Independence: The Ethical Foundation for the Practice of Public Accounting

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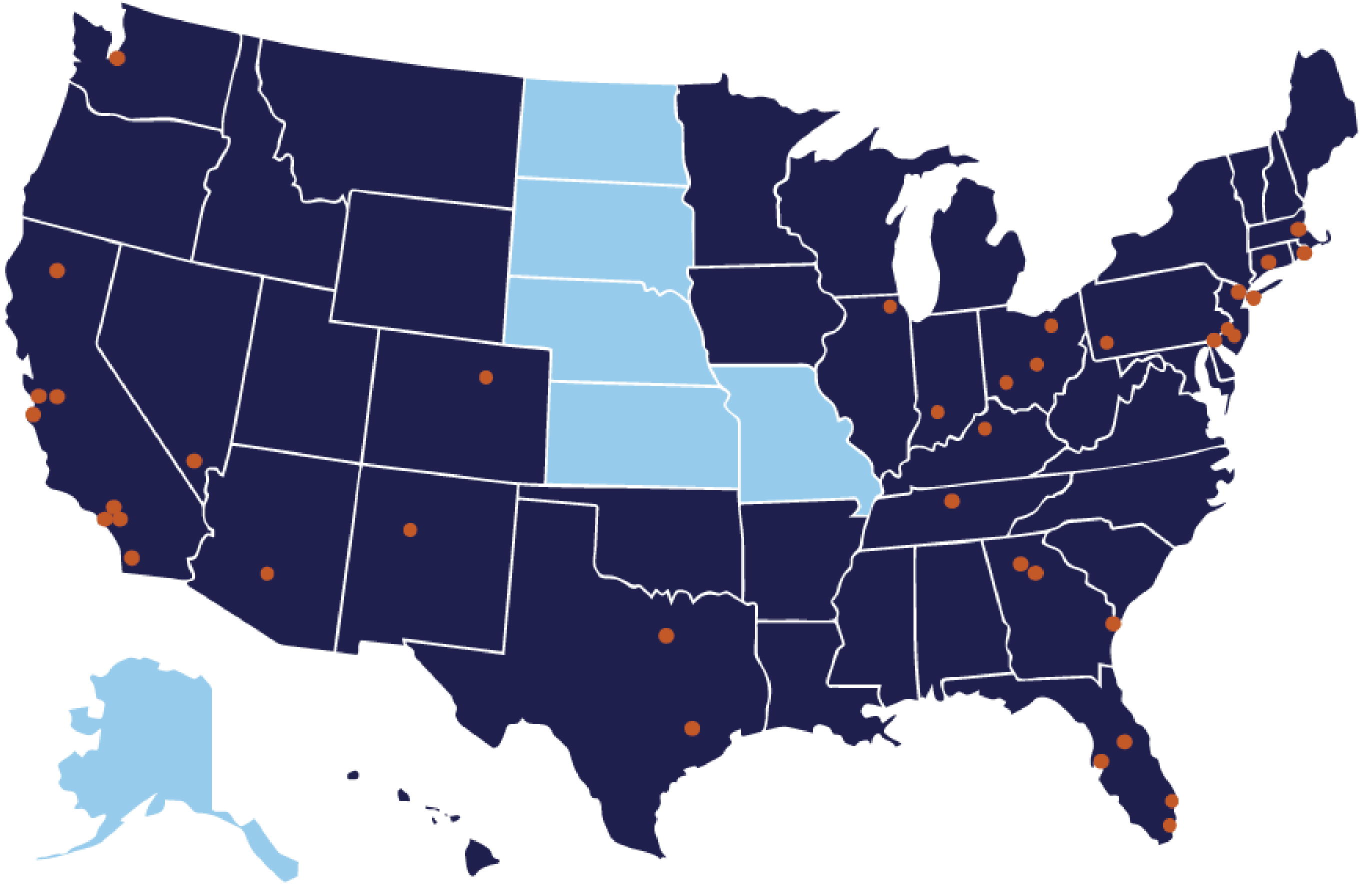

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Agenda

- Framework for Understanding – the AICPA Code of Professional Conduct
  - Public Interest
  - Objectivity and Independence
  - Ethical Decision Making
- The Independence “Rulesets”
  - AICPA vs. SEC vs. PCAOB vs. GAO vs. DOL
- AICPA Concepts
  - Personal independence
  - Firm independence
  - Non-attest services
- Implications of Independence Impairments
- Practitioner Resources

Goals for the Session

- Reinforce your understanding of your personal and your firm's ethical responsibilities under the AICPA Code of Conduct
- Articulate differences between independence and other professional ethical obligations
- Identify non-attest services which may result in independence breaches
- Be familiar with resources available to you

AICPA Code of Professional Conduct

The fundamental and distinguishing principle of our profession's code of conduct is the requirement to maintain objectivity and be free of conflicts of interest in discharging professional responsibilities. ***Regardless of the nature of the service****, practitioners must protect the integrity of their work and avoid any subordination of their judgment. The additional requirement to be independent in fact and appearance requires an audit or attest relationship; for* ***all*** *services professionals must maintain objectivity and avoid conflicts of interest.*

- Responsibilities- In carrying out their responsibilities as professionals, members should **exercise sensitive professional and moral judgments** in all their activities.
- The Public Interest- Members should accept the obligation to act in a way that will serve the public interest, honor the public trust, and demonstrate commitment to professionalism.

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AICPA Code of Professional Conduct

- Objectivity and Independence- **Maintain objectivity and be free of conflicts of interest** in discharging professional responsibilities. A member in public practice should be **independent in fact and appearance when providing auditing and other attestation services.**
- The determination of a conflict of interest involves not only professional judgment, but also whether a "reasonable and informed third party who is aware of the relevant information would conclude that a conflict of interest exists."
  - This obligation requires reasonable steps to identify circumstances that might create a conflict of interest, including identification of the interests and relationships between the parties involved and the nature and implication of the services for the relevant parties. Once identified, you must determine whether you reasonably believe that safeguards could reduce the threat to your objectivity to a reasonable level.
  - Even if you believe that you can be objective, you must disclose the nature of the conflict of interest to all parties affected by the conflict and obtain their consent to perform your services.

Conflicts of Interest

- Must be addressed in connection with **ALL** services, not just audit or attest services
- A conflict of interest creates adverse interest and self-interest threats to compliance with the Integrity and Objectivity Rule
- Common examples:
  - Advising two clients in connection with a common business transaction
  - Representing two clients at the same time regarding the same matter when there is a dispute
    - Divorces
    - Partnership "break-ups"
  - Advising a client on the purchase of a product while having a commission arrangement with the vendor
  - Providing forensic services to a client which could support a claim against another client
  - Providing tax planning services to family members with opposing interests
- First determine – are safeguards sufficient to proceed in the CPA's judgment?
- Disclosure and consent required from all impacted parties
- *Common source of malpractice complaints*

Independence – Defined as

- Independence in Mind (in Fact)- The state of mind that permits the performance of an attest service without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism
- Independence in Appearance- The avoidance of circumstances that would cause a reasonable and informed third party, having knowledge of all relevant information, including safeguards applied, to reasonably conclude that the integrity, objectivity, or professional skepticism of a firm or member of the attest engagement team had been compromised.

Independence- Conceptual Framework

- Used to evaluate whether a member's relationship with a client poses an unacceptable risk to the member's independence
- Risk is unacceptable if member's professional judgment is compromised when performing attest services for client
- Provides a risk-based approach to analyzing independence matters
- Provides guidance to identify independence threats and possible safeguards to mitigate or eliminate such threats
- Used by the AICPA to develop Independence Standards, Rules and Interpretations

Threats to Independence

- Self Review Threat- Reviewing one's own work
- Advocacy Threat- Promoting the client
- Adverse Interest Threat- Opposing interests between member and client
- Familiarity Threat- Close or longstanding relationships
- Undue Influence Threat- Attempts to coerce or exercise influence
- Financial Self-Interest Threat- Potential benefit to member through client relationship
- Management Participation Threat- Performing management role

Independence Safeguards

- Three broad categories of Safeguards:
  - Safeguards created by the profession, legislation, or regulation
  - Safeguards implemented by the attest client
  - **Safeguards implemented by the accountant or firm, including policies and procedures to implement professional and regulator requirements**
- To be effective, safeguards need to eliminate the independence threat or reduce the threat to an acceptable level

Independence "Rulesets"

- All audit and attest services subject to AICPA standards
- SEC and PCAOB Independence standards apply to:
  - Audit services for publicly-traded companies
  - Audit services for private investment companies seeking exceptions from the SEC's custody rules, including audits and other service relationships with portfolio companies of those investment companies
  - Audit services for private companies intending to go public
  - Audit services for certain private companies whose financial statements may be included in the SEC filings of another entity with substantial influence or control over the audit client
  - SEC rules are substantially more complex and restrictive – beyond the scope of this webinar

Independence "Rulesets"

- GAO Independence standards ("Yellow Book")
  - Applies to audit and attest engagements for governmental agencies, entities, projects, contracts, etc. subject to Government Auditing Standards ("GAGAS")
  - While like AICPA rules, several very important distinctions exist, particularly including need for advance, written understandings and assessments of the client's ability to adequately oversee and take responsibility for non-attest services (which include financial statement preparation).
  - GAO standards are also beyond the scope of this webinar
- DOL Independence standards
  - Applies to audit engagements for benefit plans
  - While like AICPA rules, several important distinctions exist, particularly with respect to bookkeeping and valuation services
  - DOL independence standards are beyond the scope of this webinar – see DOL AICPA Independence Rule Comparison for additional information.
- **If multiple rulesets could apply – follow the most restrictive**

AICPA Independence – Major Elements

- When an accountant is required to be “Independent”
- When an accountant is NOT required to be “Independent”
- Personal Rules
  - Applying the Rules – Professionals
  - Applying the Rules – Immediate Family Members
  - Applying the Rules – Close Relatives
- Firm level rules
  - Business Relationships
  - Financial Relationships
  - Fee arrangements
  - Non-audit Services

When is accountant required to be "Independent?"

- Whenever accountant performs an **attest** service for a client
  - Assurance arrangements:
    - Financial Statement Audits
    - Financial Statement Reviews
  - Financial Statement Compilations unless independence disclaimed
  - Service Organization Controls ("SOC") Reports on Internal Controls of Service Organizations *
  - Agreed-upon Procedures *
  - Financial Forecasts and Projections *

* There are subtle differences in the rules regarding performance of non-attest services between financial statement engagements and attest engagements

When are accountants NOT required to be "Independent?"

- Financial statement preparation engagements
- When accountant performs ONLY tax and consulting services for management use only
- Under the AICPA Code of Professional Conduct, all tax and consulting services are required to be performed with
  - Integrity
  - Objectivity
  - Due professional care

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Applying the Rules

- Independence is impaired for a "Covered Member" when
  - Financial interest in client is owned during period of engagement
    - Direct or material indirect financial interest
    - Active trustee in trust owning client financial interest
    - Joint financial interests with client
    - Loans to or from client (fees owed?)
  - Association with client during financial statement period and engagement period
    - As director, officer, or employee
    - Promoter, underwriter, voting trustee
    - Trustee of pension or profit-sharing plan
  - Non-attest services rendered without consideration to required safeguards

Applying the Rules – Professionals

- "Covered Members"
  - An individual on attest engagement team
  - An individual in a position to influence an attest engagement
  - Any partner in the office of the engagement partner
  - A manager/director/officer who has provided 10 hours or more of non-attest services

Financial Relationships

- Covered Member may not have direct financial interest in client
- Covered Member may not have material indirect financial interest
- Rules on partnerships, trusts, investment clubs, etc.
- Usually, mutual fund investments ok
- Loans to or from clients are not permitted except those specifically permitted under financial institution rules
- Depository accounts under insurance limits with financial institutions are permitted

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Applying the Rules – Immediate Family Members

- Immediate Family Members are spouse, spousal equivalent, and dependents
- The independence rules for covered members generally apply to their immediate family members except
  - They can be employed by client provided employment is not a "key position"
  - Family members of certain covered members can invest when investing done through qualified plans
  - Additional restrictions/exceptions apply to indirect financial relationships based on materiality to relative's net worth
- **Any immediate family employment or financial relationship with an audit or attest client (or an affiliate of one) needs to be closely analyzed under the Code of Conduct**

Applying the Rules – Close Relatives

- Close relatives are parents, siblings, and nondependent children
- Subject to similar employment restrictions as immediate family members for Covered Members (i.e., cannot be in a "key position")
- Financial interest restrictions apply when
  - Covered member knows or has reason to believe that the close relatives' financial interest is material to close relative
  - Financial interest enables close relative to exercise significant influence over client
- **Any close relative employment or financial relationship with an audit or attest client (or an affiliate of one) needs to be closely analyzed under the Code of Conduct**

Business Relationships with Attest Clients

- Partner or professional employee may **not** serve in
  - Any management capacity
  - Includes Board of Directors or as an officer
  - However, serving on Advisory Boards could be permitted
- Cooperative business relationships
  - Joint participation in a business activity, e.g., “prime-sub”, distribution agreements, joint marketing efforts
  - Cannot be material to either party
  - Specific additional safeguards are required
- Joint closely held investments
  - Example, joint interest in a vacation home even if for personal use

Prohibited Fee Arrangements

- Commissions received for recommending any product or service to an attest client are prohibited
- Commissions received for recommending any product or service to a client which is not an attest client are permitted, but only with disclosure
  - Between 20 and 25 states go beyond AICPA rules for disclosure with a variety of additional requirements, including, absolute prohibition, written confirmation including amounts, etc.
  - If you are in this environment, review of AICPA rules is NOT sufficient!

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Prohibited Fee Arrangements

- Contingent Fees
  - Generally prohibited for any attest client other than for certain tax services
  - Fees are not regarded as being contingent if fixed by courts or other public authorities, or, in tax matters, if determined based on the results of judicial proceedings or the findings of governmental agencies
  - Requires reasonable expectation, at the time of a fee arrangement, that a government agency will provide substantive consideration of the subject matter with respect to the claim
  - Watch out for IRS Circular 230
  - Fees that vary based upon complexity of the service are NOT contingent fees
  - SEC rules are **very** different

Non-Attest Services

- Half or more of the professional services provided by most Firms are NOT Attest Services
  - Tax
  - General Business Consulting
  - Accounting/Bookkeeping/ Financial statement preparation/ Compilations disclaiming independence
  - Technology and Management Consulting
  - Risk and Controls
  - Family office services
  - Business Valuation
  - Internal Audit
  - Wealth Management
  - Etc.

Independence and Non-Attest Services

- When non-attest services are rendered to attest clients, independence must be assessed as to whether non-attest services impair the attest services
- **Safeguards to avoid impairing independence require client to:**
  - Make management decisions and perform management functions
  - Designate competent individual to oversee services
  - Evaluate the adequacy and results of the services performed
  - Accept responsibility for the results of the services
- Engagement understanding must be in writing
- Engagement Letter is a **must** for all non-attest services rendered to attest clients in order to maintain and prove independence

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Independence and Non-Attest Services

- General Activities which Impair Independence:
  - Make operational or financial decisions for client
  - Report to Board on behalf of management
  - Authorize transactions
  - Prepare source documents
  - Have custody of assets
  - Supervise client employees
  - Determine which of the firm's recommendations should be implemented
  - Serve as a client's stock transfer or escrow agent, registrar, general counsel or its equivalent
  - Establish or maintain internal controls, including performing ongoing monitoring activities
- However, the member may provide advice, research materials, and recommendations to assist the client's management in performing its functions and making decisions.

Non-Attest Services

- AICPA Independence Rules (Sections 1.295 *et al.*) provide detailed guidance on services which do and do not impair independence in following areas:
  - Bookkeeping
  - Payroll
  - Benefit plan administration
  - Investment advisory or management
  - Corporate finance – consulting or advisory
  - Executive or employee search
  - Business risk consulting
  - Information systems – design, installation or integration
  - Appraisal, Valuation, and Actuarial Services
  - Tax Compliance Services
  - Forensic Accounting Services
  - Internal Audit Assistance Services

Independence Issues – *just a few more points*

- Independence rules generally apply to an accountant's relationship with affiliates of financial statement attest clients
  - Affiliates include the entity owning the attest client (but not individuals), subsidiaries, commonly controlled sister entities, benefit plan sponsors, etc.
  - Non-attest services, other than for executive management functions, can generally be provided to "up and over", i.e., parent and sister affiliates under the Not Subject to Audit exception
  - Look carefully at Code 1.224.010
  - This is one of the most challenging areas for independence professionals to evaluate
- Outstanding Fees
  - Fees for any service which are more than one-year old (based upon the time incurred) will be an independence impairment for an attest client

Implications of Independence Impairments

- Failure to comply with Code of Conduct can result in
  - Peer reviewer findings and related implications
    - Required to take corrective measures including changes to system of quality control
    - Provided to Peer Review committee
    - Peer review requirements for providing assurance services
  - Referral to AICPA Professional Ethics Division for possible sanctions or disciplinary action
  - Implications in license renewals with State Boards of Accountancy
  - Frequently adds additional arguments and support for claims made in connection with malpractice matters

Independence Issues – Practitioner Resources

- AICPA
  - AICPA Plain English Guide to Independence
  - AICPA Code of Professional Conduct
  - AICPA Professional Ethics Resources
    - Conceptual Framework Toolkit for Independence
    - Non-attest Services Toolkit
    - Ethics and Independence – SEC and PCAOB
- Audit Conduct LLC (www.auditconduct.com)
  - Excellent (and reasonable) webinars
  - Frequent email/blog articles

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