest client's specific circumstances. It cautions members that they should ensure that the training does not involve supervising attest 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.

May my firm manage a project for an attest client?

Managing an *attest client* project, including deciding whether to proceed with a project, is considered a management responsibility. Accordingly, if a member accepts responsibility for management of an attest client's project, then the *member's independence* would be *impaired* even if the project did not affect the attest client's financial statements.

However, if the member's services are limited to providing assistance, advice, suggestions, or recommendations regarding matters that are within the member's areas of knowledge or experience, independence would not be impaired.

May my firm assist an attest client with implementing a new accounting standard?

New accounting standards may require changes that are difficult for your *attest clients* to understand, so correspondence and discussions with *clients* may go beyond the routine activities involved when providing attest services.

Some examples of routine activities include discussions with the attest client about management's selection and application of accounting standards or policies and *financial statement* disclosure requirements; the appropriateness of methods used in determining accounting and financial reporting; adjusting entries that the *member* has prepared or proposed for management's consideration; or the form or content of the financial statements.

When assessing *independence* and assisting an attest client with implementing a new standard, you want to consider whether the *firm's* involvement becomes so extensive that the firm may need to consider a separate service subject to the requirements for nonattest services.

Some considerations may include the significance of the new accounting standard, the extent of the difference from the previous standard, or the complexity of the new standard. If your firm currently provides allowable nonattest services, you should also consider the cumulative effect on independence when providing multiple nonattest services. Before agreeing to perform nonattest services, you should evaluate whether the performance of multiple nonattest services by your firm in aggregate would create a significant threat to the firm's independence that cannot be reduced to an *acceptable level* with the application of *safeguards*.

Your firm should also be cautious of crossing the line that may lead to providing prohibited nonattest services. Your firm may explain the steps needed to achieve the principles of the new standard, but the attest client must accept responsibility for the work performed to implement the standard. Self-review and management participation threats seem to be the most prevalent threats when assisting clients with implementing new accounting standards, but there could be others. Your firm should apply the safeguards in the "General Requirements for Performing Nonattest Services" interpretation.

Paragraphs .02–.03 of the "Assisting Attest Clients With Implementing Accounting Standards" interpretation (ET sec. 1.295.113) include specific examples of activities that would and would not automatically impair independence, respectively.

For additional information, listen to episode 10 of the *Ethically Speaking* podcast.

What about cybersecurity services?

Firms are often asked to assist their *clients* with cybersecurity services. This type of service is often considered to be an advisory service, depending on the specifics of the engagement. Follow the guidance in the "Advisory Services" interpretation (ET sec. 1.295.105). The staff of the Professional Ethics Division issued a Q&A that includes specific nonattest services questions and answers (including regarding cybersecurity services).

Chapter 9

Breach of an independence interpretation

What do I do if I'm not in compliance with an independence interpretation?

Before resigning from an *attest engagement*, you may want to assess the breach under the "Breach of an Independence Interpretation" interpretation (ET sec. 1.298.010). However, if you choose to evaluate the breach using this interpretation and conclude that the consequences of the breach were satisfactorily addressed and do not resign, you should be prepared to justify such a conclusion because use of the interpretation will not preclude you from an investigation or enforcement action by the AICPA.

To use the interpretation, your *firm* must be compliant with Statement on Quality Management Standards (SQMS) No. 1, *A Firm's System of Quality Control* (QM sec. 10),[18] which requires the *member's* firm to have established policies and procedures designed to provide it with reasonable assurance that the firm, its personnel, and when applicable, others subject to *independence* requirements maintain independence when required. If your firm is not compliant with SQMS No. 1, you would not be able to address the consequences of the breach under this interpretation.

If your firm is compliant with SQMS No. 1, but a breach still occurs that results in the *attest engagement team's* integrity, objectivity, and professional skepticism being compromised, the *threat* to independence would be so significant that you could not take any actions to satisfactorily address the consequences of the breach. In addition, there is a rebuttable presumption that the attest engagement team's integrity, objectivity, and professional skepticism are compromised and that you cannot take any actions to satisfactorily address the consequence of the breach when the lead attest engagement partner or an *individual in a position to influence the attest engagement* either (1) committed the breach or (2) knows of a breach and fails to ensure the breach is promptly communicated to or known by an appropriate individual within the firm.

If your firm is compliant with SQMS No. 1 and the attest engagement team's integrity, objectivity, and professional skepticism are not compromised, then you could evaluate the breach using the interpretation to determine whether you can address the breach and perform the attest engagement. If you determine that you can satisfactorily address the breach, the interpretation calls for certain steps to be taken, including communicating with *those charged with governance* and documenting the breach; the action taken, key

[18]The Statements on Quality Management Standards (SQMSs) are codified in the QM sections in AICPA *Professional Standards*.

decisions made, and all the matters discussed with those charged with governance; and any discussions with a professional body, relevant regulator, or oversight authority.

Chapter 10

Fee issues

What types of fee arrangements between my firm and an attest client are prohibited?

Even when not related to an attest service, two types of fee arrangements are prohibited if the arrangement involves *attest clients*: contingent fees and commissions.

Contingent fees

A contingent fee is charged only if a specified result is attained or if the amount of the fee depends on the results of your *firm's* services, for example:

- A finder's fee for helping a *client* locate a buyer for one of your client's assets
- A fee based on a percentage of your client's cost reduction as a result of your service when you are performing a consulting engagement to decrease a client's operating costs

There are some exceptions to the prohibition:

- 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

Commissions

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

Here are some examples:

- 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 the 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 in writing that you received a commission for making the referral.

Note
State boards of accountancy and state societies may have more restrictive regulations regarding fee arrangements, as well as specific disclosure requirements.

PCAOB Rule 3521, *Contingent Fees*,[19] prohibits you and your firm from providing any service or product to an SEC audit client for a contingent fee or commission or receiving from the audit client, directly or indirectly, a contingent fee or commission. Although the PCAOB's definition of *contingent fees* was adapted from the SEC's definition, the PCAOB rule eliminates the exception for fees in tax matters if the fees are 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.

[19]PCAOB rules can be found in PCAOB *Standards and Related Rules*.

When are referral fees permitted?

Paragraph .04 of the "Commissions and Referral Fees Rule" (ET sec. 1.520.001) 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 in writing if you receive or pay a referral fee.

> The SEC does not have any specific guidance on referral fees, so the general standard and four guiding principles would be applicable.

Does value pricing impair my independence?

Value pricing is not prohibited by the code and will not impair your independence. Value pricing is a fixed fee determined and agreed to by the client based on the value or complexity of the service being provided to your *client*. When determining the fees, you may want to consider the complexity and scope of the service, whether your *firm* can provide the service for the fee being proposed, how the fee proposal will be received by the client, and how you will explain the value of the service compared to the fee to the client.

Is independence affected when an attest client owes the firm fees for professional services the firm has already provided?

Threats to *independence* can result when a *client* does not pay professional service fees timely. It does not matter whether the fees are related to attest services. What matters is that the *attest client* owes the *firm* fees for an extended period of time. This is the case even if the attest client has given you a note receivable for these fees.

The AICPA revised its "Unpaid Fees" interpretation (ET sec. 1.270.010) in 2022 to direct practitioners to assess the effects on independence using a threats and *safeguards* approach.

If unpaid fees are significant and relate to services provided more than one year before the report issuance date, a *member* needs to assess whether safeguards can reduce threats to independence to an *acceptable level*. If unpaid fees are clearly insignificant and relate to services provided less than one year before the report issuance date, these fees would generally not present significant threats to independence. The revised interpretation provides additional guidance, including examples of factors to consider and safeguards that may be applied.

Additional questions and answers on the topic of unpaid fees are available in Q&A section 125, *Fees*.

The SEC staff FAQ document *Office of the Chief Accountant: Application of the Commission's Rules on Auditor Independence — Frequently Asked Questions*, updated in June 2019, includes 11 questions related to nonaudit services provisions of the rules. FAQ No. 2 under section A addresses the question of whether unpaid prior professional fees affect auditor independence. 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.

Does being compensated for selling certain services to clients affect my independence?

The AICPA guidance does 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.[20]

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).

When I'm determining an attest engagement fee, does my consideration of other services performed for an attest client affect my independence?

Determining fees to charge an *attest client*, whether for attest or other services, is a business decision that should take into account the facts and circumstances — including the requirements of technical and professional standards — relevant to a specific engagement. However, when you are determining an *attest engagement* fee, it is not appropriate to

[20]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.

consider other attest or nonattest services being provided to the attest client, except for cost savings achieved from those other services.

The “Determining Fees for an Attest Engagement” interpretation (ET sec. 1.230.030) allows the *covered member* responsible for determining the attest engagement fee to consider the cost savings that come from the provision of other services to an attest client. The following are some examples of situations where cost savings might be achieved:

- You perform an audit of a company. In performing that audit, you obtain an understanding of the company’s internal controls over the payroll process and test certain aspects of employee compensation. If your firm also performs an audit of the company’s 401(k) plan, those procedures may not have to be performed again.
- Your firm has prepared the tax returns for an LLC for the past five years. This year, the LLC needs you to perform a review engagement for the first time. Your firm has substantial knowledge of the client’s operations, industry, and transactions due to the tax work. This may reduce the amount of time needed to gain an understanding of the entity and may facilitate analytical procedures.
- You perform a compliance audit for a non-profit organization. During this audit, you perform internal control testing related to compliance requirement F for Super Grant. The grantor of Super Grant requires a separate agreed-upon procedures (AUP) report related to transactions relevant to compliance requirement F. Certain tests of controls you performed during the compliance audit are relevant to the AUP.

Does it matter if a large proportion of my firm’s fees come from a particular attest client?

It does matter and it may affect your independence. According to the “Fee Dependency” interpretation (ET sec. 1.230.040), the level of the already present self-interest *threat* is heightened, and an undue influence threat is created. This is due to concerns around the potential loss of fees from attest and other services if you lose that client.

In addition, the “Integrity and Objectivity Rule” (ET sec. 1.100.001) and the “Objectivity and Independence” principle (ET sec. 0.300.050) discuss in broad terms that you should be alert for relationships that could diminish your objectivity and independence in performing attest services. This is one of those relationships.

You and your firm might consider implementing policies and procedures to help identify and monitor fees from attest clients including the following:

a. Consider threats related to fees in the planning stage of the engagement.

b. Base the consideration of threats related to fees on firm-specific criteria or factors that are applied on a facts-and-circumstances basis. (See the following section, “Factors to consider: Identifying what constitutes a large proportion of the firm’s total fees.”)

c. Periodically monitor the relationship. Defining "periodic" is a matter of judgment, but assessments that are performed at least annually can be effective. During such a review, you may discover that a prior determination no longer applies. This could be, for instance, because fees for a particular attest client no longer constitute a large proportion of your firm's fees. Or attest client fees not previously identified as a large proportion could become so when, for example, additional services are contemplated.

Factors to consider: Identifying what constitutes a large proportion of the firm's total fees

Unlike other standard-setters, the AICPA code doesn't specify a level at which fees from an attest client constitute a large proportion. The "Fee Dependency" interpretation (ET sec. 1.230.040) opts instead for a principles-based assessment.

Each situation and attest client is unique, so it is important to use professional judgment to determine which qualitative and quantitative factors are relevant. What one firm or partner might consider a large proportion of fees may be different for another firm or partner based on the size of the firm, the composition of the practice, and risk tolerance.

If an attest client is not considered to represent a large proportion of fees, there would not be an impact on the level of the self-interest threat, no undue interest threat would be created, and no additional consideration of threats related to fees may be necessary.

The following are examples of factors that can be used to determine what constitutes a large proportion of fees:

a. The size of the attest client, in terms of the percentage of fees or the dollar amount of fees versus total revenue of the firm, engagement partner, office, or practice unit of the firm.

b. The significance of the attest client to the firm, engagement partner, office, or practice unit of the firm in light of the following:

    i. The amount of time the firm, partner, office, or practice unit devotes to the attest client

    ii. The effect on the partner's stature within the firm due to the partner's relationships with the attest client

    iii. The manner in which the partner, office, or practice unit is compensated

    iv. The effect that losing the attest client would have on the firm, partner, office, or practice unit

c. The importance of the attest client to the firm's growth strategies (for example, the firm is trying to enter a particular industry)

d. The stature of the attest client, which may enhance the firm's eminence in the marketplace

e. Whether the firm also provides services to related parties (for example, also provides professional services to affiliates or owners of the attest client)

f. Whether the engagement is recurring

The interpretation requires that the fee dependency be determined at the firm level; however, a covered member, particularly at a smaller firm (and, depending on their particular facts and circumstances, larger firms), may find it helpful to think about the size and significance of an attest client's fees to an individual partner, office, or practice unit. In such situations, you should consider the factors above, and the additional considerations in the following section "Factors to consider: Level of threats when fees from one attest client represent a large proportion of total fees — Total fees of one partner or one office of my firm," as applicable.

> Rule 210.2–01(c) of Regulation S-X does not explicitly address how independence is impacted when a firm is overly dependent upon a client or group of related clients. As such, consider consulting with the Commission's Office of the Chief Accountant for staff guidance regarding these situations. When determining whether a firm is overly dependent upon a client or group of related clients, the Commission looks at all the facts and circumstances by using the general standard of independence and the four principles under Rule 210.2–01(b). For example, an accountant who derives more than 15%, or another significant percentage, of its total revenues from one client or group of related clients could cause a reasonable investor to raise questions regarding the independence of the accountant because it causes the accountant to be overly dependent on the client or group of related clients.

Factors to consider: Level of threats when fees from one attest client represent a large portion of total fees

Your firm's total fees

If you've determined that an *attest client's* fees represent a large proportion of the total fees of the *firm*, the level of the self-interest and undue influence threats are elevated, and you must now evaluate whether the threats are at an acceptable level.

Evaluating threats

The following are examples of considerations that may affect the level of the threats:

a. The operating structure of the firm

i. If it's a larger firm, attest and nonattest services may be separated to a good extent within the corporate structure. This tends to minimize the level of threats.

ii. If it's a smaller firm, it is likely less departmentalized than larger firms. Processes will be less formal and involve fewer people. As well, the firms' managing partners may engage in frequent and direct communications with the firms' partners and professional staff on attest client matters and be personally involved in staff assignments. This tends to heighten the level of threats.

b. Whether the firm is expected to diversify such in a way that reduces dependence on the attest client

c. The length of time during which the fees represent a large proportion of the total fees of the firm

d. Whether the level of the fee is set by an independent third party, such as a regulatory body

e. The qualitative and quantitative significance of the attest client to the firm (refer to "Factors to consider: Identifying what constitutes a large proportion of the firm's total fees")

Mitigating threats

If you've determined that self-interest or undue influence threats (or both) are not at an acceptable level here are examples of actions you can take that might help eliminate the threats or reduce them to acceptable level:

a. Have an appropriate reviewer who is not a member of the *firm* review the attest work performed (this reviewer can be from a network firm)

b. Reduce the extent of nonattest services provided to the attest client

c. Increase the client base of the firm to reduce dependence on the attest client

d. Increase the extent of services provided to other clients

e. Ensure that the compensation of the *partner* is not significantly influenced by the fees generated from the *attest client*

Total fees of one partner or one office of my firm

Though the interpretation does not require that the fee dependency be determined at the individual partner, office, or practice unit, a covered member, particularly at a smaller firm (and, depending on their particular facts and circumstances, larger firms), may find it helpful to think about threats related to fees that may exist for an individual partner, office, or practice unit.

Evaluating threats

The following are examples of considerations that may affect the level of the threats for an individual partner, office, or practice unit:

a. The qualitative and quantitative significance of the attest client to the partner or office (refer to "Factors to consider: Identifying what constitutes a large proportion of the firm's total fees").

b. The extent to which the compensation of the partner, or the partners in the office, is dependent upon the fees generated from the attest client.

Mitigating threats

If you've determined that self-interest or undue influence threats (or both) are not at an acceptable level for an individual partner, office, or practice unit here are examples of actions you can take that might help eliminate the threats or reduce them to acceptable level:

a. Have an appropriate reviewer who was not involved in the *attest engagement* review the attest work.

b. Ensure that the compensation of the *partner* is not significantly influenced by the fees generated from the *attest client*.

c. Reduce the extent of non-attest services provided by the partner or *office* to the attest client.

d. Increase the client base of the partner or the office to reduce dependence on the attest client.

e. Increase the extent of services provided by the partner or the office to other clients.

Factors to consider: Providing services to affiliates of a financial statement attest client

When you know or have reason to believe that a relationship or circumstance involving an *affiliate* of a *financial statement attest client* described under items (*b*)–(*l*) of the definition of *affiliate* is relevant to the evaluation of fee dependency, you need to consider that affiliate when identifying, evaluating, and addressing potential *threats* related to fee dependency.

For example, is the affiliate a sister entity? The further the affiliate is from the financial statement attest client in the financial statement attest client's group structure (for example a sister entity compared with a downstream material investee over which the financial statement attest client has significant influence), generally the less influence the financial statement attest client will have on the contracting for services by the affiliate, and the lower the level of the self-interest and undue influence threats in relation to the financial statement attest engagement.

Is it a problem if a large proportion of my or my firm's fees from an attest client are for nonattest services?

Undue influence and self-interest *threats* may exist when a large proportion of fees charged by the *firm* to an *attest client* is generated by providing nonattest services to the attest client. This is due to concerns about the potential loss of either the *attest engagement* or other services and the perception that the firm will focus on the nonattest relationship.

Evaluating threats

Because each situation is unique, it is important to use professional judgment to determine when the undue influence and self-interest threats exist and when these threats are not at an acceptable level. The following are examples of factors that are relevant in evaluating whether *threats* exist and their significance:

a. The ratio of fees for nonattest services to the *attest engagement* fee

b. The length of time during which a large proportion of fees for nonattest services to the attest engagement fee has existed

c. The nature, scope and purposes of the nonattest services, including:

   i. Whether they are recurring services

   ii. Whether law or regulation mandates the services to be performed by the *firm*

Mitigating threats

If you conclude that *threats* are not at an *acceptable level*, the following are examples of actions that might help eliminate or reduce the level of threats to an acceptable level:

a. Have an appropriate reviewer who has not provided attest or nonattest services to the attest client review the work performed on the attest engagement

b. Reduce the extent of nonattest services provided to the attest client.

How can I evaluate other threats to independence related to fees?

The self-interest and undue influence *threats* come into play in various scenarios related to fees. Each situation is unique, so it's important to use professional judgment to determine the level of the threats and how to reduce them to an acceptable level, if necessary.
The significance of an *attest client* to a member (or the member's 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. Paragraphs .16 and .18 of the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010) include specific threats related to fees and you should use the framework to evaluate specific situations that may arise in your practice.

Chapter 11

Further assistance

Where can I find further assistance with my independence questions?

This guide does not address many subjects included in the AICPA independence guidance. We encourage you to review the AICPA Code of Professional Conduct (the code) in the Online Ethics Library.

In addition, refer to the "Conceptual Framework for Independence" interpretation (ET sec. 1.210.010) in evaluating whether a specific circumstance that is not addressed in the code will 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.

AICPA resources

- The AICPA Online Ethics Library contains the AICPA Code of Professional Conduct, Ethics Questions and Answers, basis-for-conclusion documents, sample case studies, and more.
- Refer to the AICPA Professional Ethics Division's standard-setting activities for details regarding current and past projects.
- For questions related to understanding the nonattest services rules, consult *Background and Basis for Conclusions: Revisions to Interpretations and Rulings Under Rule 101 — Independence*.
- For questions related to applying the nonattest services rules, consult Q&A sections 200–280. Topics include hosting services, bookkeeping services, and suitable skill, knowledge, and/or experience.
- For independence inquiries by phone, call 888.777.7077 (option 3, then option 3). Send email inquiries to ethics@aicpa.org.
- The AICPA interactive multimedia course on independence teaches the AICPA and the SEC independence rules and qualifies for four hours of continuing professional education credits.
- The CAQ Alert 2021-02: *Amendments to SEC Independence Rules* is also available.
- The following toolkits are available to assist members with applying the "Conceptual Framework for Independence" and nonattest services guidance:

- — Conceptual Framework Toolkit for Independence
- — Nonattest Services Toolkit

- 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 Government Accountability Office (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. In late summer 2020, the Government Audit Quality Center (GAQC) released a Yellow Book independence documentation practice aid updated for the 2018 Yellow Book on the GAQC Resources web page.
- *Independence rules comparison: AICPA and* Government Auditing Standards compares the rules issued by the AICPA and the GAO.
- *Independence rules comparison: AICPA and DOL* compares the rules issued by the AICPA and the DOL.
- *Understanding circumstances that may compromise your integrity and objectivity* provides nonauthoritative guidance related to integrity and objectivity.
- The *Ethically Speaking* podcast includes the topics of definition of an office, nonattest services, and hosting services.

SEC resources

- Consult the SEC's February 2001 Rules Release for changes related to auditor independence requirements.
- Consult the SEC's January 2003 Rules Release for changes related to auditor independence with respect to nonaudit services, employment relationships, taxes, partner rotation, and communications with audit committees.
- Consult the SEC's October 2019 Rules Release for changes related to auditor independence with respect to certain loans.
- Consult the SEC's October 2020 Rules Release for changes related to the relationships or services that are more likely to pose threats to an auditor's objectivity and impartiality, definition of affiliate, investment company complex, amendments to business relationships, and mergers and acquisitions.
- Consult the Office of the Chief Accountant's August 2022 statement for a discussion on critical points to consider when contemplating an audit firm restructuring.
- You can find information for accountants, including about independence, at the Office of the Chief Accountant's website.

- Independence reference materials can be found on the SEC website, including a link to the latest FAQs as of June 27, 2019.
- Contact the SEC via U.S. Securities and Exchange Commission, Office of the Chief Accountant, 100 F Street, NE, Washington, DC 20549 (mail); oca-independence@sec.gov (email); 202.551.5300 (phone).

PCAOB resources

- See the PCAOB website for its rules and standards.

GAO resources

- Obtain the GAO Yellow Book at GAO.gov/yellowbook.
- Direct inquiries to 202.512.9535 (phone) or yellowbook@gao.gov.

Department of Labor resources

- Refer to DOL Regulation 2509.75-9, *Interpretive Bulletin Relating to the Independence of Employee Benefit Plan Accountants*.
- Direct inquiries to 1.866.4.USA.DOL.

Banking regulators' resources

- Review FDIC regulations in "Annual Independent Audits and Reporting Requirements" (Title 12 U.S. *Code of Federal Regulations* Part 363).
- The following organizations make up 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 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.

International Federation of Accountants resources

- Information about the International Ethics Standards Board for Accountants (IESBA) can be found on the International Federation of Accountants website.

- View the IESBA's Handbook of the International Code of Ethics for Professional Accountants.

National Association of Insurance Commissioners resources

- The National Association of Insurance Commissioners (NAIC) is the U.S. standard-setting and regulatory support organization created and governed by the chief insurance regulators from the 50 states, the District of Columbia, and 5 U.S. territories. Through the NAIC, state insurance regulators establish standards and best practices, conduct peer reviews, and coordinate their regulatory oversight. NAIC staff support these efforts and represent the collective views of state regulators domestically and internationally. NAIC members, together with the central resources of the NAIC, form the national system of state-based insurance regulation in the United States.
- Refer to the NAIC website.
- Section 7, "Qualifications of Independent Certified Public Accountant," of the NAIC's *Annual Financial Reporting Model Regulation* Model Laws outlines the model rule's independence requirements. The requirements of individual state laws, regulations, and administrative rules take precedence and may differ from the guidance provided by the NAIC. Accordingly, auditors of insurance enterprises should review state laws, regulations, and administrative rules to determine what has been approved in each state.